Tourmaline Oil

Energy
TSX: TOU
Market Outperform | Hold

June 30, 2023

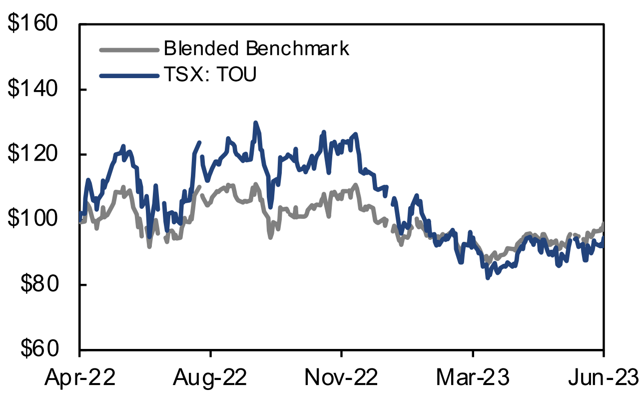
Lukas Fairley, Investment Analyst

Return on Investment	
Current Share Price	$62.42
Target Price	$80.00
Implied Return	28%
Dividend Yield	1.67%
Conviction Rating	2

Market Profile	
52-Week Range	$53.24 - $84.19
Market Capitalization ($mm)	$21,173
Net Debt ($mm)	$351
Enterprise Value ($mm)	$21,524
Beta (5-Year Monthly)	1.62

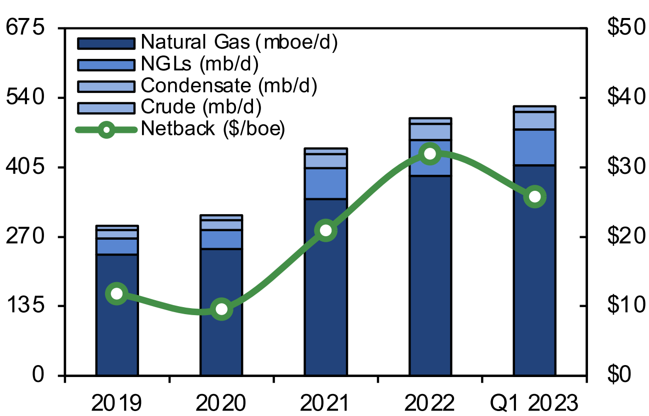
Metrics	**2023E**	**2024E**	**2025E**
Production (boe/d)	530,120	562,200	580,670
Revenue ($mm)	$6,925	$7,392	$7,842
Debt Adj. Cash Flow ($mm)	$4,362	$4,739	$5,242
EV/DACF	4.9x	4.5x	4.1x

Holding Period Trading Performance (Indexed to $100)



Source: FactSet

Figure 1: LHS Production Mix vs. RHS Operating Netback



Source: Company Filings

Business Description

Tourmaline Oil (TSX: TOU) is a Canadian senior oil and natural gas producer primarily focused on the exploration, development, and acquisition of energy production assets. The Company's primary operations are located within the Western Canadian Sedimentary Basin (WCSB), with a significant presence in the Alberta Deep Basin, Northeast British Columbia Montney, and Peace River Oil Complex. TOU began its operations in 2008 through a series of acquisitions, allowing the Company to build an extensive inventory of undeveloped land and infrastructure assets. In 2022, 91.4% of TOU's production comprised natural gas products, with the remaining 8.6% comprising light and heavy crude oil. The Company has an aggregate of 4.5B boe of proven plus probable reserves including 20.7 tcf of natural gas reserves.

