



## **OGIB BULLETIN #158**

### **WHITECAP RESOURCES WCP-TSX; SPGYF-PINK**

#### **COMPANY ANALYSIS – JANUARY 27, 2015**

As I wrote this company report on Whitecap Resources I began to feel the tingle of something that has been missing for a while. The tingle of greed.

This is a great company and its stock price has been beaten down along with the price of oil and every other energy stock in the market. Getting companies like this at a bargain price is not an opportunity that comes around very often.

For Whitecap and CEO Grant Fagerheim building a company that will not only survive tough times like this but benefit from them has been the plan since Day 1.

Whitecap can sustain its production and continue to pay its dividend at \$45 WTI. Only companies that have great balance sheets and top notch assets can do this.

Whitecap always trades at a premium to its peers, so in this low oil price environment, lesser teams and companies will fall in value much more—so it could be exciting to watch what kind of assets Whitecap can pick up from distressed sellers. This is a company that was built via acquisition and now we are in a buyer's market (to say the least).

Whitecap also pays a dividend (\$0.75 annual, paid in 12 monthly installments), and I actually DON'T like that. A management team this talented is wasting money on its shareholders; it can get a MUCH greater return drilling or acquiring.

All their assets are Tier 1; usually these juniors have a flagship property and all the rest are what I call “journeyman” plays.

## QUICK FACTS (from Jan 2015)

Trading Symbols:	WCP-TSXV
Share Price Today:	\$11.32
2015 Production Guidance:	37,500 boe/d (76% light oil)
2015 Funds Flow Guidance at \$65 WTI:	\$465 million
Basic Shares Outstanding:	253 million
Market Cap:	\$2.87 billion
Enterprise Value (EV):	\$3.67 billion
EV per 2015 cash flow :	7.9 times
Projected 2015 Debt to cash flow:	1.7 times
Current Annual Dividend:	\$0.75 per share (6.6% yield)
<a href="http://www.wcap.ca/">http://www.wcap.ca/</a>	

## POSITIVES

- Business model built around a strong balance sheet
- A CEO that is experienced and proven to be successful
- High netback oil focused assets
- The dividend can be sustained even at \$50 oil
- Will be a beneficiary of opportunities created in a difficult market

## NEGATIVES

- No clear timing on an exit strategy laid forth by CEO

## BACKGROUND

Whitecap is run by president and CEO Grant Fagerheim who has a long history of building and selling companies such as Cadence Energy and Ketch Resources. He is on record as saying that Whitecap will be the last company that he will build and that he is building it for the long haul.

Fagerheim's first job was at Dome Petroleum which ran into trouble during the 1986 oil collapse and was forced into a merger at a low share price. Watching that taught Fagerheim a valuable lesson about the dangers of debt.

That first-hand experience of 1986 is paying off today as we suffer through a similar environment.

Fagerheim has intentionally built Whitecap to be the opportunistic buying company during commodity price drops, not the selling company.

\$50 per barrel oil isn't going to be the end for Whitecap, it will likely be an opportunity.

The long term plan has been to keep Whitecap's debt to funds flow ratio below 1.5 to 1. That allows Whitecap to maintain the flexibility and premium stock valuation it needs to buy others cheap at the right time.

Whitecap was formed on July 1, 2010 through a reverse takeover of Spitfire Energy and has been built subsequently through a series of acquisitions. Over its short life Whitecap has made the following acquisitions using a combination of cash raised through equity issuances and shares issued in acquisitions:

- July 2010 acquired private company Onyx for \$50 million
- December 2010 acquires light oil assets in the Valhalla play for \$25 million
- April 2011 acquired all of the common shares of Spry Energy for \$223 million
- February 2012 acquires Compass Petroleum for \$80 million
- February 2012 acquires Midway Energy for \$550 million
- April 2013 acquired Invicta Energy for \$60 million
- April 2013 acquires \$110 million worth of Dodsland Viking assets
- June 2013 acquired Garrington and Valhalla assets for \$170 million
- October 2013 acquired Cardium and Viking assets for \$90 million

- November 2013 acquires a Viking focused private company for \$320 million
- March 2014 acquires low decline Cardium light oil assets for \$692 million
- August 2014 acquires Nisku light oil pool for \$266 million

Hardly a quarter has passed over the past four years without Whitecap making an acquisition of fairly significant size.

