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Bullish even now

"Settle in" for a period of relatively weak oil prices, Rex Tillerson, CEO of ExxonMobil, resignedly advised security analysts the other day. "[A] geopolitical event could change it tomorrow, could change everything," the oilman added. "But when I look at fundamentals, there's a lot of supply out there, and I don't see a particularly healthy global economy."

Tillerson last fetched up on these pages not quite three years ago. The occasion was a bullish analysis of a pair of companies that, it seemed to us, would likely gain from a rise in energy prices (*Grant's*, "Just in case," July 13, 2012). Needless to say, higher oil prices were a contingency not truly worth preparing for. Still, with respect to Cairn Energy PLC (CNE on the London Stock Exchange) and Paramount Resources Ltd. (POU on the Toronto Stock Exchange), prospective reward continues to outweigh evident risk in our opinion. Cairn is a sum-of-the-parts story, and Paramount is an investment-project-coming-to-fruition story. Low oil prices or not, bulging oil inventories or not, a looming Iranian nuclear deal (yet another potential source of lower crude prices) or not, we remain bullish on both. To be clear, each is a speculation.

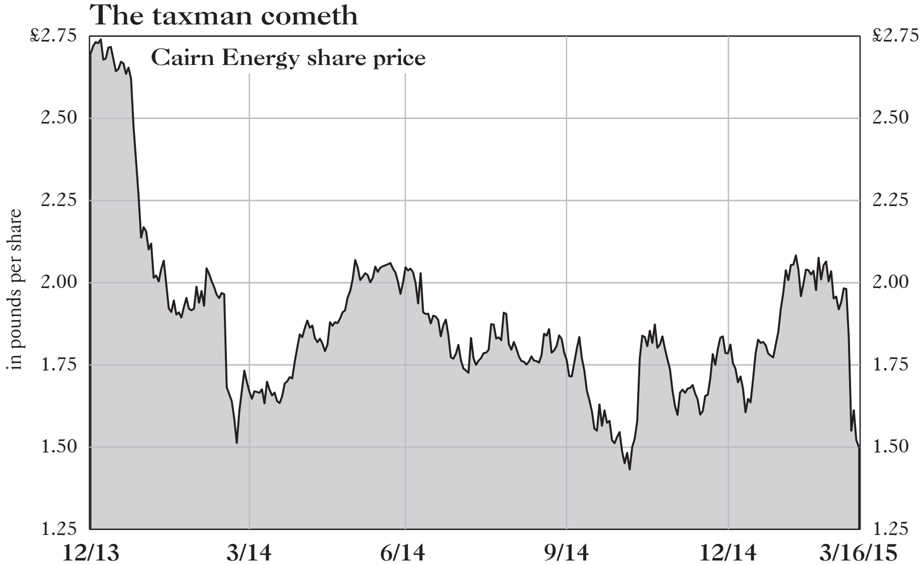
Edinburgh-based Cairn Energy, a £887 million market-cap business, has four segments of value, the sum of which seems substantially greater than the market-determined £1.53 per-share whole. They are: (1) cash, (2) a stake in publicly traded Cairn India Ltd. (CAIR IN on Bloomberg), (3) development fields and (4) exploration opportunities.

Cash is simple enough. As of year-end 2014, there was $869 million on the balance sheet, net of debt, equivalent to £1 per share.

The second component, Cairn's 9.8% stake in Cairn India, is anything but simple. The complicating element is a long-running, big money tax dispute with the Indian government. Before India's tax authorities lowered the boom, the stake was seen to be worth something like its stated face amount of $638 million, equivalent to 75 pence per Cairn Energy share. Then came the March 10 bulletin from Edinburgh. In response to a $1.6 billion demand from the Indian Income Tax Department, the company had filed a "Notice of Dispute." Like Vodafone and Royal Dutch Shell before it, Cairn Energy would do legal battle.

"Cairn strongly contests the basis of the draft assessment and the Notice of Dispute is supported by detailed legal advice on the strength of the legal protections available to it under law," said the press release. "Under the terms of the U.K.-India Investment Treaty, the government of India and Cairn are now required to enter a period of negotiations to seek a resolution to the dispute. To the extent that a satisfactory resolution is not reached during that period, an international arbitration panel will be constituted to adjudicate on the matter." Cairn Energy's stock fell 15% the following day on volume heavy enough to suggest that not every punter had been paying attention to the subtleties of the India story line. "There was nothing new about the dispute itself," as colleague David Peligal observes. "It has been an overhang on Cairn Energy's stock since early 2014."