Industry Overview

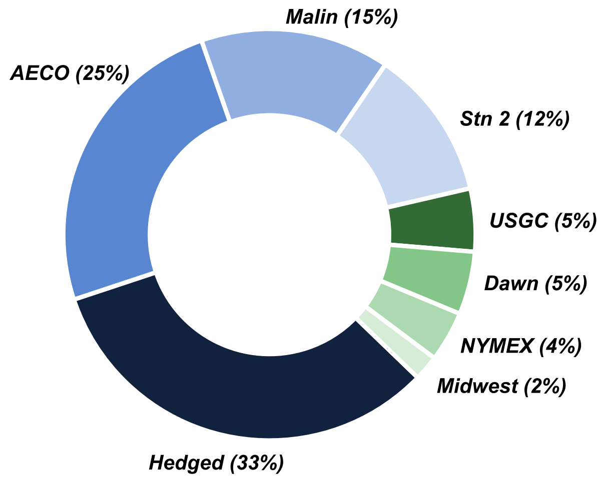
Following the multi-year lows induced by the COVID-19 pandemic in Q2 2020, the global economy's strong rebound has played a vital role in boosting oil consumption, which reached 100.4 mmbbl/d in Q1 2023. Oil supply is expected to fall short of rising demand in H2 2023 with the Energy Information Administration (EIA) forecasting WTI to reach >US$80 per barrel by Q4 2023. In addition, natural gas prices are expected to rise due to increased domestic demand with NYMEX and AECO spot prices projected to reach $2.95 per mmbtu and $3.15 per mmbtu, respectively by Q4 2023. Amid this dynamic landscape, the exploration and production subsector remains highly competitive. In recent years, increasingly supportive commodity prices have led to significant profitability growth throughout the industry which has led to many companies initiating or increasing shareholder return frameworks.

Mandate Fit

Quality Management: Michael Rose founded TOU in 2008 and currently serves as CEO. Rose has 38 years of experience in various roles throughout the oil and gas industry including serving in chief executive roles at the Duvernay Oil Corporation and Berkley Petroleum Corporation. Management continues to focus on the return of capital to TOU shareholders through dividends and share buybacks, making accretive acquisitions and growing its high-quality reserve inventory.

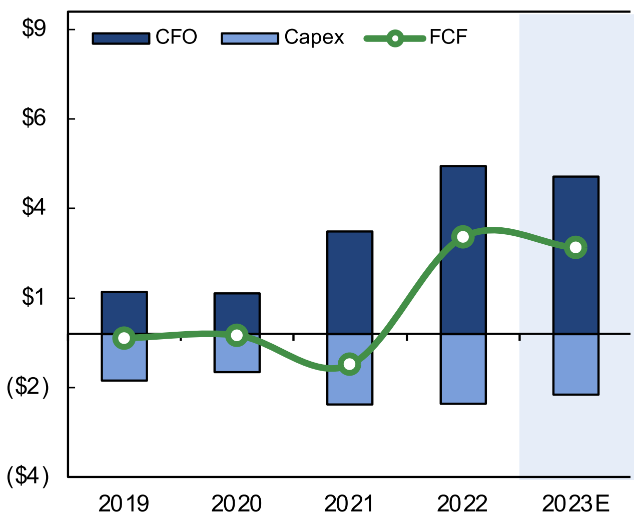
Competitive Advantage: TOU's competitive edge lies in its exceptional margins achieved through continuous operational improvements and well cost reductions over the last decade. Since 2014, operating expenditures have been reduced by ~10% to $4.30/boe in 2022, while capital efficiencies have improved by ~60% to $8,900 boe/d. This efficient cost structure therefore increases the amount of cash flow available for further growth and shareholder returns. As a result of low-cost expansion and operational efficiency, TOU is now the largest natural gas producer in Canada and holds ~30 years of drilling inventory across >5,000 locations which is the largest Tier 1 inventory held in North America. As of Q1 2023 TOU represented ~14% of WCSB receipts, ~20% of operational Canadian gas rigs, and ~50% of aggregate free cash flow generated by the WCSB gas-weighted peer group(1).

