The Three Principles that Guide Randall Abramson's Oil & Gas Investment Strategy

The Energy Report www.TheEnergyReport.com 04/23/2015

COMPANIES MENTIONED

- **Manitok Energy Inc.**
- Orca Exploration Group Inc.
- Technip S.A.
- Weatherford International Ltd.

Streetwise Reports LLC
101 Second St., Suite 110
Petaluma, CA 94952
Tel.: (707) 981-8107
Fax: (707) 981-8998
bfung@streetwisereports.com

The market analysis tools used by Randall Abramson of Trapeze Asset Management Inc., suggest that the broad market has been fairly valued for about a year. But by applying apples-to-apples metrics to companies in the energy sector, Abramson has found specific equities trading well below their estimated appraised values. By the end of 2015, Abramson predicts oil prices will rise back to $70 per barrel or more, and undervalued energy equities should propel toward fair value. In this interview with *The Energy Report*, Abramson pinpoints some unloved energy companies poised for the rebound.

Source: Brian Sylvester of *The Energy Report*

The Energy Report: In a recent research report, you looked at the macroeconomic picture through the lens of value investing. You call the macro view "complex" and "historically unusual." In the context of certain uncertainty, could you please provide us with three principles that guide your investment decisions in today's market?

Randall Abramson: The reality of the day is that we have historically low interest rates and a number of crosscurrents moving through the economy. At Trapeze Asset Management we've developed tools, some of which we have systematized since the big downturn in 2008–2009, to cope with periods like this. We use our valuation model from a bottom-up perspective to tell us where the individual bargains are, and from a top-down perspective to tell us, in general, whether the markets or sectors are overvalued, undervalued or fairly valued. Today, our work tells us that the market has been hugging fair value pretty closely for about a year, which is unusual. That one tool helps us establish where the markets are and where they ought to be heading.

> "***Manitok Energy Inc.*** *has a long runway of growth ahead.*"

The second thing that guides us is the macroeconomic overlay. We have an economic composite and a momentum indicator, both of which are designed to predict whether there is a recession coming and/or a market debacle—not a typical correction but one of those 20% or more doozies. At the moment, our economic composite is showing smooth sailing, not just in the U.S. but also in other global economies. Our momentum indicators show relatively smooth sailing too, though a few countries, including Russia, Brazil and Peru, have negatively triggered.

And, finally, we try to determine which way the world is going. Disinflationary pressures and the ascent of the U.S. dollar have pushed down the resource sector, and most commodity prices have been badly hurt. The stagnation in many economies around the world has resulted in highly accommodative monetary policies. That's a reason we like the resource sector: We think that reflation is around the corner.

TER: Fair value would suggest that we're not in a bear market for energy stocks, but clearly we are.

RA: There's no question that the sector has been in a bear market because we define, like most people, any drop greater than 20% as a bear market. Yet it's the most unusual energy bear market I've witnessed in my 25 years in the business. It's rare to get a selloff like this that is not precipitated by a recession. The demand for oil is ever growing. It normally rises even in a recession.

> "This is the most unusual energy bear market I've witnessed in my 25 years in the business. It's rare to get a selloff like this that is not precipitated by a recession."

The decline started after Brent crude went to $120/barrel ($120/bbl). It was too far above the marginal cost of production, which is usually what holds the price in check. Then you had the serious rise in the U.S. dollar, which started bringing down most commodity prices because they're priced in U.S. dollars. At the same time you had excess supply driven by the U.S. shale boom. Then, in November 2014, OPEC said that it would not curtail oil production, knowing that would drive oil prices even lower to force production cutbacks around the world. That was probably the right thing to do, but I don't think even OPEC expected to see oil at $40/bbl.

TER: What are your near-term and medium-term forecasts for oil and gas?

RA: It's always hard to tell where things are going in the near term. But when you look out, say, six to nine months, you're likely to see a substantially higher oil price. That's because it's unbelievably rare to be trading below the average all-in cost of production. The all-in cost of production is in the $55–60/bbl range. While Brent has gone back above those levels, WTI (West Texas Intermediate) is still below. It's not sustainable.

Case in point: We have seen the number of U.S. drilling rigs collapse from more than 1,900 to just over 1,000 since last fall. That hasn't translated to lower U.S. oil production yet, but it's coming. If you're not out there finding more oil, and you have abnormally high decline rates—U.S. shale oil wells tend to decline much faster than conventional oil wells—you're setting up for a decent production decline in the next 12–18 months. And, even if U.S. production were to merely flatline, the global supply/demand equation is tight enough that the ever-growing demand should quickly create a supply deficit.

