GRANT'S
INTEREST RATE OBSERVER®

Vol. 43, No. 1c 233 Broadway, New York, New York 10279 • www.grantspub.com JANUARY 17, 2025

Penny stock no more

Evan Lorenz writes:

It's cold in Europe this winter, a fact that will help to introduce an oil and gas producer that trades as if the season were warm—and as if Russian gas had not stopped coursing through Ukrainian pipelines two-and-a-half weeks ago and thereby caused European gas prices to rally. In preview, we're bullish on Vermilion Energy, Inc. (VET in Toronto and New York).

It's strange but true that Ukrainian pipelines remained open to Russian natural gas, war or no war, till the contract between Gazprom PJSC, Russia's state gas company, and Naftogaz, its Ukrainian counterpart, expired on New Year's Day. The gas had flowed—to Europe from Russia via Ukraine—for 50 years.

The timing of the closure is inopportune. Energy prices did, indeed, spike following the Feb. 24, 2022 Russian invasion, but the unusually mild winters of 2022–23 and 2023–24 stopped the surge cold.

Now natural-gas supplies are falling with the temperatures. European inventories, which started the heating season at 95% full in November, have been drawn down to 72% through December; at the same point last year they stood at 86% full. Extrapolating from current trends, Bloomberg predicts that supplies will decline to 35%–40% of capacity by spring (last year, they were at 60%).

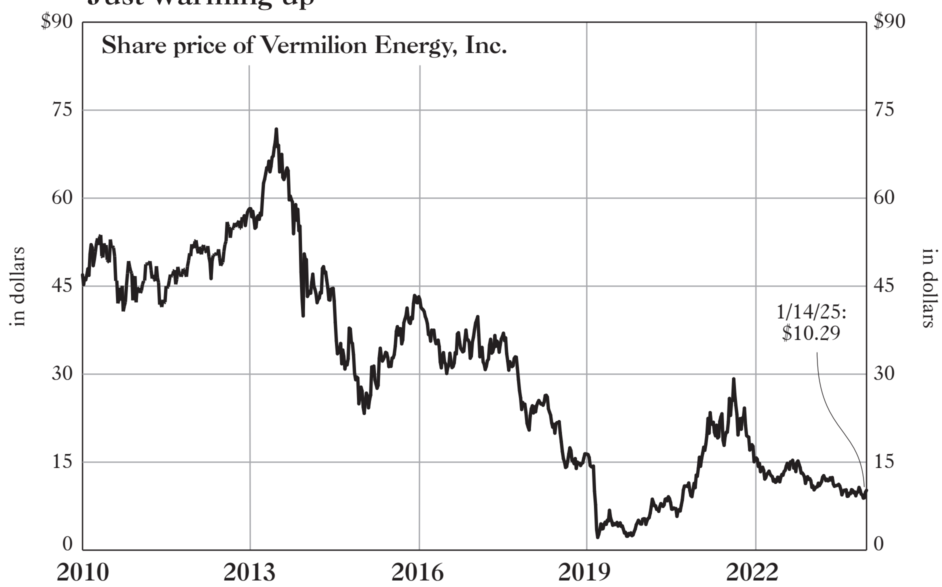
If so, Europe would find itself even more reliant on imports of liquefied natural gas. Seaborne LNG is a costly substitute for the kind piped overland. It must be compressed for shipment, shipped, and then decompressed upon landing. The good thing, from Vermilion's standpoint, is that such costs unfurl a pricing umbrella for European gas producers like itself.

Another potential price prop takes the form of a new European Union law that, come 2027, will exact penalties on companies that fail to meet certain carbon-emissions and human-rights standards. Qatar, a major LNG supplier, is threatening to end sales to Europe if the law is enforced.

