

GRANT'S

INTEREST RATE OBSERVER®

Vol. 40, No. 9b

233 Broadway, New York, New York 10279 • www.grantspub.com

MAY 13, 2022

Gas to go

Evan Lorenz writes:

Last month, Canada drew 2.8 billion cubic feet (bcf) from natural gas inventories. Over the previous dozen Aprils, Canada *injected* an average of 20.7 bcf into domestic storage. We write to speculate on what this occurrence may presage for a) the cost of living in the Lower 48 and b) the fortunes of *Grant's* pick-to-click Tourmaline Oil Corp. (TOU in Toronto).

Mother Nature's to blame for the springtime upside-down Canadian gas situation, says Cameron Bean, an analyst at Scotiabank Global Equity Research. April blizzards in North Dakota knocked out a significant volume of oil and gas production in the prolific U.S. Bakken shale formation, he observes, thus "increasing the pull on Canadian natural gas" and sending Canadian gas inventories well below their five-year range.

The story line isn't entirely new. "If you look at the European gas crisis, the reason it started is that Europe and Russia had a very cold March and April in 2021 and their inventories got real low," Leigh Goehring, one-half the nameplate of Goehring & Rozencwajg Associates, told me last week. "At that time, European gas prices in April 2021 were \$5 per mcf [thousand square feet]. By October they were \$35.

"The black swan event," Goehring went on, "was that European and Russian storage got near record lows at the beginning of the injection season due to cold weather. Is that going to be the black swan event here?"

Gas, unlike oil, can't just be poured

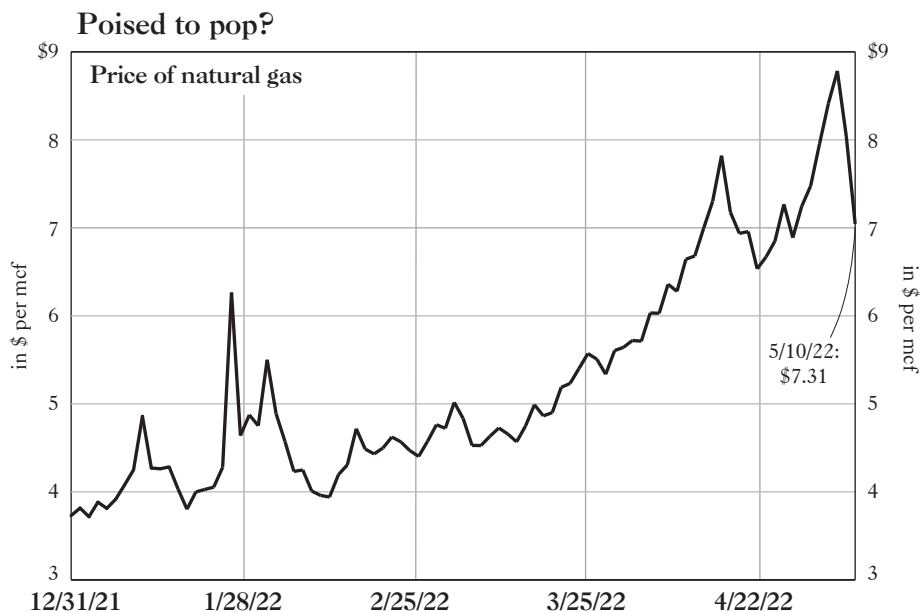
into a tanker and shipped overseas. You must first compress it, at a 600:1 ratio, into liquefied natural gas (LNG) at a temperature of negative 260°F and then inject it into specially insulated and designed vessels (the bulbous ships will never win a nautical beauty contest). On the receiving end, the importer needs an expensive decompression station in order to burn molecule one of the super-cooled methane.

Before 2016, the United States and Canada lacked major LNG facilities, which made the North American gas market something of an island. In the mid-aughts, a gas shortage lifted prices to a peak of \$15.38, set in 2005. Last decade, prolific production from

shale wells flooded the market and prices subsided to an average of \$3.20.