Whitecap started in 2010 with only 1,500 boe/day of production and an annual cash flow run rate of \$16 million. In four years, they purchased--per my recap above—\$2.6 billion of oil and gas properties/companies. How did they do it?

The first reason is the strong reputation of its CEO Fagerheim. The second is the always sturdy condition of Whitecap's balance sheet.

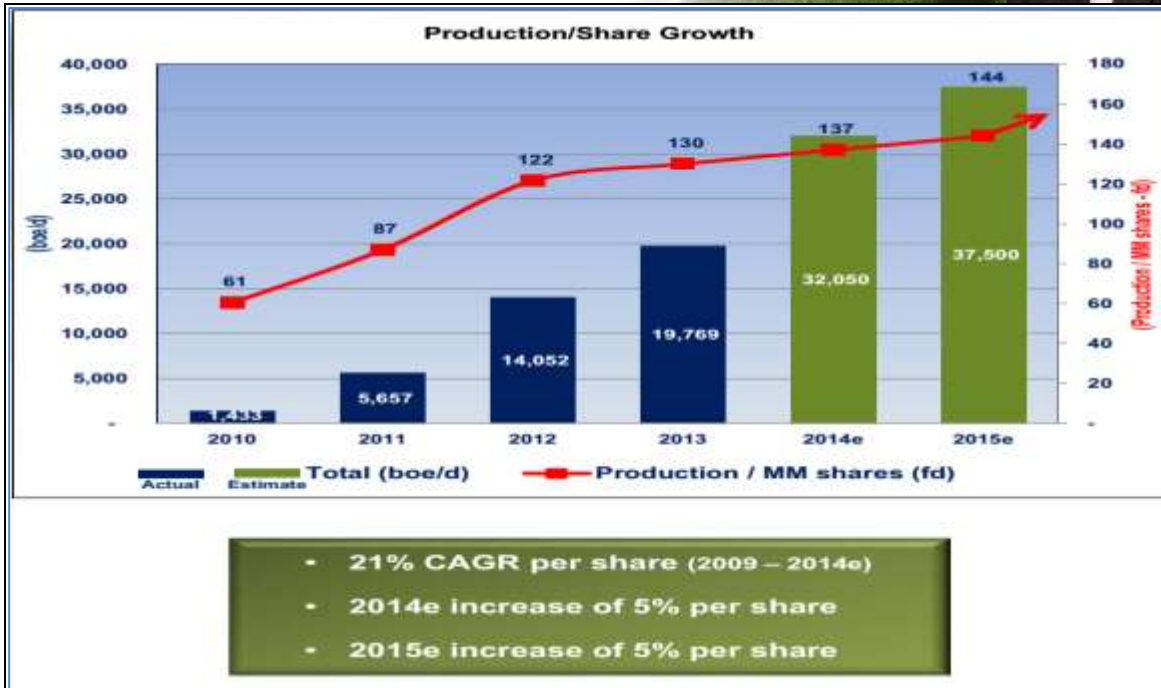
Time and time again, Fagerheim goes to the Street and raises cash at a premium stock valuation—and then buys assets or companies for much lower valuations.

A premium stock valuation is a huge competitive weapon for an acquisitive CEO. He sells equity to the Street at 8X cash flow and then buys assets for 5X cash flow.