Germany's 2023 shuttering of the last of its nuclear reactors has similarly played into the hands of European gas producers. To keep the lights on, Germany needs the sun to shine and the wind to blow—or, failing that, it must draw on the electrical grids of its neighbors, who are not invariably happy to accommodate. Thus, on Dec. 12, 2024, Norwegian power prices reached their highest level since 2009 on account of a windless day in Germany. Becalmed, German power users turned to Scandinavian electricity interconnects. On Jan. 1, the winds returned and German power prices briefly dropped below zero.

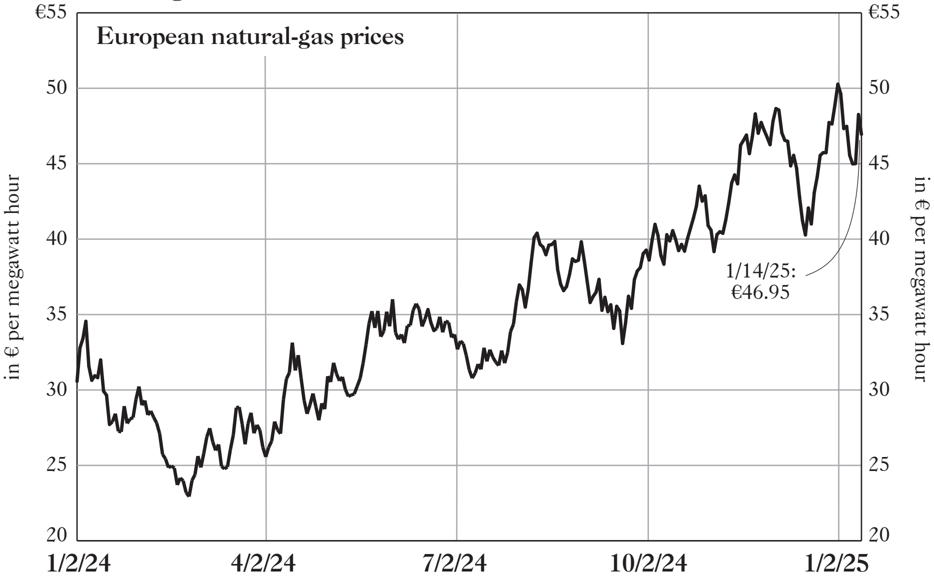
This has become a political issue for Norway, which will hold parliamentary elections on Sept. 8. The contract for a power interconnect to Denmark expires in 2026. The right-wing Progress Party, which leads in the polls, wants to scrap that power line and renegotiate deals with the United Kingdom and Germany to end "the price infection" that is plaguing Norwegian consumers. Europe

Just warming up



source: The Bloomberg

Waiting for LNG



source: The Bloomberg

may thus need more baseload generation, i.e., even more natural gas.

. . .

Vermilion came into the world as a Canadian penny stock, its shares debuting on the Alberta exchange in April 1994 at 30 cents apiece. The wildcatting E&P company stepped out of character three years later to purchase a package of French wells from Exxon Mobil Corp. for $45 million. In less than a year, Vermilion had boosted production in the acquired properties by 50%, and today it delivers two out of every three barrels of oil extracted in France. It is the French oil champion.

"The whole strategy is that when you buy from the majors, you usually get a really good value because they're not necessarily looking for the highest price," Kyle Preston, vice president of investor relations, tells me. "They're looking to exit a country or a region and put that asset in a safe set of hands, i.e., a company that can manage it effectively so that it won't come back and bite them in the future with some sort of abandonment liability."

It helps, too, that assets on the chopping block had often been starved of investment. "We found that when we get these assets from majors, there tends to be a lot of low-hanging fruit or meat left on the bone," Preston continues. "In most cases we are able to extend the life of that asset not just by years but, sometimes, decades." As an added bonus, oil and natural-gas prices trade at a premium to international benchmarks in many of the regions in which Vermilion operates.