TER: You still like some energy names, even with oil at around $50/bbl. Is it about finding specific narratives with catalysts in a bear market?

RA: First of all, you have to have a forecast that the bear market is going to end, which we do. As I said, the price for oil has overshot to the downside, below the average all-in cost of production. There's an adage in economics: Gluts beget shortages and shortages beget gluts. Clearly, we had a "mini-glut" because of the U.S. shale overhang, but we can end up in a shortage position rather quickly.

> "When you look out six to nine months, you're likely to see a substantially higher oil price."

Globally, supply amounts to 94 million barrels per day (94 MMbbl/d) versus demand of about 93.5 MMbbl/d. Demand has been growing smartly, thanks to countries like China and India. But the problem for the oil market is that U.S. supplies went from 6

MMbbl/d of supply to 9 MMbbl/d in three years. That has now flatlined just above the 9 MMbbl/day mark and I suspect it will drop. In Q1/15, global oil demand rose by 2 MMbbl/d year-over-year. So U.S. production doesn't have to drop far before overall demand outstrips supply again. That will, at the margin, quickly bring prices back up.

TER: So even though U.S. oil inventories are at their highest point since 2001, you see that changing quickly?

RA: Yes, because global inventories are relatively normal. It's only U.S. inventories that are bloated. Some people believe refineries are intentionally building supply because they see problems ahead. Refiners are known for being pretty adept. There has been commentary about the amount of heavy oil that is needed to import for refining. Heavy oil imports have been jacking up and leading to some strange inventory levels in the U.S.

TER: In the report I referenced earlier, you aptly noted that investors are often giving up returns in the rush to safe investments, like government bonds or slow-growth blue-chip equities. How do you and your team balance risk versus reward?

RA: A number of ways. I'll divide it between bottom up and top down. From a bottom-up perspective, we look for a margin of safety. That means if the price is trading at or above our appraisal, using our discounted cash flow models as fair value, we're not interested. A stock needs to be trading at a discount to fair value, because if something goes wrong we want to make sure there's a margin of safety. To make a sufficient return that beats your hurdle rate, you want something to go from at least $0.80 on the dollar back up to a dollar, and collect the dividends and growth in the company on top of that. We screen more than 1,200 large-cap stocks —the largest in the world, and a number of medium- and small-size companies, too —looking for those that are trading at less than $0.80 on the dollar. That's one piece of the puzzle.

Then you want to do your due diligence, to make sure that you understand the businesses you're buying. They shouldn't be subject to regulatory issues that could alter the entire business, or leveraged to a point where the business could be in peril. At the same time, you want to avoid what we call "value traps," where the stock might be cheap, but it's cheap for a reason. Therefore, you want to focus on earnings revisions and near-term happenings in the business.

From a top-down perspective, you want to monitor not for your typical 3–6% corrections, but for those 20% or more drawdowns in the market. Those usually arrive when recessions come.

TER: What are some oil and gas equities that Trapeze owns at $50/bbl oil?

RA: Our favorite at the moment continues to be Manitok Energy Inc. (MEI:TSX.V), a 5,000 barrel a day (5 Mbbl/d) producer with all its assets in Alberta. The company is one of the cheapest we can find in the space. It's trading at about two times enterprise value:earnings before interest, taxes, depreciation and amortization (EV:EBITDA) versus the group, which is trading at about seven times EV:EBITDA. We believe the company has a long runway of growth ahead because it has established a foothold in an area of Alberta called Entice, which it bought from Encana Corp. (ECA:TSX; ECA:NYSE). Some initial results have been excellent.

TER: Why isn't the stock price moving higher?

RA: The company was a CA$3/share stock last fall, but pressure from falling energy prices and tie-in deliverable issues at both Stolberg, its original core area, and Entice, have held the stock down. One tie-in issue was related to Husky Energy Inc. (HSE:TSX) facilities that Manitok delivers into, and the other was related to similar Encana facilities, where the condensate content overwhelmed the facility. The company has made discoveries, but the market doesn't like a company that has production glitches.

I think the market is being myopic, and production should be in line in a month or so. The market is also concerned about the higher royalty rates Manitok pays PrairieSky Royalty Ltd. (PSK:TSX) for the Entice production, and the capital spending obligations it has this year and next. But PrairieSky is aware of this issue and, hopefully, there can be a meeting of the minds to alleviate any concern.

TER: When *The Energy Report* talked with you in June 2014, you had a target of CA$4.50/share on Manitok, and it was trading at around CA$2.25/share. Now, it's around CA$0.80–0.90/share. Do you still have a CA$4.50 target?