Figure 2: 2023 Natural Gas Benchmark Price Exposure



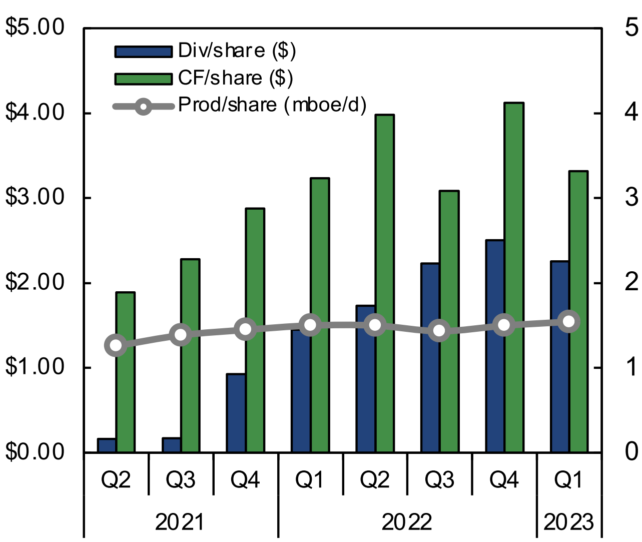
Source: Company Filings

Figure 3: Cash Flow, Capex, and Free Cash Flow



Source: Company Filings

Figure 4: LHS CF and Dividends vs RHS LTM Production



Source: Company Filings

Strong Balance Sheet: As of Q1 2023, TOU had net debt of ~$350 mm and maintained a best in-class D/CF Flow ratio of ~0.2x compared to the gas-weighted peer median of 0.8x(1). The Company currently has a BBB investment grade credit rating and maintains the lowest cost of borrowing among its peers at an effective rate of ~2.3%. Since 2017, TOU has reduced debt by over $1.0B in order to support its growing operations and ongoing development.

Growing Free Cash Flow: TOU generated a record ~$4.9B of FCF in 2022 ($14.27/share) reflecting a 67% increase YoY which was largely driven by strong realized commodity prices. After full-year production of ~500.4 mboe/d on total spending of $1.7B, TOU generated ~$3.2B of FCF and paid ~$2.7B ($7.90/share) in base and special dividends. Since 2017, TOU has improved its full cycle profitability with FCF growing at a ~24% CAGR while also increasing its dividend yield from ~3% to ~11%. As of Q1 2023, the Company was guiding to FY 2023 FCF of ~$3.9B which incorporates weaker near-term strip pricing. The resulting ~$2.2B of FCF will continue to be directed toward shareholder returns with TOU looking to payout 100% of its FCF through both base and special dividends. To-date in 2023, the Company has already increased its base dividend by 4% to $1.04 and paid a $1.50/share quarterly special dividend.

Operations

Exploration & Production: In Q1 2023, TOU's production averaged 525,916 boe/d (~22% liquids) after the curtailment of ~8,000 boe/d due to Alberta wildfire impacts which caused interruptions in the Pembina NGL pipeline system. The Company operated 15 rigs during the quarter and drilled ~71 net wells, completed ~67 net wells, and had ~38 DUCs going into Q2 2023.

Marketing: TOU operates a marketing terminal in Gordondale Alberta for both internally produced and third-party purchased oil, condensate, and NGL volumes. Additionally, TOU has ~140 MMcf/d of natural gas volumes contracted with Cheniere LNG, providing the company exposure to JKM benchmark pricing.

Growth Outlook: TOU's future growth will be primarily driven by the development of its North Montney expansion project at Conroy which the company expects will increase production by ~100 mboe/d. The Company will begin allocating capital toward the project in H2 2024 with Phase 1 to be on stream in 2026 and Phase 2 producing by 2028. When combined with other organic production growth in NE B.C., the Company will increase total production by ~700 mboe/d.

Risks

Variable drilling program results could impede TOU's growth and operational issues or underwhelming results in the Company's drilling and development program could negatively impact its share price. TOU is also subject to commodity price risk which is partially mitigated through its rigorous hedging and marketing programs. Other risks include the impact of government policy and legislation relating to royalties, income taxes, environmental regulation, as well as foreign exchange.

Investment Thesis and Valuation

TOU was valued at $80 using a 2P NAV and 2024E EV/DACF multiple of ~6.0x. The Fund sees this as justifiable due to TOU's strong balance sheet, cost efficiency, robust gas marketing, and solid free cash flow. This positions Tourmaline to offer attractive double-digit cash yields to shareholders. TOU possesses both a unique operational advantage and the financial flexibility required to sustain rapid growth in the long-term.

(1): Peer group includes TSX: ARX, TSX: NVA, TSX: PEY, and TSX: VET