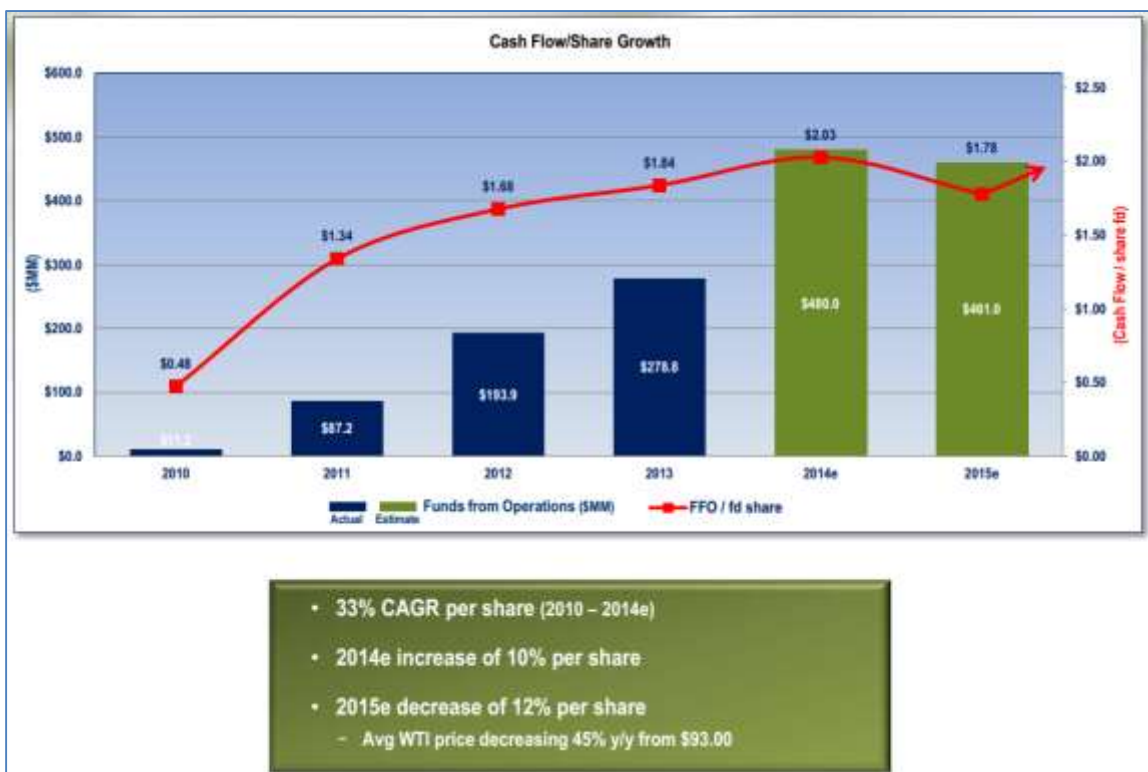
That strategy has allowed Whitecap to grow production from less than 1,500 boe/day in 2010 to an expected 37,500 boe/day in 2015.

And because these transactions are accretive it also translates into per share growth.

# OIL AND GAS INVESTMENTS BULLETIN



Production per share growth has been 21% per year and even more importantly cash flow per share growth of 33% per year.





Without leveraging up Whitecap's balance sheet Fagerheim has created a very fast growing company.

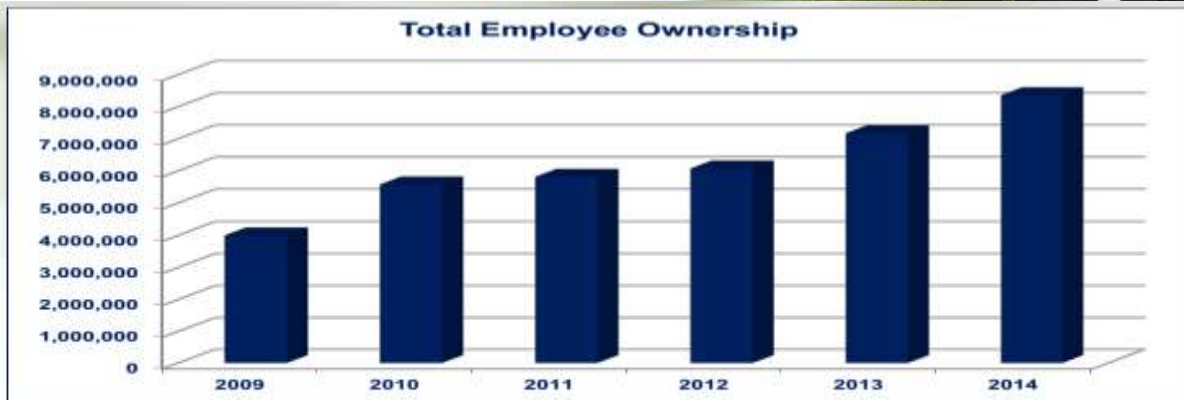
They also pay a dividend, and grow within cash flow. *They have sustainable (meaning self-funding) growth plus yield.* That means that every year all cash out in the form of dividends and capital spending needs to be covered by cash flow from operations.

