

Behind stellar year for junior energy stocks lurks takeover talk

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Page: E1

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Since the bear market hit bottom last March, junior energy stocks have had an explosive run.

For confirmation, take a peek at Peters & Co.'s index of junior producers -- basically, firms that produce up to 5,000 BOEs (barrels of oil equivalent) per day.

As of Tuesday's close, the Peters benchmark had soared more than 144 per cent in value since the rally began last spring.

During the same period, Peters' index of major integrated players -- companies like Imperial and Suncor -- advanced just 39 per cent. And its basket of large-cap producers -- firms like EnCana, Nexen and Talisman -- rose 63 per cent.

Compared to the broader equity market, the stellar performance of junior energy plays like Yoho Resources, Cinch Energy, Orleans Energy and BlackPearl Resources is equally pronounced.

The Toronto Stock Exchange's lead index is up about 52 per cent since March, and the Dow Jones Industrial Average has gained roughly 59 per cent.

"The juniors came crashing down at the end of 2008, particularly with tax-loss selling, then bounced along the bottom until March," says Peters analyst Andrew Boland. "From the bottom it's been an incredible run, and the run has been in equities, not necessarily the commodities, so there's a bit of a disconnect there."

While oil prices have more than doubled since February 2009, and have held firm of late above the \$70-US-a-barrel level, natural gas prices have struggled mightily to get back to just \$6 per MMBtu (million British thermal units) -- a level reached only briefly during a fleeting cold snap in January.

"The oil-weighted names continue to be the place where people want to put their money, and the market is doing its best to bring in as many new oil names as possible, whether it's through recapitalizations of existing firms or private companies going public," says Boland.

On the gas side, the picture is murkier. With storage levels still high, shale gas a looming threat, and drilling activity starting to edge up, the price outlook remains weak. That, in turn, could trigger a big increase in merger and acquisition activity among the

juniors, once the winter heating season ends.

"I think there's still a lot of concern about storage and U.S. gas supply. So we're entering into a few months of uncertainty here, and how that translates into M&A activity is quite direct," says Boland.

With major producers like Suncor and Talisman already looking to sell huge natural gas packages, another dip in prices would only slam asset values further, and make it tougher for junior players that need cash to get a fair price for their gas holdings.

"I think that's what is going to push the takeover activity. It's been a pretty brutal couple of years for gas producers. If people get knocked down again, this might be the final straw," he says.

Analyst Arthur Grayfer, who tracks such hot junior stocks as Bellatrix, Delphi Energy, Painted Pony and Crew Energy for Canaccord Adams, regards all of them as potential takeover targets.

"The Cardium (light oil resource play in central-west Alberta) is the big driver for Bellatrix, and that's the reason I'd say the stock has been a strong performer," he says.

Now that larger, mid-tier producers such as ARC Energy Trust, NAL Oil & Gas Trust and PetroBakken Energy are in acquisition mode, and expanding their exposure to the Cardium, Grayfer says that will only intensify interest in juniors like Bellatrix.

Crystal Holdershaw, an associate with Calgary-based Sayer Energy Advisors, which tracks oilpatch M&A activity, agrees. Among the companies on her radar are NAL, West Energy and Bonterra Energy.

"The focus was on the Bakken play (in Saskatchewan) last year, but the Cardium is definitely where it's at now. There's already been some consolidation in the past few months, and that's going to continue."

So which junior stocks are worth a look now? Paradigm Capital analyst Dan Payne likes Terra Energy, among others.

Terra recently announced an asset swap that increases its land holdings in B.C.'s prolific Montney natural gas play. It also announced a \$115-million deal to acquire 2,000 BOE/day of liquids production, contingent on financing. Payne has a 12-month target of \$2 on Terra's shares. They closed Wednesday at \$1.58 apiece.

For its part, Peters & Co. currently carries an "outperform" rating on such juniors as BlackPearl Resources (12-month target: \$3); Cinch Energy (target: \$1.90); Orleans Energy (target: \$3.15); Wild Stream Exploration (target: \$6.75); and Yoho Resources (target: \$3.25).

Veteran Calgary money manager Josef Schachter, who tracks energy stocks for Toronto-based Maison Placements Canada, rates Delphi Energy as his top domestic junior pick, with a 12-month target price of \$2.80.

Schachter's favourite international stock is WesternZagros Resources, which has an active exploration program in the Middle East. His one-year target for the stock is \$2.50. It closed Wednesday at just 63 cents on the TSX.

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