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Canacol Energy

Q222 results update

Q2 results deliver strong operating cash flow

Oil and gas

Canacol reported EBITDAX of US$55.2m for Q222, up 24% compared to Q221 due to a 29% increase in natural gas revenues as a result of both increased production and average sales prices. This resulted in strong operating cash flow, with funds from operations up 16% to US$39.1m (Q221: US$33.6m). A non-cash deferred tax expense led to a net loss of US$6.4m for the quarter due to the impact of the weakening Colombian peso on unused tax losses and cost pools. The 2022 drilling programme of up to 12 wells is progressing, with six wells successfully completed to date and the high-impact Pola-1 well to be spudded by year-end. Meanwhile, the new Colombian government is expected to change the country's energy transition plans, having stood on a platform of ending new oil contracts. Finance Minister José Antonio Ocampo has, however, spoken of the importance of natural gas. In our view, the value of gas as a transition fuel increases with an accelerated shift away from oil and coal.

Year end	Revenue* (US$m)	Adjusted EBITDAX**(US$m)	Cash from operations (US$m)	Net debt*** (US$m)	Capex (US$m)	Dividend yield (%)
12/20	247	188	152	299	89	5.5
12/21	250	194	124	356	101	6.0
12/22e	272	209	169	450	184	8.9
12/23e	310	246	186	519	189	8.9

Note: *Revenue net of transport expenses and royalties. **Adjusted EBITDAX is before non-recurring or non-cash charges and exploration expenses. ***Cash and equivalents minus short- and long-term debt.

Change of government

Colombia's new left-wing government was inaugurated in August 2022, with President Gustavo Petro pledging to end new oil contracts in the country as part of its energy transition plans and the minister for mining and energy also announcing an end to new gas contracts. In contrast, Ocampo, the finance minister and an economist whose appointment is designed to calm markets, takes a more positive view of gas on the basis that it will be critical as a transition fuel.

470bcf Pola-1 to spud by end-2022

Canacol holds 11 contracts across Colombia, with gross mean risked prospective resources of 7.6tcf across 178 prospects and leads, and will investigate further larger features identified on 2D seismic with a 470km^2 3D seismic programme planned for this year. The Pola-1 well will be the first well to test new acreage in the Middle Magdalena Valley, and will target 470bcf (cf 2P reserves of 607bcf), so if successful will be transformational for the company.

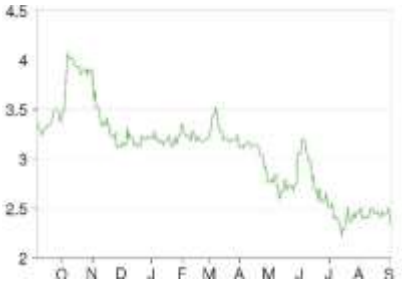
Valuation: Significantly undervalued

Our total net asset value (NAV) is based on a combination of 2P reserves and additional 'to be developed' risked reserves that we expect to be added over the next five years. We calculate the core NAV at C$2.29/share (previously C$2.24/share), to which we add C$4.08/share for additional risked reserves to arrive at our valuation of C$6.36/share, more than double the current share price. We believe the share price does not fully reflect the potential upside from exploration.

6 September 2022

Price	**C$2.42**
Market cap	**C$413m**
	C$1.25/US$
Net debt (US$m) at 30 June 2022	453
Shares in issue	170.9m
Free float	60%
Code	CNE
Primary exchange	TSX
Secondary exchange	BVC

Share price performance



%	1m	3m	12m
Abs	(3.3)	(27.2)	(30.2)
Rel (local)	(1.6)	(21.4)	(24.6)
52-week high/low		C$4.08	C$2.22

Business description

Canacol Energy is a natural gas exploration and production company primarily focused on Colombia.

