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Blog Post: Closing the Discount: Pender's Approach to the Unloved Parts of the Energy Sector

Our focus on identifying high quality businesses that generate strong returns on invested capital and have promising internal reinvestment opportunities generally results in our funds having little to no exposure in resource companies. That said, we're always opportunistic, especially if we find a stock that we believe is trading at a substantial discount to a conservative estimate of intrinsic value, regardless of sector. The key with all potential "Close the Discount" ideas is to ensure there is a sufficient margin of safety and a potential catalyst or market forces which can close that discount in a time frame that generates a good return.

Hard to compound a burned barrel

In addition to being highly volatile and cyclical, resource companies tend to be capital intensive price takers and subject to evolving regulatory risks. The business of an oil producing company is to exploit and sell an underlying asset that is undifferentiated and finite. So as existing resources are exploited, new resources have to be developed or acquired to sustain even a flat level of production. Selling a commodity in an industry with excess capacity and declining barriers for new capacity, thanks to advances in shale oil extraction, means the price of oil is more of a reflection of direct operating costs rather than capital employed. This means that over a cycle, an oil producing company may generate a low and, in some cases, negative return on capital. Contrasted with capital light compounders with differentiated products, pricing power, network effects and captive markets, it's evident that resource companies are generally structurally inferior businesses.

That's not to say that investing in resource companies can't generate significant returns. It's just hard finding companies in the sector which can generate sustainable long-term capital appreciation. This leads us to view potential investments in the resource sector as 'renting' not 'owning'. Since we have no idea where the oil price is going, we focus on opportunities where we hold an investment edge and where we can take advantage of market inefficiencies. A significant disconnect between price and value can happen when a stock is too small, unloved or misunderstood by the market and this is something we can exploit. Behavioral biases can also grasp an entire sector, like the extreme pessimism exhibited in the energy sector in recent years when oil prices fell below the cost of production and energy stock valuations implied this environment would persist. When looking for potential investments in the sector we also focus on idiosyncratic characteristics like hidden assets or special situations where the catalyst to unlocking value is not dependent on the underlying commodity price. Having small and nimble mandates allows us to take advantage of these limited opportunities when they arise in the market.

Athabasca Oil Corp

Athabasca Oil Corp, a position we initiated in the Pender Value Fund and Pender Canadian Opportunities Fund early in 2018, is an example of a company which exemplifies the market inefficiencies we look for. Athabasca went public in 2010 as a pure-play oil sands producer and was one of the largest and hottest IPO's at the time, raising $1.35B at a nearly $7B valuation. Immediately following the IPO the company started to run into problems which continued for years, with the final nail in coffin being the collapse of oil in 2014-2016, driving the shares down over 90% from its IPO price.

We came across Athabasca after screening for out-of-favour energy companies and, as we started to dig further, we found many attributes which increased our interest in the company. Most of the former management team and board had been replaced and the company had a new strategy focused on diversifying away from heavy to light oil. Management had also found creative ways to raise capital. One initiative was to sell royalty streams which only kick in when oil prices are considerably higher than current levels. So, if there's ever another bull market in oil, the company gives up a little bit of upside in return for valuable capital in an environment with constrained energy sector funding. The company also entered into a joint venture with one of their oil plays. Athabasca received a large cash payment and struck a unique capital carry agreement whereby it contributes only $75M on the first $1B of investment into the project, yet it maintains a 30% working interest. This agreement allows Athabasca to de-risk the development of the project that would be too large and capital intensive to complete on its own, while receiving favourable economics and optionality in return.

The new management team was able to use the capital raised from these transactions to take advantage of a unique situation in the Canadian oil sector last year. Statoil, a Norwegian state-controlled energy producer, had poured billions of dollars into the Canadian oil sands in the previous decade, along with many other multinational energy giants. With the subsequent collapse in oil prices and increased environmental concerns, the Norwegian government pressured Statoil to make an expedited exit from their oil sand assets. Athabasca was able to acquire Statoil's assets through a non-competitive process at highly favourable terms. The acquisition of Statoil's Canadian assets included several infrastructure assets which have significant market value but were not reflected in the acquisition price.

Despite the new management team progressing on a successful transformation and the acquisition from Statoil, the share price continued to languish as its tumultuous history had left its mark on investor sentiment. Market inefficiencies can arise when investors get anchored to a specific view of a company. There is a tendency for investors to avoid or overlook an investment they were previously burned by, disregarding sell-side research as the bankers and brokers who had previously promoted the company have lost credibility. Our process allows us to take advantage of these sorts of situations where behavioural biases result in the mispricing of a security. Athabasca's management announced earlier this year that they would look to monetize their "hidden" infrastructure assets with the proceeds likely going towards debt repayment or capital return, which should be a catalyst for a correction in the share price.

None of this is to say our investment in Athabasca is without risk. As a high cost, heavy oil producer with concentrated assets, the company has a high-risk profile and high leverage to the price of oil. But, leverage cuts both ways and we have been fortunate this year with rising oil prices. Even with oil prices remaining flat or declining moderately, we still see several catalysts ahead, which could unlock value in Athabasca's share price.

Energy XXI Gulf Coast

While finding these opportunities are rare, occasionally market participants have structural limitations which force them to trade for non-fundamental reasons, creating a market inefficiency which can be exploited. Energy XXI Gulf Coast is a US offshore oil producer with operations primarily off the coast of Louisiana. The Pender Value Fund had previously made a successful investment in the distressed credit of the company alongside the Pender Corporate Bond Fund and we saw an opportunity to leverage our competency again with the company's equity. Energy XXI ran into issues when oil prices collapsed and with a highly levered balance-sheet, the company was forced to file for bankruptcy in April 2016. It went through a restructuring process completed in early 2017 where the majority of debt was eliminated and debt holders received new equity positions.

Coming out of restructuring, Energy XXI had a strong balance-sheet with a net cash position, a large resource base of proven and probable oil reserves and existing productive assets. However, many previous debt holders who now held shares in the company had investment mandates which prevented them from holding an equity position in their funds. This resulted in over half of the company's outstanding shares being liquidated into the market over a short nine-month period, driving the share price down from ~US$28 to a low of under US$4. While some of the share price decline was driven by operational issues, the majority of the decline was driven by non-fundamental selling due to restrictions placed on investors. We used this to our advantage in building a position in the Pender Value Fund late in 2017. With a net cash position and probable oil reserves conservatively worth over $1.5B we believed there was a significant discount to value reflected in the share price. As a micro-cap stock in an unloved sector of the market and lacking sell-side coverage, a significant disconnect between Energy XXI's share price and its underlying value can persist. Our investment thesis was that eventually other market participants would search out these anomalies and close the discount and in fact this came to fruition. In June 2018 the company announced an agreement to be acquired by an affiliate of Cox Oil for US$9.10/share.

Playing the odds

Investing in resource companies generally carries a high level of uncertainty and risk as the largest driver of returns, the price of the commodity being produced, is unknowable in the long-term. Our focus on bottom-up fundamental active management provides us with the flexibility to invest in resource companies when we believe there is favourable risk to reward. Evaluating the risks and taking a contrarian viewpoint increases our conviction of a positive outcome with these opportunistic investments.

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July 18, 2018

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