

# PALOS

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## Weekly Commentary

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## Tourmaline Oil Corp. – Three C's: Consolidation, Cash Flow & Creating Value for Shareholders

**Tourmaline Oil Corp.** (TOU: TSX) is an intermediate oil and natural gas producer with operations focused on the Western Canadian Sedimentary Basin (Alberta and BC). Core operations are located in the Montney play (North East B.C.), the Alberta Deep Basin, and the Peace River complex. Production is currently weighted to natural gas (70% of production) with condensates, oil, and natural gas liquids (NGL's) rounding out the mix.

Tourmaline reported Q1/2021 results on May 5. Highlighting the quarter was record cash flow of CAD\$629 million (\$2.11/fully diluted share), a 122% increase over Q1/2020 and 59% higher than Q4/2020. Record Free cash flow (FCF) of \$233.5 million was used to finance the dividend and reduce debt by approximately \$153 million. Cash flow forecasted for the full year has remained at \$2.2 billion with a FCF yield of \$1.1 billion. TOU provided an update to its 5-year plan. Guidance for 2021 points to increased capex (+10.7%) and higher production (+3.2%) as well as FCF projection of \$4.5 billion by 2025 (+9.8%). Net debt was reduced by 8.6% in the quarter. The strong performance was attributed to better than expected well dynamics, improved pricing, acquisition integration and capital spending efficiencies.

After the market close on May 18 Tourmaline announced three strategic acquisitions. The first was Tourmaline's purchase of a 50% interest in privately owned **Saguaro Resources Ltd.**, a private company with acreage in the Montney. The \$205 million acquisition includes Saguaro's Laprise asset, which is situated adjacent to other Montney assets that were acquired by Tourmaline in 2020 (Polar Star and Chinook). Tourmaline will assume responsibility for operating the joint venture. Secondly, a series of three smaller acquisitions (\$55 million) will add strategic Montney assets to the portfolio. Finally, TOU confirmed the closing of three smaller tuck-in acquisitions for \$55 million. This included 49km of condensate pipeline with a capacity of 34 mboe/d, further strengthening the Montney complex.

In addition to acquisitions, management announced that TOU had completed an arrangement with **Topaz Energy Corp.** (TSX: TPZ) whereby TPZ will acquire a Gross Over-Riding Royalty (GORR) for \$245 million in cash. By definition, a GORR provides the purchaser with an ownership entitlement on top line production revenues.

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The Topaz deal includes a GORR on recently acquired Montney assets as well as a 10% working interest in the Gundy facility, which is also a key asset in the Montney. Proceeds from the GORR will be funneled towards financing recent acquisition activity.

Tourmaline has successfully transitioned from a growth oriented mid-cap E&P (exploration and production) company to a senior producer with a market cap approaching \$9 billion. The company has steadily increased its dividend, and the \$0.16/quarter dividend declared on March 10 is double the initial \$0.08/quarter dividend paid in 2018. Led by a well experienced management team, Tourmaline is positioning itself as the country's premier natural gas producer which includes a major footprint in one of the most promising jurisdictions (Montney). Should energy pricing and free cash flow trends continue to rise, TOU has the potential to be net debt free by 2023.

Another major tail wind is the eventual commissioning of the LNG Canada project being developed at Kitimat on the BC coast. The project should be operational by 2023/24 and will offer Canadian natural gas producers with access to Asian markets where pricing is historically much stronger than in North America. Should the Montney/LNG Canada dynamics play out as we expect, TOU is destined to become a cash generating machine, obviously good news for patient investors. The **Palos Income Fund LP** and the **Palos Equity Income Fund** have held shares in Tourmaline since our initial investment on September 24, 2019. Since then, TOU shares have seen a phenomenal return on investment of 124% (including dividends).

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) <sup>1</sup>	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$9.70	13.19%
Palos Equity Income Fund - RRSP	PAL101	\$7.21	13.40%
Palos Merchant Fund L.P. (Dec 31, 2020) <sup>2</sup>	PAL500	\$1.35	-21.15%
Palos WP Growth Fund - RRSP	PAL210	\$22.85	43.18%
Palos-Mitchell Alpha Fund <sup>3</sup>	PAL300	\$12.00	13.91%
S&P TSX Composite (Total Return with dividends reinvested)			13.20%
S&P 500 (Total Return with dividends reinvested)			11.28%
S&P TSX Venture (Total Return with dividends reinvested)			9.39%
Chart 2: Market Data <sup>1</sup>			Value
US Government 10-Year			1.62%
Canadian Government 10-Year			1.54%
Crude Oil Spot			US \$63.58
Gold Spot			US \$1876.70
US Gov't10-Year/Moody BAA Corp. Spread			203 bps
USD/CAD Exchange Rate Spot			US \$0.8285

<sup>1</sup> Period ending May 21, 2021. Data extracted from Bloomberg

<sup>2</sup> Fund is priced annually

<sup>3</sup> Fund is priced weekly on Tuesdays

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