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Cooking with gas

Evan Lorenz writes:

With inflation rising, nerves fraying and stock valuations still toppy, the recent pullback notwithstanding, good risk-adjusted returns are extra hard to find. One promising hunting ground is the market that governments are subsidizing.

Politicians worldwide are treating soaring fuel prices as another pretext to stimulate the voting public. Whatever its success at salving the pain at the pump (or getting out the vote for the next election), the fuel chits will do little to solve almost a decade's worth of global underinvestment in new wells or to replace lost Russian barrels. Assuredly, though, the stimmies will stiffen the bid for energy. In preview, *Grant's* is bullish on Paramount Resources Ltd. (POU on Toronto), a cheap, lightly leveraged energy producer in Canada.

If this sounds a little familiar, that's because it is. The prior issue of *Grant's* featured the bull case on Canadian-domiciled Tourmaline Oil Corp. Both companies focus on the productive shale plays in Alberta and British Columbia and make their headquarters in Calgary. And the connections don't end there: Tourmaline CEO Michael Rose is married to Susan Riddell Rose, the chair and CEO of Perpetual Energy, Inc. and the sister of James Riddell, the chairman and CEO of Paramount.

Irrepressible entrepreneur and Canadian energy stalwart Clayton Riddell founded Paramount Oil & Gas Ltd. in 1971 for the purpose of extracting natural gas from northeastern Alberta. Geologists had long known about the hydrocarbons in the region, but no one had figured out how to extract the shallow gas deposits economically. Paramount perfected air-drilling technology in low-pressure reservoirs, a technique still in use today. In 1978, Riddell gathered up the assets that Paramount Oil & Gas had accumulated and placed them in a new company, Paramount Resources, which he listed, in the same year, on the Alberta Stock Exchange.

Riddell's M.O. was to make big bets funded by large dollops of debt. "Leverage allows you to keep more," the founder told *The Globe and Mail* in a Sept. 3, 2007 interview. "Instead of owning 10% of Paramount, I was able, by levering it up, to continue to own 50% and also to control the growth a bit. Other people have grown magnificent companies like Canadian Natural Resources Ltd. or Renaissance Energy Ltd. They built big, big companies and made tremendous wealth for themselves and others. I just did it a different way. I made it smaller, but kept a bigger chunk."

Of course, debt enhances both the upside and downside of cyclical turns. The price of crude plummeted to $26.21 per barrel on Feb. 11, 2016 from a high of $107.26 on June 20, 2014. The collapse in energy prices sent Paramount's stock into a tailspin: a 95% decline between September 2014 and January 2016. In 2015, Clay Riddell stepped down as CEO and appointed his son, James, to the top role.

The successor found himself in a difficult spot. At year-end 2015, Paramount's balance sheet bulged with C$1.8 billion ($1.4 billion at the current exchange rate) in net debt, a figure equal to 9.8 times that year's Ebitda. Over the ensuing seven years, Riddell has deleveraged by selling assets, issuing stock (the share count rose by 41% between 2014 and 2021) and increasing cash flow.

Today, Paramount is a liquids-focused energy producer with assets in British Columbia and Alberta. Last year it pumped an average of 82,001 barrels of oil equivalent (boe) per day with 44% of production in the form of liquids (condensate, other natural gas liquids and oil) and the balance in natural gas.

Paramount operates in three Canadian regions: the Grande Prairie (63% of 2021 production), a part of the Montney shale patch in northwest Alberta; the Kaybob (28%), which includes parts of the Montney and Duvernay shale plays in west-central Alberta and central Alberta; and the dominion of "other" (9%), which encompasses the Duvernay shale in central Alberta as well as the Horn River Basin in northeast British Columbia.

Excluding an oil sands holding with no current production, Paramount's land base sums to 1.64 million net acres, of which 1.126 million have no attributable reserves—yet. With proved and probable reserves of 662 million boe, and assuming no new discoveries, the company has 22 years of production ahead of it. Despite expanding its production by 20% last year, Paramount managed to increase its proved and probable reserves by 5% at a cost of C$2.12 per incremental barrel.

The shares trade at 7.8 times estimated 2022 earnings, 4 times enterprise value to consensus 2022 Ebitda and offer a 3.1% dividend yield. For comparison, the energy component of the S&P 500 trades at 11.1 times the 2022 estimate and 6.3 times 2022 Ebitda.

While Paramount is rated single-B-

Lesson learned

source: The Bloomberg

plus (i.e., middling junk), the company has substantially deleveraged on James Riddell's watch. As of Dec. 31, 2021, net debt footed to C$456.7 million, or 0.4 times estimated 2022 Ebitda. The balance sheet also houses seven triple-sized drilling rigs and stakes in other public and private energy companies. The biggest of these investments is a 37.3 million share interest in NuVista Energy Ltd., worth C$394.5 million as we go to press. (Such holdings are not necessarily for all time. On March 9, Paramount realized C$27.8 million by selling 2.5 million shares of its NuVista position.)

While most energy companies do not own their drilling rigs, Paramount is unlikely to dispose of these assets—and for good reason. "Having your own rigs and knowing what you got is an asset," Donald Textor, a board member of EOG Resources, Inc., the portfolio manager of DFT Energy, L.P. and an investor in Paramount, tells me. "Rigs are tight. Crews are tight. Frac crews are tight. Having [your] own rigs at the moment is a real asset."

In a March presentation, the company laid out its priorities for achieving incremental cash flows: first, reduce net debt to around C$300 million; second, boost shareholder returns through dividends and buybacks; and, finally, invest in growth. Riddell is expected to hit his debt target in the next quarter or two. Based on consensus estimates, Paramount will generate C$446.1 million in free cash flow in 2022.

Seven of the 10 analysts on the case rate Paramount a buy while none is a seller. Even after unloading a net 361,213 shares over the past 12 months for proceeds of C$8.7 million, insiders own 46% of shares outstanding. And though only around half of the shares are freely traded, short interest sums to just 2.9% of the float.

"I think Jim has assets lined up that for the next 20–30 years can generate extraordinarily high rates of return," says Textor. "He is going to have a high-class problem: What do you do with the free cash flow? He's instituted a dividend, and now he has increased it. More dividend increases are likely." May we all be so burdened.

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