It sounds like the common sense way to run a business, *but Whitecap is one of the few companies in recent years that have had the discipline to live within cash flow and not ring up ever higher levels of debt.*

The key to executing this plan is having top quality, high netback and low decline assets as well as maintaining a laser focus on costs at all times. Whitecap has assembled the perfect assets for this business model in a portfolio of high rate of return light oil plays.

Whitecap is one of the very few companies that can both maintain its dividend and production at prices as low as \$45 per barrel. And should oil prices stay at this level for an extended period of time--Whitecap will be on the right end of some very attractive asset acquisitions.

As you will find with all of these entrepreneurial CEOs, Fagerheim is not in this for the salary or for the annual bonus. He is in this to get rich by building a company. Therefore he owns a lot of shares, as do his top lieutenants and Board members.



- Since 2009 insiders increased common share ownership by 120%
- 8.36MM common shares owned by insiders and employees
- >\$125MM of capital at risk currently

## PROPERTIES

Whitecap has made a lot of acquisitions over a very short period of time. Every one of those acquisitions have been made with the company's long term business model in mind:

- A focus on reasonable (3 to 5%) growth within cash flows (excluding acquisitions)
- A conservative total payout ratio; cash in from operations is equal to or greater than cash out through dividends and capex
- Maintain a predictable and stable production base
- Focus only on areas with strong capital efficiencies (=cheap to get oil out)
- Build a large inventory of light oil drilling locations

This company is all about sustainability. The focus of the core business hasn't been all-out-growth; the growth has come through accretive acquisitions.

I don't like this approach, I love it.

Fagerheim has assembled a portfolio of high netback, low decline, light oil assets that are perfect for the dividend plus growth business model.



Like every good oil producer these days, Whitecap has ten plus years of identified drilling locations citing 2,229 in total. In the depressed oil price environment that is 2015 Whitecap is only going to drill 81 of those locations

At that rate it would actually take 27 years to drill them all.

The slide above lists 6 core light oil areas of operation. Realistically there are only two that are the focus for the vast majority of operations for Whitecap.

The Viking and the Cardium make up 83% of the listed drilling locations and will account for almost all of the wells drilled in 2015.



### Cardium Horizontal Resource Play

- **Cardium oil resource play – repeatable and expandable**
  - Light sweet oil (39° API)
  - Strong operating and cash flow netbacks (\$47 - \$51/boe)
  - Low risk optimization of 7 legacy Cardium oil waterfloods
- **Industry leading capital efficiencies (2011 to current)**
  - Focus on improving capital efficiencies through ERH drilling and advancing frac technologies
- **Drilling program**
  - 2014: 41 wells (9 ERH)
  - 2015: 30 wells (10 ERH)
- **Cardium Gross DOIIP 1,690 MMbbls (1,245 MMbbls net)**
  - Recovered to date 4.4% (73.7 MMbbls)
  - Possible oil RF = 14%

It is a bit hard to believe that it was as recent as 2010 that Alberta light oil production was in a state of decline. Back then we had the oil sands offering the promise of production growth for decades to come, but the heydays of light oil seemed well past.