Next events

2022 drilling	Ongoing
Pola-1 well spud	By Q422
3D seismic	Q422

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Edison profile page

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New government, new transition policy

Colombia's new left-wing government took over from the outgoing right-wing administration in August 2022. President Gustavo Petro was elected on a platform that included transitioning the country from fossil fuels to renewables through a policy of not awarding any new Colombian oil contracts. The appointment of philosopher and university professor Irene Vélez Torres as minister for mines and energy would appear to back up this commitment, given her background in socio-environmental conflicts. Since her appointment she has said that the government will grant no new gas exploration contracts and could import gas from Venezuela if reserves from existing projects are not sufficient to manage the transition. Vélez Torres has subsequently acknowledged the importance of natural gas and maintaining self-sufficiency for Colombia. Imports from Venezuela would be problematic since the Venezuelan state oil company Petróleos de Venezuela (PDVSA) is subject to US sanctions, although US officials have been in discussions with the Venezuelan government this year as part of attempts to mitigate the impact of the Russian invasion of Ukraine on oil prices.

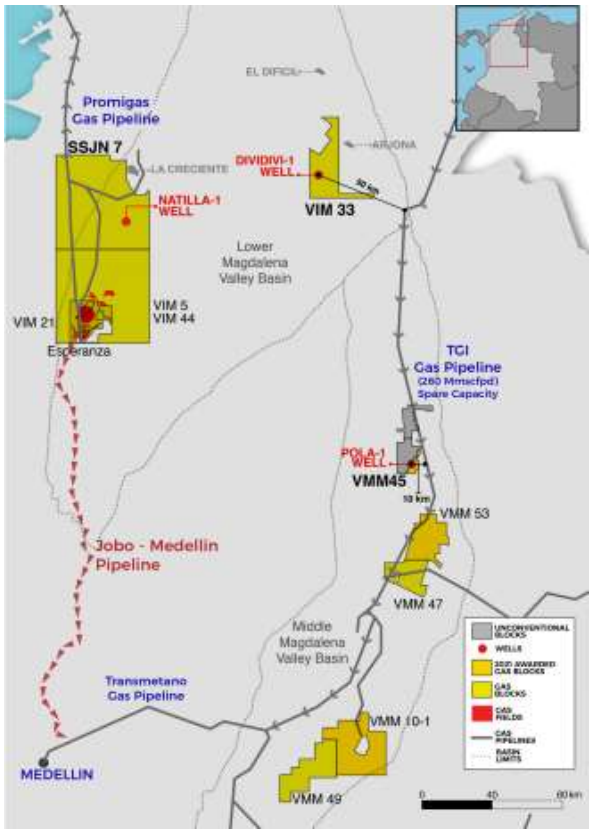
This potential shift in policy is, however, balanced by the more moderate views of the new finance minister, José Antonio Ocampo, who has stated that, although the government will halt oil exploration, gas exploration will be required as a transitional energy source and as such will continue to be required. In our view, the importance of gas as a transition fuel increases with an accelerated shift away from oil and coal. Ocampo is an experienced economist whose appointment is seen as a signal to reassure markets. He has served as finance minister and agriculture minister in the past and has experience working at the UN and Banco de la República (Colombia's central bank).

Canacol has plenty of running room within its existing acreage. The company holds 11 exploration and production contracts in Colombia, with five in the core producing Lower Magdalena Valley (LMV) and six in the new high-impact Middle Magdalena Valley (MMV). The company has identified 178 prospects and leads across this acreage, which was independently verified to hold gross mean risked prospective resources of 7.6tcf (unrisked 20.5tcf) by Boury Global Energy Consultants as of December 2021. The bulk of these prospective resources, 6.6tcf, sit in the MMV and is currently untested, but will be crucial to maintaining the company's goal of maintaining a 2P reserves replacement ratio of 200%. Canacol's first test of this new area will be the Pola-1 exploration well, due to spud by the end of 2022. The well is targeting 470bcf of mean gross risked prospective resources. Success here would be transformational for the company, given that existing 2P reserves are 607bcf.

2022 drilling programme: 100% success to date

Canacol's 2022 drilling programme is continuing successfully, with all six wells drilled to date (three development and three exploration wells) encountering gas (Exhibit 2). The Claxon 1 exploration well is currently drilling and is located approximately two kilometres to the south of the recently announced Alboka 1 discovery, which tested 33mmscfd from the primary Cienaga de Oro (CDO) sandstone reservoir. Claxon 1 will target the same CDO sandstone reservoirs present at Alboka, and the company estimates that the well will take approximately four weeks to drill, complete and test. Cornamusa 1 has been tied into production and tested at 12.4mmscfd. The second rig is being mobilised to drill the Canaflecha 2 development well, located on the Esperanza E&E contract (in which Canacol has 100% working interest). The company expects the well to spud in August 2022 and is targeting gas within the CDO in the Canaflecha field, which was discovered in 2008.

