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He smells gas

Evan Lorenz writes:

By the end of this year, for the first time ever, war or no war, the demand for oil may well exceed global oil-pumping capacity. So prophesied Goehring & Rozencwajg Associates, LLC in 2021 (*Grant's*, Oct. 15), and so they reiterated just the other day—actually, the day before Russia barged into Ukraine without so much as flashing a passport: "Never in the history of world oil markets have we been in this situation—we are about to enter uncharted territory."

In preview, *Grant's* is bullish on Tourmaline Oil Corp. (TOU on Toronto), the No. 1 natural gas producer in Canada. And to this analysis we append a follow-up note, also bullish, on Fluor Corp. (*Grant's*, June 25, 2021).

Tourmaline would have been a satisfactory investment even before the Biden administration decided to suspend the sale of new leases to drill for oil and gas on federal lands. It would have deserved a place in a well-tempered portfolio before Sen. Elizabeth Warren (D., Mass.) threatened American drillers with a windfall profits tax, before Saudi Arabia and the United Arab Emirates snubbed President Biden's entreaties to ramp up oil and gas production and before the White House set aside plans to boost exports of liquefied natural gas on the ground that weaning America off fossil fuels was a higher priority than making a contribution to lower European energy prices.

However, given the simultaneously fossil-fuel-phobic and fossil-fuel-needy state of the world today, we expect that Tourmaline, founded in 2008 by the Canadian oil and gas entrepreneur Michael Rose, will prove a more-than-satisfactory, even, possibly, an excellent investment.

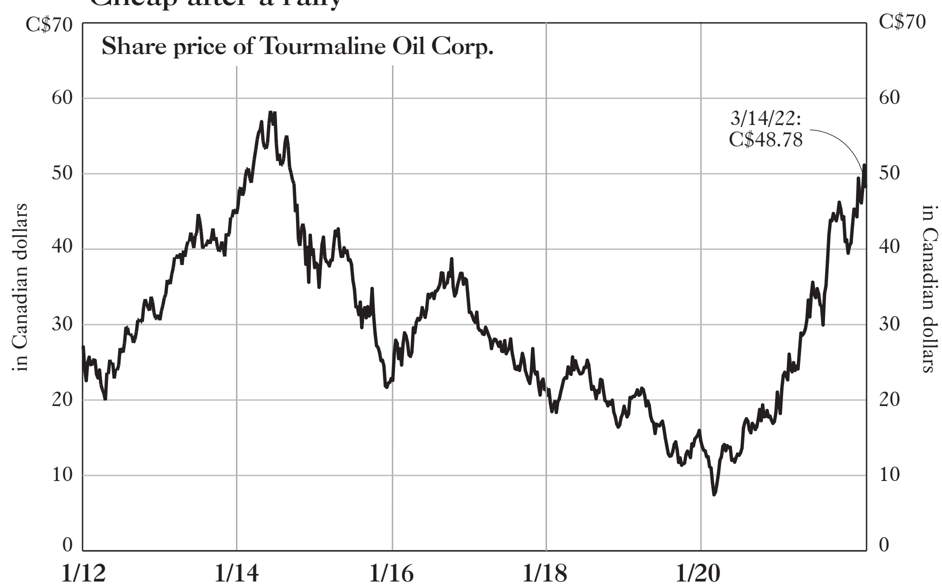
Rose began his career in energy with a job at Shell plc in 1979. He founded Berkley Petroleum Corp. in 1993 and sold it to Anadarko Petroleum Corp. for C$1.4 billion ($1.1 billion at today's exchange rate) in 2001. While the ink was still drying on that deal, he created Duvernay Oil Corp., a Canadian shale play, which he sold to his alma mater, Shell, for C$5.8 billion in 2008.

Tourmaline is active in three shale plays within the greater Western Canadian Sedimentary Basin, which encompasses British Columbia and Alberta. The three comprise the Alberta Deep Basin, the Montney Formation and the Peace River Formation. At year end, Tourmaline's interests spanned 3.3 million net acres and included 4.2 billion barrel oil equivalent (boe) of proven and probable reserves. Well-spacing calculations lead management to reckon that Tourmaline controls 75 years' worth of drilling inventory.