Then the revolution that started in the Canadian oil business in the Bakken in SE Saskatchewan breathed new life into some big old oil plays.

In Canada there are no oil plays that are bigger, or older than the Cardium which was discovered way back in 1953 by Mobil Oil. The industry had produced over a billion barrels of oil from the Cardium before horizontal drilling and multi-stage fracking gave it a second life.

With almost 8 billion barrels in place, there is a lot of oil left to chase in the Cardium.

The thicker, highly permeable and porous rock in the Cardium was developed dating back to the 1950s. That is the good rock into which all you need to do is drill a vertical well in order to get high flow rates of light oil.

The focus now is on the edges of the play (called “halos”) where the rock isn’t as thick or porous. The halo areas of the play weren’t well suited to development with conventional vertical wells, but they can be developed with horizontal wells and fracking.

The land grab for this land took place in 2010. By 2011 slickwater fracking had allowed companies to establish an economic type curve. This was just one advancement of several that improve economics in tight oil plays each year.

You can see in the image on the previous page how the Cardium land that Whitecap has is set at the edges of the main Cardium pools. These are halo areas.

Each of the different Cardium pools (West Pembina, East Pembina, Garrington, Loch End, Willesden Green, Ferrier) have different economics. The gas-to-oil-ratio is not exactly the same in each pool and the formation is deeper in some places than others.

A higher oil weighting is better, as is a shallower depth which lowers costs.

Whitecap has exposure to several of the different Cardium pools.



### Exceptional Type Curve Economics

Type Well Economics	East Pembina Cardium	Garrington Cardium (Standard)	Garrington Cardium (ERH)	West Pembina Cardium
DCE&T (\$MM)	\$2.50	\$3.00	\$3.60	\$3.00
Production, IP30 (boe/d)	230	320	476	317
Production, IP365 (boe/d)	83	113	164	159
P+P <sub>A</sub> Reserves (Mboe)	182	227	321	222
Year 1 Oil + NGLs (%)	89%	85%	84%	92%
NPV BT <sub>10</sub> (\$MM)	\$1.92	\$2.53	\$4.01	\$3.68
Profit to investment ratio	0.8	0.8	1.1	1.2
Rate of return (%)	34%	41%	61%	102%
Payout (years)	1.88	2.36	1.58	1.09
Reserve cost (\$/boe)	\$13.74	\$13.22	\$11.21	\$13.51
Production efficiency (\$/boe/d – IP365)	\$30,120	\$26,549	\$21,951	\$18,868
Initial operating netback (\$/boe/d)	\$51.00	\$46.93	\$47.29	\$51.41
Recycle ratio	3.7	3.6	4.2	3.8

The best economics by a considerable margin reside in West Pembina which is the most “oily” part of the play. The numbers for each of the pools are provided above by Whitecap. (DCE&T=Drill, Complete & Tie-in)

It will take Whitecap a long time to drill through its 662 Cardium drilling locations, but there is more work to do here than just that. Other operators have started waterflooding parts of the horizontal play recently developed.

Waterflooding *can* greatly improve reserve recoveries, lower decline rates and increase the ultimate value of the properties.

Investors have really only seen “Act 1” from all of these horizontal oil plays. Over time we will see the industry squeeze a lot more oil out of these big hydrocarbon deposits.



Not surprising—given his focus on high quality plays—Fagerheim has had Whitecap also build up a significant position the Viking in southern Saskatchewan.

### Western Saskatchewan Viking Oil

- Light oil (36° API) Viking resource play
  - Strong capital efficiencies, short payout periods
  - Decline mitigation via waterflood
- Improving capital efficiencies
  - Drill & complete costs continue to improve
  - decreased 29% from 2011 to current
  - Type curve improvements since 2011
- Drilling program
  - 2014: 110 Hz wells
  - 2015: 55 wells
- Gross DOIIP 1,314 MMbbls (1,133 MMbbls net)
  - Recovered to date 2.1% (27.4 MMbbls)
  - Possible oil RF = 9.1%