Exhibit 1: Canacol acreage



Source: Canacol Energy

The first exploration well to be drilled in the MMV, the high-impact Pola-1 well, is due to spud before the end of 2022 and will take c four months to drill. We discussed Pola-1 together with further future high-impact wells Natilla-1 and Dividivi-1 in detail in our May 2022 Outlook note.

Exhibit 2: 2022 drilling programme

Well	Block	Type	Result
Toronja-2*	VIM-21	Development	Gas
Carambolo-1*	VIM-21	Exploration	Gas
Chirimia-1 ST*	VIM-5	Development	Gas
Alboka-1*	VIM-5	Exploration	Gas
Cornamusa-1*	VIM-21	Exploration	Gas
Toronja-3*	VIM-21	Development	Gas
Claxon-1*	VIM-5	Development	
Canaflecha-2	Esperanza	Exploration	
Pola-1	VMM 45	Exploration	

Source: Canacol Energy. Note: *Wells drilled/underway

Valuation and financials

Q2 results deliver strong operating cash flow

Canacol reported Q222 EBITDAX of US$55.2m, an increase of 24% compared to Q221 (US$44.6m). This was assisted by a 29% increase in natural gas revenues to US$67.9m in Q222 (Q221: US$52.6m), which was due to an increase in production and average sales prices. This resulted in strong operating cash flow, with funds from operations increasing by 16% to US$39.1m (Q221: US$33.6m). The average sales price for Q222 was US$4.73/mcf, 16% above Q221 (US$4.09/mcf), assisted by a tighter spot market. Due to increased sales in the spot market, volumes sales (and production) for Q2 were also strong at 188mmscfd, up by 10% on Q221 (c 171mmscfd). As such, we have tweaked upwards our price forecasts for FY22–24 (by 1%) and increased our FY22 volume sales forecast to 190mmscfd, from 185mmscfd previously, which is still comfortably within the company's guidance range of 160–200mmscfd. We note that the run rate for volumes sales over January to July is nearly 5% higher than the same period a year earlier.

A non-cash deferred tax expense of US$12m led to a net loss of US$6.4m for the quarter, compared to net income of US$2.4m in Q221. The deferred tax expense was due to the impact of a weakening Columbian peso (relative to the US dollar) on unused tax losses and cost pools. We do not adjust our full-year tax forecast as this expense offsets a US$12m deferred tax credit incurred in Q122, which we did not adjust for in our previous forecasts as we had assumed it would reverse out before the year-end. Net capex for the quarter was US$46.5m, resulting in net debt (for covenant purposes) of c US$463m at the end of Q222, implying net debt to EBITDAX of 2.2x (roughly in line with Q122). This includes cash of c US$91m. The company also reported a working capital surplus of c US$101m

Exhibit 3: Old versus new valuation and forecasts

	New	Old	Difference	Comment
Valuation (C$/share)				
Adjustments	-3.63	-3.63	0%	
Producing assets	5.92	5.87	1%	Increased volume sales and pricing
Core NAV	2.29	2.24	2%	
Additional reserves	4.08	4.05	1%	Increased production implies higher additional reserves (at 200% RRR*)
Valuation	6.36	6.29	1%	
Financial extracts (US$m, unless otherwise stated)				
FY22e				
Production (mmscfd)	190	185	3%	Strong sales over May-July increases run rate
Pricing (US$/mmscfd)	4.72	4.67	1%	Strong interruptible spot sales prices in Q2
Revenue	272	263	4%	Higher production/volumes sales
EBITDAX	209	200	5%	Higher revenue
CFO	169	162	5%	Higher cash earnings (EBITDAX)
Capex	184	180	2%	Higher production
FY22–25e				
Production	852	846	1%	Ripple effect of higher production in FY22
Capex	739	734	1%	Higher production (at same F&D costs per mscf)

Source: Edison Investment Research. Note: *RRR = reserves replacement ratio.