RA: It wouldn't be an immediate target because I don't think that oil is going to be $80/bbl shortly. However, with the Canadian dollar having gone from par to about CA$1.22 now on the U.S. dollar, the value of Manitok today is in the CA$2.50/share range, but could easily rise to CA$4/share or substantially higher with higher oil prices. As drilling at Entice continues, production and reserve additions should rise significantly over the next couple of years, offering compelling upside potential.

TER: How does a tiny company like Manitok maintain investor interest in a $50/bbl oil market?

RA: As long as companies are delivering growth and earnings, they will continue to garner market attention. When those things stop the market tends to abandon ship. To date, Manitok has been using the Cenovus Energy Inc. (CVE:TSX; CVE:NYSE) analog, which is about 25 kilometers away, meaning Cenovus wells that look similar to the Entice wells. But the Entice results to date have been well above that analog.

> "The global supply/demand equation is tight enough that the ever-growing demand should quickly create a supply deficit."

Soon, Manitok will have had its Entice wells on for a five-month period. In another month or so we'll be getting results on those and, hopefully, we'll see a different royalty rate structure for the company too. And costs are coming down across the board in the sector, so the cost per each well should be lower, leading to 20–25% internal rates of return on drilling. With all of that meshed together, even at $50/bbl oil, this company will look appetizing. The market should be more relaxed about the company's debt level, which is about 1.5 times EBITDA versus the peer average above 2 times EBITDA.

TER: Is the revised royalty the next catalyst for the stock?

RA: That's a piece of the puzzle. The bigger catalyst here is seeing what the well results are, and getting the facilities issues locked down. Hopefully, Manitok will be viewed as a diamond in the rough.

TER: What are some other names that you have positions in?

RA: One that is farther afield is Orca Exploration Group Inc. (ORC-A:TSX.V; ORC-B:TSX.V). The company produces more than 90% of Tanzania's natural gas, about half of which is used to produce power. The stock has been stuck in the

CA$3/share range for the longest time as Tanzania struggles with corruption issues. And the national utility, TANESCO (Tanzania Electric Supply Co. Ltd.), has not been meeting its obligations to Orca and other companies on a timely basis, even though things have improved since the World Bank got involved more than a year ago.

> "We had a 'mini-glut' because of the U.S. shale overhang, but we can end up in a shortage position rather quickly."

Orca is also not producing at the levels the market expected by now, but a pipeline slated for completion years ago is finally going to be commissioned in a few months. Hopefully, that pipeline will deliver enough Orca natural gas to help alleviate the severe brownouts Tanzania has experienced for many years. In the meantime, Orca is remarkably cheap. The company has more than US$60M cash and is owed more than US$60M by TANESCO and has no debt—there's about CA$2.50/share of net working capital, including amounts we expect Orca to ultimately collect from TANESCO. You're nearly getting all the reserves for free. And the 2P reserves are worth in excess of CA$11/share according to the company's third-party engineers.

TER: Is the company's move into Italy an attempt to mitigate risk in the stock?

RA: It's an attempt to diversify, and management liked what it saw there.

TER: Tell us about Orca management and some of its key people.

RA: Chairman and CEO David Lyons has had a large ownership stake for many years. He spun out Orca from PanOcean Energy Corp., a successful company that ran for many years. Its primary investment was in Gabon, so he knows what it takes to operate in Africa. Lyons ultimately sold PanOcean to Addax Petroleum (AXC:TSX) in 2006. I think that Orca will get sold, too. In November 2014, the company announced that there were unsolicited expressions of interest, either in the entire company or its assets. Something may already be afoot.

TER: Why hasn't that created more of a run on the stock?

RA: People are simply scared of Tanzania. A country that does not pay its bills on a timely basis does not sit well with most investors. People pay a premium for safety, and they discount things that they're concerned about. Our job is to determine whether those risks are real. While we don't believe there are material risks here, resolving Orca's issues has taken way longer than we'd thought.

TER: Are there any other equity stories you'd like to tell us about?

RA: We like the oil and gas service space as well. One name in that space is Paris-based Technip S.A. (TEC:EP; TKPPY:OTC). Technip is one of the leading oil and gas service companies, offering both subsea and onshore/offshore services, everything from soup to nuts in the business. The stock has been knocked down, along with the whole energy space, to the point where it's trading at about 4.7 times EV:EBITDA versus about 7 times for the group and 10 times for names like Halliburton Co. (HAL:NYSE). We think it's a serious bargain. It's just a lesser-known name.

TER: What's the next catalyst for Technip?

RA: It's just about the oil price recovering. The service sector tends to be higher beta, and moves more dramatically. We need to see higher oil prices. When we wake up toward the end of the year, you should see a significant recovery of most players in energy services.