After that French coup, Vermilion expanded into the Netherlands (in 2005), Australia (2005), Ireland (2009), Germany (2014), the United States (2014) and Croatia (2019). As a midsize oil producer with worldwide assets, Vermilion bears higher general and administrative expenses than similarly sized Canadian peers. However, thanks to the premium prices that hydrocarbons fetch beyond North America, these far-flung assets produce greater margins than those in the typical Canadian play. Prior to 2020, investors rewarded the company for that strategy with a premium multiple.

. . .

But the post-lockdown collapse in energy prices sawed Vermilion's 2020 Ebitda almost in half and transformed a moderately leveraged balance sheet (2 times Ebitda at year-end 2019) into an overleveraged one (3.6 times 12 months later). To set matters right, the company canceled its dividend, slashed its capital spending and parted company with its CEO, Anthony Marino.

The Vermilion story again veered off-course in 2022. Yes, Russia's invasion of Ukraine sent European natural-gas prices flying—by as much as 610.5% on Aug. 26, 2022 from the average logged in 2021—and Vermilion duly generated record-high free cash flow. But a 20% windfall profits tax, laid on earnings that topped the average over the prior five years, skimmed off much of the corporate cream.

Rapacious governments are beyond the company's control, but Vermilion has spent the past four years on balance-sheet repair. Between Dec. 31, 2020 and Sept. 30, 2024, it reduced debt by C$1.2 billion to C$834.3 million, or 0.9 times trailing Ebitda. Today, with the dividend restored and a 37% share-price decline in the post-2019 rearview mirror, the stock is priced to a 3.5% yield; a buyback program has reduced the float by 6.6%.

On Dec. 23, 2024, Vermilion announced the acquisition of Westbrick Energy Ltd. for C$1.1 billion in an all-cash deal that's expected to close next month. Westbrick owns 1.1 million acres of land in the Deep Basin, a liquids-rich natural-gas shale play in Alberta. These mineral rights sit adjacent to Vermilion's own wells in the Deep Basin—in fact, Vermilion partnered with Westbrick on 140 wells.

Vermilion has been the busier of the two partners, developing 75% of its mineral rights in the Deep Basin compared with just 25% for Westbrick. This year, if all goes according to plan, the transaction will boost Vermilion's reserves per share by a whopping 60% and will lift free cash flow per share by 15%. Such feats would value the company at a 19.5% free-cash-flow yield. The proximity of the acquiree's acreage to Vermilion's existing infrastructure raises hopes that Vermilion will be able to boost Westbrick's margins in the long term.

The transaction will add 50,000 barrels of oil equivalent per day (boe/d) in production, which is expected to boost Vermilion's 2025 output to 129,500 boe/d, with 62% of those barrels in the form of natural gas. Pro forma the deal, 65% of Vermilion's production will come from the Deep Basin and the Montney (a shale play that spans British Columbia and Alberta), 14% from European gas wells, 12% from southeast Saskatchewan light oil and 9% from international oil (wells in France, the United States and Australia). Thanks to the premium prices on the Old Continent, the European-gas division is expected to deliver 37% of earnings compared with just 35% for the Canadian shale plays.

Vertimilion Energy, Inc. at a glance

all figures in C$ millions except per share data

	TTM*	2023	2022	2021	2020
revenue	C$1,936.9	C$2,007.9	C$3,415.2	C$2,040.7	C$1,140.8
Ebitda	971.0	1,105.2	3,040.1	1,440.0	559.2
net income	-831.6	-237.6	1,313.1	1,148.7	-1,517.4
earnings per share	-5.08	-1.45	7.80	6.97	-9.61
shares outstanding	157.5	163.7	168.4	164.8	157.9
cash	190.9	141.5	13.8	6.0	6.9
debt	903.4	914.0	1,081.4	1,651.6	1,933.8
lease obligations	121.8	33.0	51.5	60.2	76.5
total assets	6,084.2	6,235.8	6,991.1	5,905.3	4,109.1

*12 months ended Sept. 30, 2024.

sources: company reports, the Bloomberg

Of course, the uptick in leverage from the deal will magnify the impact of any energy-price volatility. The Vermilion C-suite is taking a two-pronged approach to mitigate this risk. First, they plan to hedge 50% of Westbrick's production. "So far for 2025, we've got about 35% of our total production hedged," Preston tells me. "When you break it down into different commodities, we have just over 50% of our European gas hedged at an average floor price of around C$19 [$13.11] per thousand cubic feet [mcf]. For North American gas, we've got just over 40% hedged at an average floor price of C$3.30 [$2.28]."