Type Well Economics	Lucky Hills/Viking	
	Type A	Type B
DCE&T (\$MM)	\$0.90	\$0.90
Production, IP30 (boe/d)	118	105
Production, IP365 (boe/d)	56	43
P+P <sub>A</sub> Reserves (Mboe)	75	55
Year 1 Oil + NGLs (%)	78%	78%
NPV BT <sub>10</sub> (\$MM)	\$1.24	\$0.74
Profit to investment ratio	1.4	0.8
Rate of return (%)	113%	63%
Payout (years)	1.10	1.70
Reserve cost (\$/boe)	\$12.00	\$16.35
Production efficiency (\$/boe/d – IP365)	\$17,200	\$20,730
Initial operating netback (\$/boe/d)	\$45.50	\$45.00
Recycle ratio	3.8	2.8

Whitecap Viking Type Curve Evolution

Like the Cardium, the Viking was developed conventionally dating back decades. Also like the Cardium, horizontal drilling has given the Viking a new lease on life.

Over 8,000 vertical wells have been drilled into the Viking since the 1950s but recovered only a small percentage of the oil in the ground.

The Viking *could* be the best horizontal light oil play in North America. The formation is shallower and so lower cost than most horizontal oil plays.

Viking wells don't have big sexy flow rates. But that isn't a problem since the costs of developing are lower, so the wells are still very profitable. The Viking also offers great potential upside through waterflooding.

If the oil price gets so low that Viking wells don't make any money, then chances are there isn't anywhere else in North America where you can drill a profitable well either.

In addition to the Cardium and Viking, Whitecap has another 300 oil drilling locations in eastern Alberta and western BC in its Dunvegan and Boundary Lake assets.



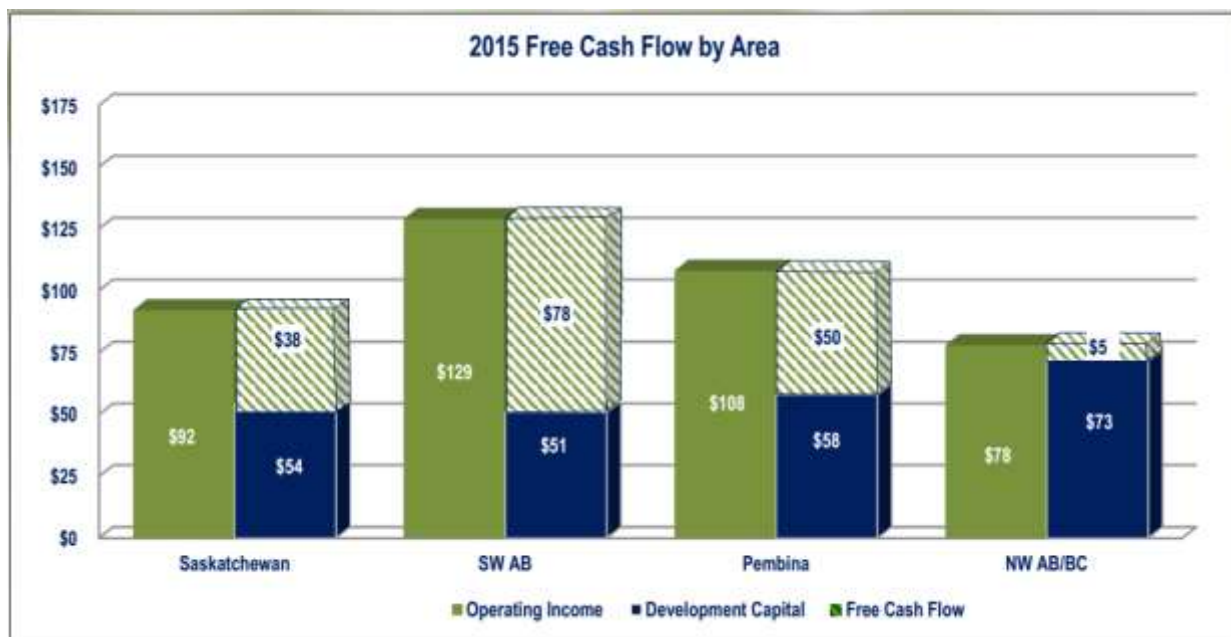
Most of the drilling in 2015 though, will be directed at the two main plays.