Implications for NAV

Our core NAV for Canacol increases C$2.29/share from C$2.24/share, as a result of the changes to our forecasts for volume sales and prices. Our additional 2P reserves valuation increases slightly to C$4.08 from C$4.05, giving a total NAV of C$6.36 (from C$6.29 previously). The breakdown of our valuation is shown below.

Exhibit 4: Base case valuation

Asset				Recoverable reserves			Net risked value	
	Country	Diluted WI	CoS	Gross	Net WI	NPV	Absolute	C$/share**
		%	%	bcf	bcf	US$/mcf	US$m	
Net (debt)/cash end FY21*							(369)	(2.58)
SG&A - NPV of 5 years							(161)	(1.12)
Decommissioning provisions							(26)	(0.18)
Cash in from assumed exercise of options							35	0.25
Producing assets								
Esperanza	Colombia	100%	100%	190	190	1.33	254	1.77
VIM 21	Colombia	100%	100%	57	57	2.09	118	0.82
VIM 5	Colombia	100%	100%	360	360	1.32	476	3.32
Core NAV				**607**	**607**		**328**	**2.29**
Exploration/development upside								
5-year programme (assumes 200% RRR)		100%	100%	746	746	0.78	584	4.08
Total NAV				**1,353**	**1,353**		**911**	**6.36**

Source: Edison Investment Research. Note: *Adjusted for shares repurchased since year-end. **We use fully diluted number of shares of 179.1m.

We have used a generic discount rate of 12.5% in our valuation. This is in line with that used for funded, cash-generative E&Ps with operations in emerging markets, resulting in our valuation of C$6.36/share. At a 10% discount rate, it would increase to C$7.02/share. We provide a sensitivity to this key input below.

Exhibit 5: 2P and risked exploration NAV sensitivity (C$/share) to WACC

	8.0%	10.0%	12.5%	15.0%
2P NAV	3.57	2.95	2.29	1.73
Risked NAV	7.64	7.02	6.36	5.81

Source: Edison Investment Research

Relative valuation

Canacol trades at a P/CF multiple of 2.6x in FY22e and 2.2x in FY23e compared to its Canadian (junior) E&P peers on 2.7x and 2.4x, respectively, and its North American E&P peers with South American operations on 1.5x and 1.3x, respectively. North American E&P peers with South American operations include Frontera Energy, Gran Tierra, Parex Resources, Petro

