



## 2 Small Caps With Amazing Potential

### Description

Investing in small-cap oil explorers and producers can be a risky business. However, while the risk maybe high, so is the reward for astute investors capable of picking those companies with bargain-basement prices and solid operations. With crude now trading at over \$100 per barrel and the narrower price differentials between Canadian crude blends and WTI set to boost cash flow and profitability, now is the time to take closer look at opportunities in the small end of the patch.

Here are two smaller players that offer investors significant potential upside.

#### **A recent sell-down leaves this intermediate producer significantly undervalued**

**Twin Butte Energy** (TSX: TBE) recently saw its share price crushed as the market took an immediate displeasure to its revised lower 2014 guidance. This has created a buying opportunity for risk-tolerant investors, with signs that the company is heavily undervalued by the market.

First, Twin Butte's oil reserves have a net present value, when discounted by 10%, of \$1.2 billion, or almost \$3.50 per share. This is a solid premium of 90% over its current share price, indicating that the market has yet to appreciate the value of the company's core assets: its oil reserves.

If the company continues to successfully execute its drilling and development program I would expect these oil reserves to grow, boosting the value of its core assets, which should see its share price appreciate.

Secondly, Twin Butte is heavily weighted to higher oil and natural gas liquids, making up 91% of its production mix. This allows it to generate a higher profit margin; as its operations mature and operational costs fall, it could generate a solid operating netback per barrel produced.

Twin Butte is also in a solid position to take full advantage of higher crude prices. This will significantly increase cash flow and mark an improvement in its bottom line.

Third, the market reaction to the revised 2014 guidance is overblown. The company has advised the market that its production is expected to be 6% to 8% less than previously forecast. But total crude

production will not decrease significantly, with the annual daily average expected to be around 22,000 barrels per day instead of 22,500 barrels.

The revised guidance also forecast the company's financial performance using an assumed average WTI price of \$97 per barrel. This is 6% lower than the current price and 1.3% lower than the December 2014 futures price. Thus, I am expecting Twin Butte to deliver a financial performance in line with that originally forecast.

Finally, when all of these factors are considered in conjunction with Twin Butte's push to boost higher-margin light and medium crude production in preference to heavy crude, its profitability can only continue to grow. This is because Canadian light and medium crude trades at a lower discount to WTI than heavy crude, which makes up around 56% of Twin Butte's crude production.

Clearly, the company's core assets and the value of its future production are heavily discounted by the market. When coupled with Twin Butte's quality assets and solid exploration program, it's clear that its share price can only appreciate in value over the long term.

### **This small-cap continues to remain under-appreciated despite turning its operations around**

Over the last year, small-cap oil producer **Zargon Oil and Gas** (TSX: ZAR) has seen its share price pop by a healthy 54%, but this still leaves it 40% down over the last five years. It was only two years ago when its shares were crushed because of poor operational and financial results, which were caused by management taking its eye off the ball and trying to grow too rapidly.

Since then, the company has refocused, divesting itself of non-core assets, preserving capital through targeted capital investments and cost savings, and focusing on boosting higher-margin crude liquids production. For the first quarter of 2014 oil and crude liquids made up 65% of Zargon's production mix. This was a 1% improvement over the prior quarter, but represented an 8% decline compared to the first quarter of 2013.

This decline can be primarily associated with Zargon completing the disposition of \$1.5 billion in property assets in southeast Saskatchewan. These proceeds, earmarked for retiring bank debt, have significantly strengthened Zargon's balance sheet.

This asset divestment program is also focused on lowering Zargon's cost base, which will boost the profitability of its core crude producing operations and lead to a higher operating netback per barrel. The success of this aspect of the restructuring program can already be seen by Zargon's operating netback for oil and crude liquids jumping a healthy 6% quarter over quarter and 14% year over year.

As a result, I believe that as asset divestments, an increase in higher-margin oil and crude liquids production, and cost-cutting take place, the profitability of Zargon's production will grow.

Both investments are high risk but it's clear that both have quality, low-decline assets and management teams focused on building higher margin crude and liquids production while reducing operating costs. Of the two, Twin Butte is my preferred option, but Zargon certainly offers investors considerable potential if the restructuring program is successfully implemented, which seems likely considering the volume of non-core asset sales completed to date.

### **CATEGORY**

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