Offsetting the high rates of decline that these horizontal wells have is a challenge. To keep production levels up and growing—requires a frantic level of drilling.

So Whitecap has acquired lower decline conventional properties. They don't have large drilling inventories to increase production—but they provide steady cash flow that doesn't need much spending to maintain.

The combination of these lower decline cash flow properties with horizontal growth opportunities is what has given Whitecap the ability to be a self-sustaining, dividend paying, low debt company.

As you can see from the chart below, three of the four main operating areas for Whitecap will produce significant free cash flow even at \$65 per barrel oil.





## FINANCES / VALUATION

You can successfully run a company if you combine good assets and a mediocre balance sheet. You can also successfully run a company with mediocre assets and a good balance sheet.

It is when you combine good assets and a good balance sheet that you become a top quality company. The image below speaks volumes about the quality of Whitecap.

<b>2015 Whitecap Sustainability</b>				
Oil (US\$WTI)	\$45.00	\$55.00	\$65.00	\$75.00
Edm Par Diff (US\$WTI)	(\$7.00)	(\$7.00)	(\$7.00)	(\$7.00)
FX (C\$/US\$)	\$0.81	\$0.83	\$0.85	\$0.87
AECO (C\$)	\$2.50	\$2.50	\$2.50	\$2.50
CF netback (\$/boe)	\$26.75	\$29.90	\$33.00	\$35.70
Average production target	36,000	36,500	37,500	37,500
<b>SMM</b>				
Cash flow	\$351	\$401	\$451	\$488
Development capital	(\$200)	(\$225)	(\$245)	(\$245)
Dividend	(\$191)	(\$191)	(\$191)	(\$191)
Free cash flow	(\$40)	(\$15)	\$15	\$52
Total payout ratio	111%	104%	97%	89%
D/CF	2.4	2.0	1.8	1.5
Projected growth per share	1%	3%	5%	5%

The \$45 per barrel WTI model shows you the strength Whitecap has. At that oil price the company is going to generate \$351 million in cash flow and need to spend \$200 million in order to grow production by 1% per share.

That means that the company is generating cash flow that is \$150 million more than it needs to sustain production. Whitecap will pay that cash out in the form of a dividend, but it could just as easily be used to pay down debt or to drill wells which would actually create significant growth in 2015.



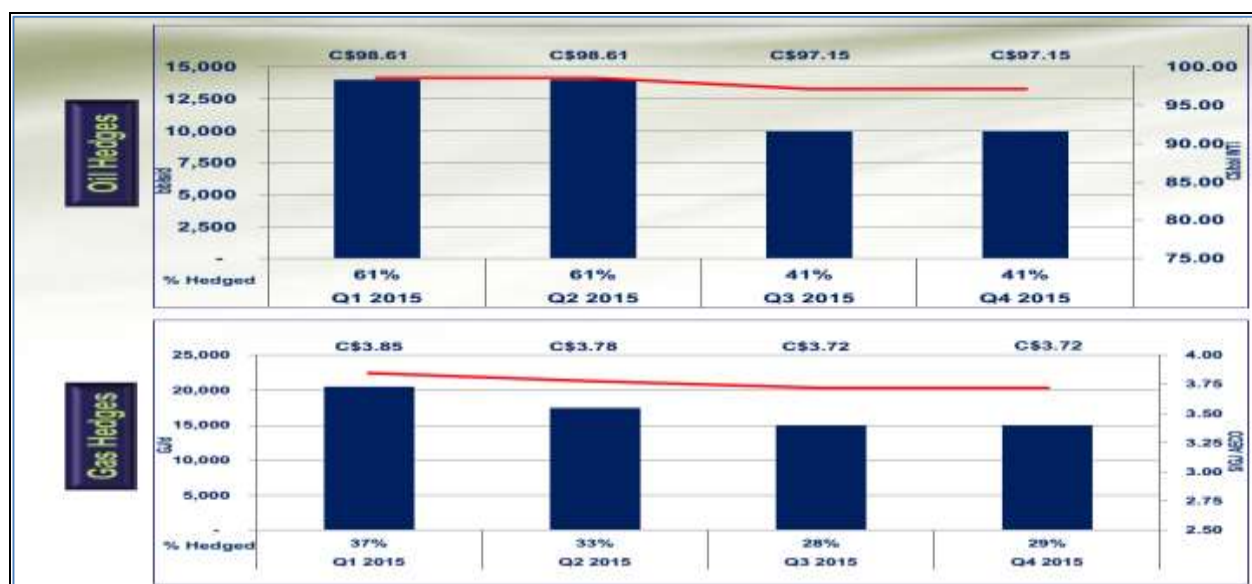
I recently read a study by Nathan Weiss of Unit Economics of 33 senior and intermediate US producers. The study showed that these companies on average need WTI prices of more than \$90 per barrel in order to be able to self-finance a stable level of production.