Last year, Tourmaline pumped 2.06 billion cubic feet (bcf) of gas per day and 97,206 barrels of oil per day for a combined daily boe of 441,115. It expanded production on an oil-equivalent basis by 42% and bumped up its proven and probable reserve base by 33%.

Natural gas is Tourmaline's main product, and it's hard to imagine a more volatile one. Over the past decade, the price of gas at Louisiana's Henry Hub has ranged from $1.48 to $6.31 per thou-

Cheap after a rally



source: The Bloomberg

sand cubic feet (mcf) and that of benchmark Canadian gas from $0.03 to $14.39.

As you can't ship gas in a FedEx box, you must opt for pipelines or LNG carriers. And as Canada currently lacks major LNG export capacity, pipelines are the go-to carriers. The American gas price less transport costs is what the Canadian exporter stands to earn. At the moment, Canadian gas trades at $3.69 per mcf, the American molecules at $4.61.

There are further complications. Tourmaline derives about half of its asset value from the prolific Montney Formation, a shale play that reaches from northeastern British Columbia to northwest Alberta. Most of this area is the property of the British Columbian government, not private landowners.

Naturally, the provincial authorities exact their pound of flesh, but that pound has become ever more complex to calculate and administer. An attempt to simplify such levies, now in progress, presents the risk that, as long as the bureaucrats are re-examining the question of taxation, even for the welcome purpose of simplifying it, they may decide to reach a little deeper into Tourmaline's pocket.

Canada's indigenous persons will also have a say in Tourmaline's future. In June 2021, the B.C. Supreme Court ruled that the cumulative effect of industrial activity, rather than the impact of any one specific project, had violated an 1899 treaty that guaranteed the Blueberry River First Nations and their descendants the right to maintain their way of life.

Whatever else the current negotiations between the province and Blueberry River and other First Nations may mean for Tourmaline, they have already had one chilling effect on production: B.C. has issued no drilling permits in the Montney since August 2021.

Even so, with respect to Michael Rose's creation, Bay Street is all smiles, with 13 of 13 analysts who cover the stock saying buy and short interest summing to just 1.5% of the equity float. Over the past 12 months, insiders sold a net 257,044 shares for proceeds of C$8.5 million.

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However, the No. 1 insider—founder, chairman and CEO Rose—bought 100,000 shares at a net cost of C$3.7 million over the same 12 months. As a class, Tourmaline officers and directors own 6% of the shares outstanding (Rose himself holds 4.9%)—the highest level of insider ownership among major Canadian energy producers.

There are mitigants to the other concerns just mentioned, too. As to permitting, Tourmaline has a bank of approved wells in British Columbia where it can continue to drill. If the Blueberry River quarrel continues, it could shift production to Alberta. And if the First Nations dispute cripples overall Canadian production, higher gas prices could prove a consolation.

Bay Street's rave reviews notwithstanding, the shares change hands at just 4.3 times enterprise value to estimated 2022 Ebitda and 7 times this year's forecast earnings. For comparison, the energy component of the S&P 500 trades at 6.2 times estimated 2022 Ebitda and 10.7 times estimated net income.

"When we look at these companies from a bare-bones value perspective, we look at what we call PDP [net asset value]," Cameron Bean, who rates Tourmaline a buy for Scotiabank, tells me. "That's your proven, developed producing reserves. That's if you took your production today, reinvested no more capital and let that decline. On current strip pricing, I have their PDP NAV at around C$48 [using a 9% discount rate], which is just C$3 below the share price. We typically don't see companies trading at their PDP NAV value, particularly not good companies. The valuation is quite low."

The shale crash of 2014 and subsequent boomlets and bustlets have soured many an investor on hydraulic fracturing, but there's nothing wrong with the technology. Of the 297 wells that Tourmaline drilled last year, not one was a dry hole.

Nor does fracking require the wholesale incineration of the investors' capital. Since its 2010 listing, Tourmaline has generated compound annual growth in production per share of 24%, in free cash flow of 21%. On a free cash-flow basis, management estimates, the company could break even at gas prices of as little as $1.50, and that includes the capital investment needed to maintain current production.

