OGIB INTERIM BULLETIN #502 - July 28th, 2016

A 2-IN-1 BULLETIN
AND A MAJOR APOLOGY

OK, for the first time in a while, my multi-tasking caught up with me and causes me huge embarrassment.

The first interim bulletin you will read below was written and ready to go last Friday...and for some brainless reason it didn't go out to you all. And I didn't realize it until today. I am so sorry for being so sloppy. Ugh.

In that Interim Bulletin I said I'm bearish oil short term through the shoulder season (Sept-Oct) and I'm shorting Baytex to play it.

I also shed some light on Mark Papa's Silver Run and how it compares to Resolute. The Street IS going to do something with Resolute to fix that glaring value gap--I just don't know if it's a dividend company being hived off with the Utah assets, a buyout by someone like Silver Run, or a financing.

Below the first bulletin is today's real bulletin--just updates on the first bit of Q2 reporting that is coming in--**Pacific Ethanol, Baytex and Secure Energy**.

Before all of that, a few market comments:

I do expect oil to grind lower through the rest of the summer and into the early fall. The Market attaches its psychology to different "facts" or sets of facts all the time. Right now it's focused on the product glut, and the oil glut--not on rig counts.

September and October are also sketchy months for the US indexes, and to me it makes sense I look to start increasing any positions in oil stocks during the choppy and fearful trading that often develops in those months.

Natgas fundamentals have been strong lately, with weekly injections coming in below expectations most weeks. To me it's now more likely that the North American market will not hit storage congestion this year--but still be full.

That sets the Market up to have a Huge Run Up--IF IF IF we get a very cold winter; a 3 months Polar Vortex. La Nina is real; it's happening so far.

It was disappointing to see both Consol and Southwestern say they are ready to ramp up production later this year. But demand continues to increase, and while production is not dropping much it's not going up 3-5 bcf/d like it has most of each of the last 10 years.

Smaller natgas producers are being squeezed out of this Market as you need to have very low costs to make money at $2.50-$3/mcf natgas pricing. That's why I'm sticking to Advantage Oil and Gas and Range Resources.

Natgas prices didn't jump today on a quite bullish injection. I think that means the Market sees these next two weeks as peak heat, and expects demand could fall off right through the shoulder season.

The Canadian natgas market has had a dramatic turnaround to the positive, as Alberta actually withdrew 4 bcf from storage last week. Earlier this year I thought natgas up here would go no-bid, (and it got as low as 5 cents for a few minutes) at some point this summer, but as US natgas prices are down today, Canada is up 15 cents to $2.42/GJ.

My negativity on Canadian pricing kept me away from Painted Pony, whose stock has done amazing things this year. I am so happy for CEO Pat Ward, who is a true gentleman of the industry.

LAST FRIDAY INTERIM BULLETIN
PORTFOLIO **SHORT**
BAYTEX ENERGY
BTE-NYSE/TSX

PORTFOLIO PURCHASE

SILVER RUN ACQUISITION
SRAQU-NASD

PORTFOLIO SALE
WHITECAP ENERGY

Shorted 10,000 BTE-TSX at $6.88 this morning. Cover at $7.51 if I'm wrong. Once the Baker Hughes rig count # came out (+14) and the stock dipped below its 50 dma, it was time to try this trade.

Macro call; nothing company specific. ETF investors could try DWTI, the 3x levered negative oil ETF.

I also sold the last 1500 Whitecap at $9.69 for very small gain; pennies.

RESOLUTE--the comps keep coming.

There has been a string of (freakishly) fortuitous news releases about the Delaware Basin just after I purchased Resolute. Just yesterday I told you what I DIDN'T know about Resolute--well that changed this morning with more details about Mark Papa's Silver Run purchase of Centennial. Check out the news under **SRAQU-NASD**.

They will own 89% of Centennial, and they are issuing 20 million shares at $10 to help finance the deal. Here is the valuation they say they will have as a Delaware pure play:

"The anticipated initial enterprise value of the combined company is approximately $1,735 million, implying a multiple of 12.6x and 6.6x projected calendar 2017 and 2018 adjusted EBITDA, respectively, and post-closing equity value of $1,835 million at $10.00 per share. Silver Run expects to be debt-free at the closing of the transaction and have $100 million of cash-on-hand and an undrawn revolving credit facility to fund future drilling and acquisitions"

First off, 12x EBITDA in the Permian is cheap--most good ones are 15-18x. So that leaves some immediate upside for SRAQU. I have little doubt Mark Papa's name will give it TOP premium. So I bought just 1000 shares at $11.57. I would buy a lot more if I didn't think oil was going to $39/b first.

If we back out the 7212 boepd they had in Q1 at $40K/flowing boe, that's $288.5 million of the $1.735 billion EV. That leaves $1.4465 billion divided by 1357 identified locations--for a value of $1,066,000 per location.