TER: Are there any other stories you'd like to share with us?

RA: I'll give you one more: Weatherford International Ltd. (WFT:NYSE), which is also in the oil and gas service space. Weatherford has been in turnaround mode after it added too much debt. But it sold divisions, cut costs and de-levered. Like Technip, once the price of oil and gas recovers, you could see a material recovery in the price of Weatherford.

TER: What has the macro picture of the last five or six years taught you as an investor on a micro level?

RA: In general, we've learned from our macro tools that when they are not giving us red flags to remain fully invested, the market will continue to climb the wall of worry. While it's doing that, until there is something to actually worry about, you need to be fully invested, assuming you can find bargains. Otherwise, cash becomes a significant drag to your portfolio.

TER: Thank you for talking with us, Randall.

Randall Abramson, *CFA, is CEO and portfolio manager of Trapeze Asset Management Inc., a firm he cofounded in 1999 shortly after founding its affiliate broker dealer, Trapeze Capital Corp. Abramson was named one of Canada's 'Stock Market Superstars' in Bob Thompson's* Stock Market Superstars: Secrets of Canada's Top Stock Pickers *(Insomniac Press, 2008). Trapeze's separately managed accounts are long/short or long only, and have either an all-cap orientation or large cap-only mandate via the company's Global Insight model. Abramson graduated with a bachelor's degree in commerce from the University of Toronto in 1989, and his career has spanned investment banking, investment analysis and portfolio management.*

Read what other experts are saying about:

- Manitok Energy Inc.

Want to read more *Energy Report* interviews like this? Sign up for our free e-newsletter, and you'll learn when new articles have been published. To see a list of recent interviews with industry analysts and commentators, visit our Interviews page.

If you would like to comment on the content of this interview, engage with the interviewee or any of the companies discussed in this interview, or if you would like to be interviewed by *The Energy Report*, please contact Brandon Fung of *The Energy Report* at bfung@streetwisereports.com, (707) 981-8107.

IMPORTANT DISCLOSURES

1) Brian Sylvester conducted this interview for Streetwise Reports LLC, publisher of *The Gold Report, The Energy Report, The Life Sciences Report* and *The Mining Report,* and provides services to Streetwise Reports as an independent contractor. He owns, or his family owns, shares of the following companies mentioned in this interview: None.
2) The following companies mentioned in the interview are sponsors of Streetwise Reports: Manitok Energy Inc. The companies mentioned in this

interview were not involved in any aspect of the interview preparation or post-interview editing so the expert could speak independently about the sector. Streetwise Reports does not accept stock in exchange for its services.
3) Randall Abramson: I own, or my family owns, shares of the following companies mentioned in this interview: Manitok Energy Inc. and Orca Exploration Group Inc. I personally am, or my family is, paid by the following companies mentioned in this interview: None. My company has a financial relationship with the following companies mentioned in this interview: None. I was not paid by Streetwise Reports for participating in this interview. Comments and opinions expressed are my own comments and opinions. I determined and had final say over which companies would be included in the interview based on my research, understanding of the sector and interview theme. I had the opportunity to review the interview for accuracy as of the date of the interview and am responsible for the content of the interview.
4) Interviews are edited for clarity. Streetwise Reports does not make editorial comments or change experts' statements without their consent.
5) The interview does not constitute investment advice. Each reader is encouraged to consult with his or her individual financial professional and any action a reader takes as a result of information presented here is his or her own responsibility. By opening this page, each reader accepts and agrees to Streetwise Reports' terms of use and full legal disclaimer.
6) From time to time, Streetwise Reports LLC and its directors, officers, employees or members of their families, as well as persons interviewed for articles and interviews on the site, may have a long or short position in securities mentioned. Directors, officers, employees or members of their families are prohibited from making purchases and/or sales of those securities in the open market or otherwise during the up-to-four-week interval from the time of the interview until after it publishes.

The Gold Report , *The Energy Report* and *The Life Sciences Report* do not render general or specific investment advice and do not endorse or recommend the business, products, services or securities of any industry or company mentioned in this report.

From time to time, Streetwise Reports LLC and its directors, officers, employees or members of their families, as well as persons interviewed for articles on the site, may have a long or short position in securities mentioned and may make purchases and/or sales of those securities in the open market or otherwise.

Streetwise Reports LLC does not guarantee the accuracy or thoroughness of the information reported.

Streetwise Reports LLC receives a fee from companies that are listed on the home page in the "Learn More About Companies in this Issue" section. Their sponsor pages may be considered advertising for the purposes of 18 U.S.C. 1734.

OTHER DISCLOSURES