Exhibit 6: Peer group valuation

	Market cap (US$m)	EV (US$m)	P/CF FY22e (x)	P/CF FY23e (x)	EV/EBITDA FY22e (x)	EV/EBITDA FY23e (x)	FCF Yield FY22e (%)	FCF Yield FY23e (%)	Div yield FY22e (%)	Prod growth FY23e (%))	EV/kboed FY22e (x)
Canacol Energy Ltd	303	724	2.67	2.21	3.51	3.04	-8%	9%	6%	8%	21.5
N American E&P peers with S American ops	**858**	**1,042**	**1.54**	**1.34**	**1.59**	**1.68**	**31%**	**42%**	**1.4%**	**16%**	**29.5**
Frontera Energy Corp	734	1,017	1.07	1.03	1.46	1.63	28%	53%	0.0%	6%	24.5
GeoPark Ltd	771	1,272	1.96	1.52	2.35	2.49	21%	29%	2.5%	5%	31.9
Gran Tierra Energy Inc	509	996	1.19	0.98	1.69	1.92	44%	40%	0.0%	12%	31.7
Parex Resources Inc	1,814	1,428	2.01	1.75	1.15	1.24	19%	22%	4.8%	15%	26.3
Petrotal Corp	461	497	1.47	1.42	1.30	1.14	43%	65%	0.0%	43%	33.0
Canada	6,226	7,257	2.85	2.64	3.08	3.03	20%	23%	2.5%	10%	34.6
Junior E&P<30kboed	**797**	**933**	**2.77**	**2.68**	**3.14**	**3.33**	**23%**	**23%**	**3.3%**	**4%**	**43.5**
Cardinal Energy Ltd (Alberta)	982	1,035	3.02	3.26	3.20	3.80	25%	19%	4.6%	4%	47.6
Surge Energy Inc	611	831	2.52	2.11	3.08	2.86	21%	28%	2.0%	4%	39.3
Intermediate E&P>30kboed	**1,619**	**1,891**	**2.66**	**2.40**	**2.81**	**2.69**	**19%**	**24%**	**1.4%**	**13%**	**32.0**
Baytex Energy Corp	2,837	3,701	2.92	2.33	3.59	2.53	21%	27%	0.0%	6%	44.0
Birchcliff Energy Ltd	2,312	2,594	3.04	3.88	2.89	4.08	26%	17%	0.6%	4%	33.0
Crew Energy Inc	734	969	2.84	2.68	3.54	3.65	22%	24%	0.0%	4%	30.8
Enerplus Corp	3,652	4,198	3.70	3.16	3.71	3.42	19%	19%	0.8%	4%	42.3
Frontera Energy Corp	734	1,017	1.07	1.03	1.46	1.63	28%	53%	0.0%	6%	24.5
Kelt Exploration Ltd	918	912	3.14	2.67	2.95	2.83	9%	10%	0.0%	25%	29.9
Nuvista Energy Ltd	1,810	2,115	2.75	2.39	2.89	2.66	21%	24%	0.0%	20%	30.9
Obsidian Energy Ltd	713	966	1.83	1.65	2.12	2.08	27%	35%	0.0%	15%	30.1
Paramount Resources Ltd	3,181	3,358	3.48	2.88	3.60	3.09	15%	18%	3.8%	18%	36.7
Parex Resources Inc	1,814	1,428	2.01	1.75	1.15	1.24	19%	22%	4.8%	15%	26.3
Pipestone Energy Corp	672	831	2.79	2.27	2.35	1.92	27%	34%	0.0%	27%	25.8
Tamarack Valley Energy Ltd	1,373	1,773	2.35	2.28	2.75	2.80	20%	23%	2.6%	12%	39.9
Large E&P>100kboed	**16,334**	**19,028**	**3.23**	**3.08**	**3.56**	**3.56**	**21%**	**21%**	**4.2%**	**6%**	**37.0**
ARC Resources Ltd	9,136	10,703	3.22	3.06	3.43	3.53	19%	16%	2.5%	3%	31.0
Canadian Natural Resources Ltd	61,716	72,049	4.00	4.24	3.97	4.70	18%	16%	4.8%	3%	55.1
Crescent Point Energy Corp	4,230	5,506	2.34	2.02	2.84	2.95	27%	26%	2.7%	2%	41.6
Ovintiv Inc	13,419	17,343	2.96	2.10	3.45	2.75	21%	29%	1.8%	0%	34.4
Peyto Exploration & Development Corp	1,558	2,289	2.42	2.25	3.21	3.41	23%	24%	5.2%	7%	21.8
Tourmaline Oil Corp	19,907	20,265	5.25	5.34	5.60	4.96	11%	13%	8.1%	7%	39.9
Whitecap Resources Inc	4,371	5,037	2.39	2.53	2.40	2.62	26%	21%	4.1%	21%	35.3
US	**22,994**	**26,970**	**3.69**	**3.43**	**3.95**	**3.77**	**18%**	**20%**	**1.6%**	**7%**	**60.0**
RoW	**4,162**	**5,406**	**1.93**	**2.11**	**2.13**	**2.08**	**43%**	**35%**	**2.5%**	**17%**	**54.5**
Average	**12,631**	**14,864**	**2.99**	**2.80**	**3.21**	**3.11**	**23%**	**25%**	**2.0%**	**10%**	**47.3**

Source: Edison Investment Research, Refinitiv. Note: Prices at 5 September 2022.