Debt and gas go ill together. Thus, it helps to know that if, as analysts project, the company generates C$3.9 billion in Ebitda this year, leverage would weigh in at a conservative 0.2 times (i.e., C$870 million in year-end net debt divided by forecast Ebitda). It's the volatility of gas prices that, according to DBRS Morningstar, mainly explains Tourmaline's underwhelming triple-B bond rating, the next-to-lowest rung of investment grade.

Tourmaline's balance sheet houses other sources of financial strength. Pipelines, processing facilities and other capital assets could be sold or, indeed, spun off. Tourmaline's infrastructure unit, reconfigured as a freestanding business, could form the fourth-largest midstream operator in Canada. A 36.8% stake in Topaz Energy Corp. (of which more below), worth C$1 billion, is monetizable.

Thus, low costs, rising energy prices and a lightly levered balance sheet leave Tourmaline in an enviable position. Some C$2.85 billion in free cash flow is in the cards this year based on current drilling plans, the forward strip of energy prices and hedges that cover 37% of anticipated production,

Tourmaline at a glance

all figures in C$ millions except per share data

	2021	2020	2019	2018	2017
revenue	C$4,381.1	C$2,198.5	C$2,117.3	C$2,087.7	C$1,852.5
operating income	2,590.3	675.3	362.7	624.2	551.6
net income	2,026.0	618.3	319.7	401.1	346.8
earnings per share	6.49	2.27	1.18	1.48	1.29
shares	316.8	272.1	271.9	271.7	269.6
cash	0.0	220.2	0.0	0.0	0.0
debt	869.6	1,942.3	1,619.0	1,476.1	1,534.8
total assets	15,292.1	12,790.2	11,180.6	10,732.5	10,181.5

sources: company reports, the Bloomberg

management says. That works out to C$8.58 per share in free cash flow versus the current share price of C$48.78.

"We have committed to returning the majority of annual free cash flow to shareholders," Rose told listeners-in on the March 2 earnings call, "and we are executing on that plan." In addition to the regular quarterly dividend of C$0.20 per share (up from C$0.18 in the fourth quarter and C$0.16 in the first quarter of 2021), Tourmaline has begun to pay special dividends, including C$0.75 in the December quarter and C$1.25 in the current period. If the front office is correct, the shares may yield in excess of 10% this year versus the 6.2% on offer from U.S. sub-investment-grade bonds.

Rose himself is not the least of Tourmaline's assets, as his fans are quick to point out. "I'd give him my money and just walk away and wait for the checks to roll in—he's that good," one oil executive, who asks to go nameless (and who says he tried but failed to back Tourmaline at its 2008 founding), tells me.

"It was the worst investment mistake I've ever made in my life," another admirer, who also asks to be anonymous, says of the investment he didn't make in the pre-public-market Tourmaline. "I'm reminded of it constantly."

"I've asked competitors, 'How do these guys find the plays?'" Kent Milani, a former vendor of seismic data used in the work of exploring for new drilling sites, tells me. "Some have said that Mike Rose can smell it. . . . Of course that is an exaggeration, but they are excellent operators."

And excellent deployers of capital, too. In the 2020 and 2021 natural gas doldrums, Tourmaline made numerous acquisitions at an overall cost of C$1.8 billion. To finance them, it floated shares in Topaz Energy, consisting of incorporated interests in Tourmaline's own wells and midstream infrastructure, and retaining the aforementioned 36.8% interest in the Topaz entity.

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Burnishing the bull case on Tourmaline is the mega LNG Canada (LNGC) project now under construction in Kitimat, British Columbia. A joint venture of Shell, Petronas, PetroChina Co. Ltd., Mitsubishi Corp. and Korea Gas Corp., LNGC is slated to begin gathering, liquefying and exporting natural gas from western Canada in 2025.

It's hard to exaggerate the size of LNGC relative to the Canadian gas market. According to the Canada Energy Regulator, Canadian drillers produced 16.3 bcf of gas a day in September. When LNGC comes online, it will be able to ship 11.5% of that production abroad. What's more, Shell and its j.v. partners have the option to double throughput at the Kitimat complex, creating the potential to absorb 23% of Canada's current production.