The taxman cometh



source: The Bloomberg

What *is* the stake in Cairn India worth? Less than nothing if the Indian authorities make a clean sweep, the aforementioned 75 pence if Cairn Energy does. On March 12, Goldman Sachs downgraded the shares to neutral from buy, saying: "We expected to see an improving tax situation in India on retrospective tax cases, but this does not seem to be the case given the delivery of the draft bill; as a result, we increase the probability weighting of an unsuccessful outcome from 25% to 50% in our valuation." The notion that there is any liability over and above what Cairn Energy holds in its Indian investment is, to us, fanciful, though it's that imagined threat which has evidently created the opportunity.

Beyond that layman's hunch, we hardly pretend to know. Certain it is that we have no expertise in extraterritorial tax enforcement. We can observe that Vodafone got some good news last year when the Indian government chose not to appeal a court ruling in a $490 million tax wrangle that had gone against the taxman (another, much larger dispute between India and Vodafone is still unresolved). Royal Dutch Shell similarly chalked up a victory over a disputed $3 billion tax claim. Believers as we are in the goodwill of the government of Prime Minister Modi, we expect a reasonable settlement. In the accompanying table, we value the company's Cairn India position at the stated, 75 pence-per-share value and, alternatively, at half that value; you can do your own handicapping.

"The third value segment," Peligal relates, "is the company's development fields. Kraken and Catcher in the U.K. North Sea are the two big projects. Once they go into production in 2017, they'll provide free cash flow with peak net production to Cairn of around 22,500 barrels of energy equivalent (Boe) per day. Furthermore, a minor part of the value here is the Skarfjell discovery in Norway, which is in the early stages of development planning. What are these assets worth in this demoralized market? For purposes of discussion, assume a long-term Brent oil price of $70 per barrel. That could be high or it could be low. It has the merit of being today's market price for future Brent on the oil curve in mid-2018. At $70, the development assets would be worth 40 pence per Cairn Energy share. At a $50 forward Brent price, they would be worth zero.

Cairn Energy PLC—sum of the parts

Cairn Energy per share in pounds

Cash	£1.00
Cairn India stake	0.75
Cairn India stake (50% of market value)	0.37
Development fields	0.40
Exploration assets (Senegal discoveries)	0.45
Cairn Energy sum of the parts	£2.60
Valuing the Cairn India stake at 50%	£2.22
Cairn Energy stock price today	£1.53

source: company filings

"The fourth segment," Peligal proceeds, "encompasses exploration assets in the west African nation of Senegal. The company's two offshore Senegalese discoveries—wells designated SNE-1 and FAN-1—might have significant value. Certainly, the economics look promising. Management believes that it can earn an economic return at anything above a mid-40s Brent price. A reserve auditor for SNE-1 made the following calculations: at a 90% probability, there are 150 million barrels of recoverable oil; at a 50% probability, there are 330 million barrels of recoverable oil. What might the pair be worth? If we value our estimate of Cairn Energy's working interest in recoverable barrels of oil for the two wells at $5 per barrel, and then dramatically discount this estimate by another 70% to be on the safe side (because management hasn't operated in Senegal before, things could go wrong, the world is dangerous, etc.), it's not unreasonable to think that these Senegal assets might be worth U.S. $375 million, or just under 45 pence per Cairn Energy share.

"While the sum of these Cairn Energy parts is greater than today's stock price, it's unclear how the market is breaking it down," Peligal continues. "For example, perhaps the market is assuming some recovery in the Indian tax imbroglio and little value on Cairn Energy's operations. Then again, maybe it doesn't matter—any way you look at it, there seems to be a discount. The reality is that Cairn Energy has become a difficult situation—it's small and slightly confusing. Oil equity specialists don't want to own it. It's a sum-of-the-parts story. And equity generalists don't necessarily want to bother. What do they know about Indian taxes? So Cairn Energy is an orphan. Ultimately, for a sum-of-the-parts-story to work, the head guy has to believe that monetizing the parts is the right thing to do for shareholders. Cairn Energy Chairman Ian Tyler, who took control last year, seems to be the right person to extract value for shareholders. He has slashed spending on exploration and has gone to the lengths of firing people. Before, the company was exploring in Greenland, Malta, Ireland, and Morocco—it was as if they were playing with a geographical jigsaw puzzle and just randomly picking up countries. Those days are over. More importantly, if and when the Cairn India stake is allowed to be sold (it's immovable for as long as the tax dispute lasts), it seems likely that Tyler will immediately sell—and return those proceeds to shareholders."