Exhibit 7: Financial summary

US$m	2019	2020	2021	2022e	2023e
Year-end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	219.5	246.8	250.5	272.5	309.7
Cost of sales (opex)	(17.1)	(18.0)	(20.7)	(20.1)	(19.5)
Gross profit	202.4	228.8	229.8	252.4	290.1
General & admin and other recurring expenses	(36.4)	(41.3)	(35.4)	(43.1)	(44.2)
EBITDAX*	166.0	187.5	194.4	209.3	245.9
Share based payments	(7.9)	(5.9)	(4.6)	(4.7)	(4.8)
Exploration expense	(3.0)	-	(19.3)	-	-
Other non-recurring	(3.2)	(8.7)	(8.3)		
EBITDA	151.9	172.9	162.2	204.6	241.1
Depreciation	(54.3)	(64.5)	(67.7)	(79.1)	(88.5)
Operating Profit (before amort. and except.)**	103.8	117.1	122.1	125.5	152.6
Intangible amortisation	-	-	-	-	-
Exceptionals	(6.2)	(8.7)	(27.6)	-	-
Other	-	-	-	-	-
EBIT	97.6	108.4	94.5	125.5	152.6
Net interest	(32.9)	(31.0)	(34.4)	(35.1)	(35.0)
Profit Before Tax (norm)	70.9	86.1	87.7	90.4	117.6
Profit Before Tax (FRS 3)	64.7	77.4	60.1	90.4	117.6
Tax	(30.5)	(82.1)	(43.9)	(41.6)	(60.5)
Profit After Tax (norm)	40.4	3.9	43.8	48.8	57.1
Profit After Tax (FRS 3)	34.2	(4.7)	16.2	48.8	57.1
Average Number of Shares Outstanding (m)	178.3	180.6	178.1	170.9	170.9
EPS - normalised (c)	22.67	2.18	24.59	28.57	33.42
EPS - normalised fully diluted (c)	22.67	2.18	24.59	28.57	33.42
EPS - (IFRS) (US$)	0.19	(0.03)	0.09	0.29	0.33
Dividend per share (c)	0.05	0.21	0.21	0.22	0.22
Gross margin (%)	92.2	92.7	91.7	92.6	93.7
EBITDA margin (%)	92.2	92.7	91.7	92.6	93.7
Operating margin (before GW and except.) (%)	47.3	47.4	48.7	46.0	49.3
BALANCE SHEET					
Non-current assets	620.8	596.3	625.4	730.6	831.4
Intangible assets	53.9	62.8	70.0	171.6	281.2
Tangible assets	506.1	524.8	531.0	516.5	507.7
Investments	60.8	8.7	24.4	42.4	42.4
Current assets	133.3	153.5	218.4	106.9	79.8
Stocks	-	-	-	-	-
Debtors	69.6	70.7	71.4	71.4	71.4
Cash	41.2	68.3	138.5	27.0	0
Other/ restricted cash	22.4	14.5	8.5	8.5	8.5
Current liabilities	(97.8)	(92.6)	(77.1)	(77.1)	(85.7)
Creditors	(89.6)	(85.4)	(74.5)	(74.5)	(74.5)
Short-term borrowings	(8.2)	(7.2)	(2.5)	(2.5)	(11.1)
Long-term liabilities	(413.5)	(449.8)	(581.6)	(564.5)	(597.2)
Long-term borrowings	(333.4)	(359.9)	(492.0)	(474.9)	(507.6)
Other long-term liabilities (inc. decomm.)	(80.1)	(89.9)	(89.6)	(89.6)	(89.6)
Net assets	242.7	207.4	185.1	196.0	228.4
CASH FLOW					
Operating cash flow	108.4	152.3	123.8	169.2	185.7
Capex inc acquisitions	(84.3)	(89.0)	(101.5)	(184.3)	(189.3)
Financing expenses	(29.5)	(28.7)	(31.7)	(36.6)	(35.3)
Equity issued/(repurchased)	7.2	(2.3)	(8.8)	(13.2)	-
Dividends	(7.1)	(20.6)	(29.5)	(29.5)	(29.5)
Net cash flow	(5.3)	11.8	(47.6)	(94.4)	(68.4)
Opening net debt/(cash)	288.1	300.3	298.9	356.0	450.3
HP finance leases initiated	-	-	-	-	-
Other	(7.0)	(10.3)	(9.5)	(0.0)	-
Closing net debt/(cash)	300.3	298.9	356.0	450.3	518.7

Source: Company accounts, Edison Investment Research. Note: *EBITDA excluding pre-licence costs and exploration impairment, stock-based compensation and non-recurring items. **Operating profit excluding pre-licence costs and exploration impairment, and non-recurring items.

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