If the LNG project rings a bell, it may be because Fluor Corp., a *Grant's* pick-to-click, is its general contractor (see the issue dated June 25, 2021). Fluor's single largest contract, LNGC also represents the single biggest risk to the Fluor share price. Cost overruns on a different LNG project led to the bankruptcy of McDermott International, Inc. in 2020.

Under David Seaton, CEO from 2011–19, Fluor pursued large, fixed-price work instead of the cost-plus kind. From 20% in 2014, the fixed-price portion of the backlog swelled to 64% in 2021. David Constable, who took the helm in 2020, targets a backlog with no more than a quarter of fixed-price work by 2024.

On that score, so far, so good. As of Dec. 31, 2021, Constable told his earnings-call audience last month, the LNGC project was 60% complete, up from about 50% on Sept. 30, and he predicted that it would be throwing off strong profits this year.

Fluor's backlog has fallen almost by half, to $18.9 billion from $35.6 billion in 2018, but help is on the way. November brought a preliminary award for years of lucrative work at the U.S. nuclear-weapons arsenal, formally designated the "Y-12 National Security Complex and Pantex Plant management and operating contract by the U.S. Department of Energy's National Nuclear Security Administration." The contract, potentially worth $2.8 billion a year, could stretch for a decade if the parties chose to exercise all options. Signed and sealed, the contract would lift the cost-plus portion of Fluor's backlog to more than 50% of the whole. And if high and rising commodity prices coaxed drillers and refiners to invest in more capital assets, that, too, would be a positive.

Meanwhile, Fluor expects to realize some of the value of a previously hidden jewel. The Nuclear Regulatory Commission has so far fixed its imprimatur on only one small modular nuclear reactor, and Fluor's NuScale unit is the owner of that design. Fluor says it will sell about one-third of NuScale to Spring Valley Acquisition Corp., a blank-check company, in a transaction that's expected to close in the second quarter. Redemptions by the holders of the SPAC will determine the exact percentage of NuScale ownership that Fluor retains.

Since the *Grant's* analysis last summer, Fluor has generated a 50.9% return compared with the S&P 500's 0.6% gain, both figures including reinvested dividends.

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In speaking to Bay Street energy analysts, I learned that the market expects Shell and its j.v. partners to fill the first stage of LNGC with their own Canadian gas. Birchcliff Energy Ltd., another cheap, lightly leveraged Canadian producer, told me that Shell, caught in the Blueberry River dispute, is having trouble securing permits to drill in British Columbia.

So stymied, Shell has approached local producers to secure gas for 2025 delivery at a small premium to local prices. "The way we see it is, we see us and a lot of producers calling their bluff," Jesse Doenz, the controller and manager of investor relations at Birchcliff, tells me. "If they can't fill that facility, we might end up signing a long-term deal to get some of our gas on the first train." For reference, liquefied natural gas shipped to Japan and Korea commands a price of $39.03 per mcf versus $3.69 for gas sold domestically.

Nor is LNG Canada the only export project in the works. Birchcliff belongs to the Rockies LNG consortium, which aims to complete its own liquefied natural gas terminal in British Columbia in 2027 or 2028. "The idea is that it will be a floating LNG facility, which is significantly cheaper than what Shell is doing by a magnitude of three to four times," says Doenz.

Canada has "the cheapest molecules in the ground for a Tier 1 jurisdiction," observes Darren Maupin, founder and director of Pilgrim Global, which holds positions in both Tourmaline and Birchcliff.

Each north-of-the-border driller has its own particular advantages, Maupin adds: "Tourmaline has its scale, its dominance and its incredible balance sheet. Mike Rose is a world-class CEO. If one of those equity partners in the Shell LNG project panics because they are all short gas, what's the M&A list? Well, No. 1 is Tourmaline. No. 2 or 3 would be Birchcliff. Birchcliff is a lot smaller than Tourmaline, but it has a very nice collection of assets and is really well run."

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