"However, in just six short years, the U.S. today has become the world's largest LNG exporter," Goehring & Rozencwajg wrote in an April 21 blog post under the headline, "The Global Natural Gas Crisis is coming to North America." According to the U.S. Energy Information Administration, the 50 states exported 11.9 bcf's worth of LNG per day in March out of an estimated daily production of 96.2 bcf. Late this year or early next year, an LNG facility in the Calcasieu Ship Channel near Lake Charles, La., will add an additional 1.7 bcf per day of export capacity.

While Canada has no such export



source: The Bloomberg

infrastructure right now, the mega-project LNG Canada in Kitimat, British Columbia, is slated for completion in 2025. When commissioned, the project will have the ability to export 23% of Canada's 16.5 bcf of daily production (*Grant's*, June 25, 2021).

In short, the North American gas market is, or soon will be, an island no more. The problem, as Goehring & Rozencwajg see it, is that growing export capacity is coinciding with peak domestic production. Big gas fields have only so many hydrocarbons to give. Deplete half of those reserves, and pumping rates tend to decline.

Two shale fields, the Marcellus, which stretches from New York to Maryland and as far east as Ohio, and the Haynesville, situated in Louisiana, Texas and Arkansas, account for two-fifths of U.S. natural gas production. Based on their analysis of underlying well-performance data, G&R contends that the Marcellus and Haynesville will soon peak and begin to decline, just as the Barnett and Fayetteville shale plays did before them.

Though the price of natural gas at Henry Hub has almost doubled this year, to \$7.31 per mcf from \$3.73, it's still a bargain compared with the \$29.97 per mcf quoted in Europe. "Given the underlying fundamentals that have now developed in U.S. gas markets, we believe prices are about to surge and converge with international prices within the next six months," Goehring & Rozencwajg conclude their April 21 blog post. "The conver-

gence of U.S. and international gas prices will come out of nowhere and take all investors by surprise."

If this analysis is on the beam, it would mean another leg up in inflation as the rising cost of energy trickles into nearly every purchase a consumer makes. It would also be a boon to companies like Tourmaline that drill for natural gas.

Since Tourmaline featured in the March 18 issue of *Grant's*, its share price has appreciated by 31.2% in U.S. dollar terms. Even so, at 7.4 times estimated 2022 earnings per share, it's hardly rich. The driller pays out a base quarterly dividend of C\$0.20 and distributes extra free cash flow in the form of special payments. Over the past 12 months, the stock has paid C\$4.25, which works out to a 6.2% dividend yield.

Recent results show a company in rude health. In the first quarter, on an oil-equivalent basis, Tourmaline increased production by 23% year over year to an average of 507,059 barrels per day. The bump in pumping rates, plus higher energy prices, led to a 90% year-over-year increase in revenues and a 165% year-over-year surge in free cash flow. As of March 31, net debt amounted to C\$769.1, or 0.2 times consensus 2022 Ebitda. Tourmaline holds a 36.8% stake, worth C\$1.2 billion, in the Canadian royalty company Topaz Energy Corp.

Nevertheless, the stock has yet to reflect a sustained increase in the price of natural gas. Based on current pump-

ing plans, the company hedge book (40% of production for the remainder of 2022, 21% for 2023 and 4% for 2024) and the futures curve for energy prices, Tourmaline estimates it will generate C\$11.73 in free cash flow per share this year, or a 17.1% yield based on the current share price. Taking its cue from the forward natural gas price curve, management estimates that free cash flow per share will fall to C\$10.73 next year, despite a planned 3% uptick in production rates.

However, the potential for a supply-demand crunch leading to sustained, higher prices is lost neither on Bay Street nor *Grant's*. "With storage being so low on both sides of the border... are we looking at a potential... shortage of supply if we have a normal or worse-than-normal winter?" Josef Schachter, the eponym behind Schachter Energy Research Services, Inc., asked on the May 5 earnings call.

"Obviously, it's a very volatile environment," Tourmaline CEO Michael Rose replied. "I'd say [that] supply and demand are relatively in balance. So we do expect storage injections to pick up here on both sides of the border and, I think, we'll head into winter probably lower than normal, but I suspect we'll have adequate supplies. And I don't think anybody wants really egregious price spikes. I know where you're going with it, and we agree with you. It's really not constructive for anybody."

That wasn't a no.

•

Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc. PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else. Copyright ©2022 Grant's Financial Publishing Inc. All rights reserved.