Can a Deal Be Sweet for Both Sides?

Description

It's not surprising to see merger and acquisition activities in the energy space, seeing as the sector has been under some serious pressure in the last few years or so.

Oil prices seem to have stabilized above US$60 per barrel for now. The WTI oil price now sits at ~US$66 per barrel, while the Brent oil price is higher at ~US$71 per barrel.

Vermilion Energy Inc. (TSX:VET)(NYSE:VET) is a well-run, mid-cap oil and gas producer. On Monday, it announced the acquisition of **Spartan Energy Corp.** (TSX:SPE). For the day, the stock fell ~3%, while Spartan stock's movement was essentially negligible.

What's the deal?

The total consideration for Spartan is ~$1.4 billion, which consists of $1.23 billion of Vermilion stock plus the assumption of ~$175 million in debt. For each Spartan common share, shareholders will receive 0.1476 of a Vermilion share.

The Vermilion and Spartan management have unanimously approved the deal, which is still subject to customary closing conditions, such as approvals from Spartan shareholders, Toronto Stock Exchange, New York Stock Exchange, and regulatory bodies.

Vermilion is getting a good deal

Spartan is an oil-weighted (~91% oil), high-netback business with low-decline oil assets and strong free cash flow and future growth potential. Spartan will add 23,000 barrels of oil equivalent per day to Vermilion's production.

Obviously, Vermilion is getting a good deal. It's paying an enterprise-value-to-funds-from-operations multiple of 4.7 times for the acquisition, which will be accretive to its funds from operations per share by 15% and production per share by 7%. Vermilion's increased production guidance is now 86,000 to 90,000 barrels of oil equivalent per day.

Furthermore, the acquisition will improve Vermilion's debt ratio and payout ratio. Specifically, its net-debt-to-funds-from-operations ratio and payout ratio will be reduced from two times to 1.7 times and from 84% to 83%, respectively.

…But what's in it for Spartan shareholders?

When I wrote about Vermilion and Spartan last week as two energy stocks with strong upside potential, little did I know that Vermilion would acquire Spartan.

Vermilion is hardly paying a premium on Spartan. The deal implies ~5% premium to Spartan's market close price on Friday. However, here's the thing: Spartan shares will turn into Vermilion shares.

So, in another perspective, holders of Spartan shares will participate in the upside of energy prices via Vermilion, which has a bigger scale and is much more diversified. After the acquisition, Vermilion will generate ~48% of its funds from operations from Europe and Australia, where it enjoys premium pricing from Brent oil and European gas.

Most importantly, we do not know when these energy stocks will recover to higher levels. Vermilion stock's two-year high is ~$54 per share, and it's currently trading ~20% below that. It's even worse for Spartan stock; it's trading ~38% below its two-year high.

Spartan stock doesn't pay a dividend, but Vermilion does. Spartan shareholders will get a monthly dividend, an annualized dividend yield of ~6.5% based on Monday's market close price. So, with the acquisition by Vermilion, Spartan stockholders who choose to hold on to Vermilion stock will get paid generously to wait.

Investor takeaway

This isn't the kind of event that I expected to happen as a Spartan shareholder. However, I don't think it's a bad thing for Vermilion to acquire Spartan, because I'll now get a generous monthly dividend while I wait for the share price to appreciate.

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