That's not as high as Diamondback, but this deal is being done at metrics about 20-30% below market based on EBITDA multiple. Resolute has 147 net locations, for a value of $156.7 million.

The math for Resolute EV on this valuation only drops $100 million, or $6.45/share off my $27.87 fantasy number based on the Diamondback deal last week--**still gives me $21.42/share.**

Centennial Highlights (from the release

- Pure-play core Delaware Basin company
- 42,500 net acres primarily in Reeves and Ward counties
- Approximately 7,200 boe/d of net production
- 48.6 MMboe of net proved reserves as of June 2016 based on internal estimates
- Stacked pay consisting of 5 currently producing shale zones with upside for 7 more
- 1,357 gross identified potential horizontal drilling locations
- Among the best performers in the Southern Delaware Basin based on production per lateral foot

TODAY'S INTERIM BULLETIN

OK—Q2 reporting season has started, so there is LOTS of news.

Unless I own a large position in a stock, I don’t dive too deep into quarterly statements. Most commodity stocks are calls on the commodity itself. Obviously I look for low cost producers and others who are innovating technically to increase production and lower costs more than the rest…but for most of my positions I’m just looking to see how or why they did or didn’t beat the street on consensus numbers.

If I see/hear something in sell side research after the call, I call management for clarification…so most of my comments are high level and not granular.

PACIFIC ETHANOL – PEIX-NASD

PEIX reported Q2 revenue of $422.9 million (consensus $383.5 million) and earnings of $.11 per share (consensus $-.04). Adjusted EBITDA was $20.4 million, well above consensus expectations of $11.2 million.

When I first bought PEIX earlier this year, I thought PEIX would meet or even beat consensus of annual EBITDA of $58 million in the middle two quarters. Consensus will have to go up now, which should be good for the stock.

Ethanol production gross margins appeared to be $.121 per gallon. So far in Q3, Pacific Ethanol's gross production margins are roughly $0.25 per gallon, double those reported in the first quarter. If the quarter-to-date average persists (quite likely), PEIX should report third quarter EBITDA of $31.4 million.

Pacific Ethanol sold 122.5 million gallons of ethanol produced by their plants during the quarter—95% capacity!—up from 112.9 million in Q1 at an average sales price of $1.72 per gallon vs. $1.53 in Q1. Third party ethanol sales were 110.7 million gallons, besting the previous record of 102.0 million gallons set in Q3 2015.

It looks like the average Midwestern ethanol plant earned spot margins of $.285 per gallon (Valero reported operating income of $.48 per gallon of production this week) while generic West Coast margins averaged $.125 per gallon. The recently-acquired Aventine plants still need upgrades and modernization, so there should be margin expansion potential there.

Even with no increase in Enterprise Value (EV=market cap + debt), the stock should perform better as more of the EV is made of equity value, as they pay down debt from the Aventine acquisition. PEIX is still likely debt free on the four western plants. Long Term debt did increase this quarter by $12.1 million however.

BAYTEX (BTE-TSX/NYSE)

I’m short Baytex; not because it’s a bad company—I actually like mgmt a lot—but I find it a great ETF substitute to make calls on oil. I’m short 10,000 shares at $6.88.

In their quarter, they revised down production guidance by 2000 boepd to 67K-69K boepd due to selling assets. They beat the Street with 39 cents CFPS vs. consensus of 35, and only spent 44% of cash flow. They exited Q2 with net debt of 5.5-6x cash flow at $1.943 billion.

It’s that outsized debt and normal valuation that is causing the Street to take profits after a $1.50-$8 run.

They have brought on 6500 of their 7500 bopd of heavy oil as oil prices moved up—but of course now oil is moving down and the Canadian heavy oil differential is moving out so this move may have come too soon.

SECURE ENERGY – SES-TSX

This is one of my favourite energy service names—likely the favourite right now—though the case for OFS stocks (OilField Services) is still tough. There is a full report in the Members Centre on Secure, and though it’s dated (August 2014), it explains the the three pillars of their business model—drilling mud (like CEU), terminalling (cleaning and selling) oil (the core of the company) and Onsite Services.

EBITDA was $8.5 million vs. consensus of $7.4 million. Revenues were lower than consensus but margins were higher. Debt is hanging around 2x cash flow, and they’re spending $50 million of capital this year. Their maintenance capital is minimal here, so if things REALLY got tough they could turtle the company better than most.

This stock got beat up badly, and the shine of the company’s premium valuation from 2009-2014 took a hit as they bought an oil-by-rail company at the top of the market—just as the differentials for oil came in and made that $100 million acquisition redundant for awhile.

Should oil prices go lower, and the WCS discount widen (it is slowly widening now as concerns that Canada is filling its pipeline capacity up) then this deal may contribute more EBITDA next year.

-Keith