Second, they say they intend to pay down the deal-related borrowings. Allocating 60% of projected free cash flow this year for balance-sheet repair, management estimates that debt will register at 1.5 times Ebitda by year end. Preston says that Vermilion will try to deleverage even faster by selling non-core assets, including 275,000 acres in southeast Saskatchewan. Longer term, Vermilion targets reducing borrowings to one-times Ebitda or less.

Before the fracking revolution, the United States depended on Canada for natural gas. A decade-and-a-half into the new era, American shales produce so much gas that the United States has become the world's largest exporter of LNG. This explains why the price of gas in Canada trades at $1.38 per mcf, a steep discount to the $3.97 per mcf at which the same molecule is quoted at Henry Hub, La., and much less than the $14.17 that gas fetches in Europe.

While Canada exports around two-fifths of its gas production, it effectively has one customer, namely, the country whose incoming president is on record as seeking to annex it. The customer base will broaden as the first phase of LNG Canada becomes operational in the middle of this year. LNG Canada is a mega-terminal in Kitimat, British Columbia, that has the means to export 1.8 billion cubic feet (bcf) per day, or approximately 10% of Canada's production. Through the end of the decade, additional LNG projects, including the second phase of LNG Canada, are expected to add an incremental 4.3 bcf per day in capacity. The advent of these export terminals should redound to the benefit of Canadian gas prices and Vermilion's bottom line alike.

Vermilion continues to expand its gas operations in Europe. It is testing wells in newly acquired properties in Croatia and Slovakia and producing between 17 and 21 million cubic feet of gas per day from a pair of wells it completed in Germany last year. These wells sit on 700,000 acres of undeveloped land that shares geology with wells that Vermilion is currently drilling in the Netherlands.

"I would say at the corporate allocation strategy, nothing's changed," CEO Dion Hatcher told investors at the Dec. 23, 2024 call announcing the Westbrick deal. "We're going to target modest production growth of 2% to 3%. We want to ensure that we've got a resilient base dividend, and we've increased our base dividend.... We see a lot of value in the base business, and we're excited to be buying back shares and, again, that's going to be in the range of 3% to 5% [of shares outstanding each year].

"So when you add those things up, again we're targeting that consistent 9% to 10% [of total shareholder returns]," Hatcher continued. "We're able to supplement that from time to time with a high rate of return acquisitions." That math doesn't account for the accretion that may come from post-deal deleveraging or the possible upside lurch in energy prices.

Bay Street is friendly toward Vermillion, with eight out of a dozen analysts on the case saying buy, while Wall Street seems to have its doubts; short interest registers at 7.9% of the American float versus just 2.6% for the Canadian one. Insiders have sold a net 45,900 shares over the past 12 months for proceeds of C$834,629. (Excluding an executive who left for competitor Tenaz Energy Corp., insider purchases sum to 4,100 shares over the past year.)

"We view Vermilion as a cheap international E&P player with a roughly 20% free-cash-flow yield to equity today," Michael Appleby, an analyst at Arbiter Partners Capital Management, which is long the stock (and in which, to declare an interest, the editor of *Grant's* is a limited partner), tells me. "They have added on leverage post this acquisition, but we believe it is a manageable amount—around 1.5 times cash flow—and the company is in a position to benefit from further strengthening in EU gas prices as well as a potential better year in Canadian energy in 2025."

If energy prices climb in both Europe and Canada, Appleby continues, Vermilion's free-cash-flow yield might rise to 30% of its market cap.

•