On now to Canada and to Paramount Resources, a family-controlled, asset-rich energy company that's building a plant to transform natural gas into butane, propane and the like. The still unfinished facility is the asset that the bulls (such as they are) covet. It's set down in the liquids-rich gas fields of west central Alberta called the Montney resource play.

Investors dread holdups in construction and development in all seasons. They are perhaps slightly more forgiving of delays when commodity prices are plunging—and when, as is also the case at hand, the reason for delay concerns an upside surprise. What pushed construction of the plant behind schedule is the discovery of so much more of the natural gas liquids that the company was looking for. Not designed for bounty on the new scale, the plant had to be redesigned, thus pushing a 2014 completion date into late 2015. Once up and running, the so-called Musreau deep-cut natural gas processing facility promises to deliver significant free cash flow even at today's commodity prices.

"A very brief recap of the past few

years might help set the stage for where we are in the Paramount story," Peligal relates. "Having proved up a major resource in the Musreau area of Alberta over the past few years, Paramount moved into the commercial phase. It drilled commercial development wells and built field facilities. It's the equivalent of building your factory after you perfect your invention of widgets. Paramount's widgets are barrels of condensate, mcf's of saleable natural gas, and barrels of product like butane, propane, and ethane. At a condensate price of C$65 a barrel and a natural gas price of C$2.75 per mcf, the facility would generate free cash flow of C$405 million per year. At a condensate price of C$45 a barrel and a natural gas price of C$2.25 per mcf, the plant would still generate free cash flow of C$225 million. Put simply, the economics for this facility are impressive—obviously crucial in today's low oil and gas price environment."

"It doesn't work as well as it did at $90 oil," Paramount's president and COO Jim Riddell (he of the controlling Riddell family) tells Peligal, "but it still works very well and has a pretty good rate of return. At $50 oil, it's still around a 50% or 60% rate of return. So, hypothetically, if a project costs C$10 million, you get that back in a year and a half—and that well is going to be producing for the next 20 years. It's not the 100%-plus return that it was, but it's still very good."

With 104.9 million shares outstanding at C$30 each, Paramount commands a C$3.1 billion market cap, half of the level of October. The evaporation in equity value has cast into relief the accretion of indebtedness. Since the end of 2012, Paramount's net debt has jumped to almost C$1.5 billion from C$701 million. Unhedged as to energy prices, the company is rated B2 by Moody's and B by Standard & Poor's.