In recent years these companies have been relying on the generosity of lenders to grow because even at high oil prices they wouldn't have been able to grow with self-generated cash flow. Imagine how production at these companies is going to fare now that oil has been cut in half.

Meanwhile, Whitecap can self-finance at WTI \$45 per barrel while still paying a significant dividend. Every producer in North America would fall before Whitecap ever would.

At \$45 per barrel Whitecap's leverage ratio creeps up to 2.4 times debt to cash flow. That is higher than the company would like, but remember that it still has \$150 million of excess cash flow that goes towards the dividend that could be re-routed to balance sheet improvement if desired.

Whitecap is pretty well hedged for the year, about 61% in the first half at \$98 per barrel and 41% in the second half.





Valuation wise, Whitecap has never looked cheap. As I mentioned, that has unquestionably been a good thing. Time and again the company has been able to issue equity at high valuation multiples and acquire assets at low multiples.

This is a strategy that has created value per share in every instance and why an expensive valuation is not necessarily a reason to not by a stock.

Today Whitecap is trading at about 8X 2015's cash flow based on \$65 WTI prices. If you were to assume that in 2016 oil prices might be considerably higher, then that multiple of cash flow would much lower against 2016's cash flow.

The reality is that oil can't stay where it currently is forever. Almost the entire industry is unable to drill profitable new wells at current prices. To me that means that Whitecap is very cheap relative to the cash flow it will generate once oil prices rebound.

And importantly, most importantly. Whitecap is certain to be a company that will around to enjoy those higher oil prices and will likely do so with some new assets that it picked up from distressed competitors between now and then.

## WHAT THE ANALYSTS SAY

Research Coverage		Current Price Targets	
• AltaCorp Capital Inc.	\$15.00	• GMP Securities	\$17.50
• Barclays	\$18.00	• Macquarie Equity Research	\$19.00
• BMO	\$13.00	• National Bank Financial	\$18.00
• CIBC World Markets Inc.	\$18.50	• Peters & Co.	\$15.00
• Cormark Securities	\$22.00	• RBC Capital Markets	\$17.00
• Desjardins Capital Markets	\$16.00	• Scotiabank Global	\$16.00
• Dundee Securities Ltd.	\$14.00	• TD Securities	\$14.50
• FirstEnergy Capital	\$17.00		



## STOCK CHART





## CONCLUSION

Fundamentally, I think Whitecap is probably the single best oil producer in all of North America. Who else can run a sustainable business model and throw off \$150 million of cash flow at \$65 oil?

Of course, oil is lower than that—but that means other producers have seen their valuation drop a lot more. WCP still has a big competitive edge in valuation.

Great assets, great team, lots of banking support for M&As—I'm very excited to see what opportunities the company is able to pounce on over the next 12 to 18 months.

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