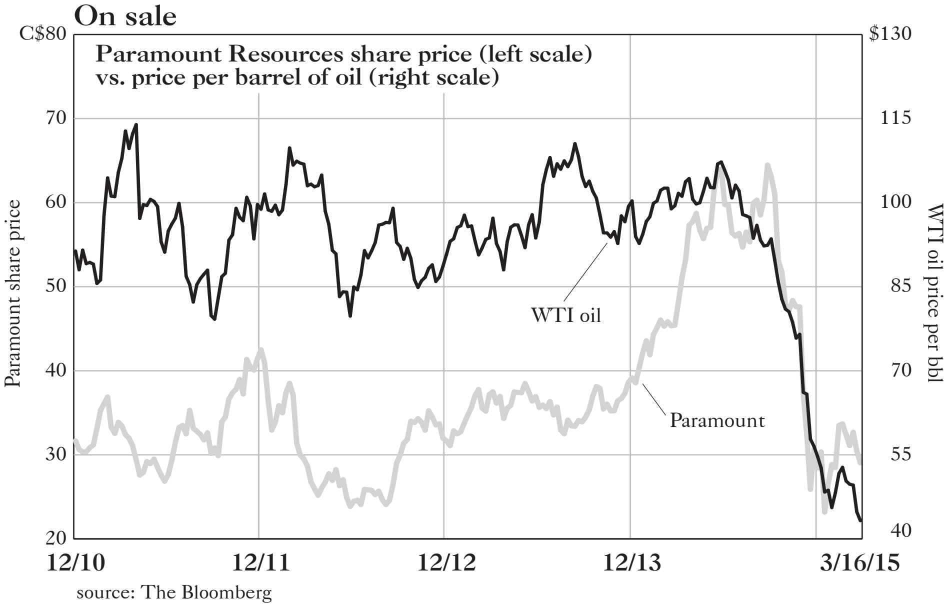
"The increase in net debt over the last three or four years is a function of us overspending our cash flow as we build out major projects at Musreau," Riddell tells Peligal. "And this project has taken about three-and-a-half or four years—we're basically at the completion of it. So we've drilled literally 100 wells at a cost of C$1 billion and spent almost half a billion dollars in total infrastructure in order to get it completed. Of course, when you're not getting any cash flow while you build the thing, you're increasing your debt. When we look at the trailing numbers, you're going to see a number that is probably eight times debt to cash flow. Now, as the cash flow is coming on stream from the completion of the project, we're going to see that cash flow to debt ratio number drop considerably. We project that we'll be somewhere around three to four times debt to cash flow level at the end of this year—and that's at today's commodity prices. We're taking our production from just over 20,000 barrels of oil equivalent per day (boe/d) in the third quarter of 2014 to well over 70,000 boe/d at some point this year."

It seems a reasonable bet that the Riddells, owners of slightly less than half of the Paramount shares, will not absentmindedly turn the company over to the creditors. On that score, says Jim Riddell, management will commit to no new major investments unless and until oil prices return to $70 a barrel. Meantime, capital spending is on the decline to a budgeted C$400 million in 2015 from C$854 million in 2014 and C$705 million in 2013.

Eric S. Stein, founder of ESS Capital Management, an owner of Paramount shares and—*and*—a paid-up subscriber, came to the phone to talk to Peligal. "In our view," said Stein, "which is a bit contrarian, you want to be long Canadian condensate because you have a structural imbalance. In Canada, condensate is consumed by oil sands producers who use the light oil as a diluent, which allows the thick, heavy bitumen that they produce to flow easily through pipelines. In 2014, Canada produced approximately 1.8 million boe/d from the oil sands and consumed nearly 300,000 boe/d of condensate, the vast majority of which was imported from the U.S. However, most condensate imports come from the U.S. Gulf Coast, where supply is abundant but is located 2,500 miles away. As a result, the premium for condensate in Canada should always reflect the cost of transportation to deliver it to Alberta. Historically, the price of condensate is a $5 to $10 premium per barrel.

"What we think is really interesting," Stein went on, "is that oil sands production is projected to grow from 1.8 million boe/d last year to approximately 2.5 million boe/d by 2017. We think it's important to note that the oil sands production growth is based on projects that are already happening and nearing completion. The current decline in oil prices will reduce the future rate of oil sands growth, but not projects expected to come online over the next one to three years. As a result, condensate demand will grow to nearly 450,000 boe/d by 2017 and the supply-demand imbalance will get worse. So we think condensate producers in western Canada are geographically advantaged with a commodity that is actually in short supply. So that's a positive. But one of the negatives is that most of the condensate is produced from liquids-rich natural gas plays and many investors are rightfully bearish on Canadian gas vis-à-vis the massive growth in U.S. gas production. However, due to the price of condensate, many of these liquids'

On sale



source: The Bloomberg

rich condensate plays are profitable with very low gas prices, so we think the gas fears are a bit overblown. Over the intermediate term, the outlook for Canadian gas could improve. There is the potential for West Coast U.S. and Canadian LNG exports. If these projects were to move forward, liquids-rich gas producers like Seven Generations Energy and Paramount would be well positioned with their natural gas and condensate production. But you shouldn't base your investment decision on LNG happening. These are condensate plays, and if you believe oil sands production will be stable, or even grow, then these producers are very well positioned."

Note, please, the conjunction "if." *If* oil prices do not persist in plunging, *then* the value embedded in Paramount might be monetized. Otherwise, not.

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