EDISON

Vermilion Energy

Acquisition

Spartan - a value-accretive transaction

Oil & gas

On 16 April 2018 Vermilion announced the proposed acquisition of Spartan Energy, a south-east Saskatchewan producer with estimated 2018 production of c 23kboed (91% oil) for a consideration of C$1.4bn, funded through C$1.23bn in Vermilion shares and the assumption of c C$175m of debt. The deal was priced at a 5% premium to Spartan's closing price and is recommended by its board. In this note we incorporate Spartan's asset base into our Vermilion forecasts and valuation based on the planned 15 June 2018 transaction closing date. We estimate the acquisition to be 9% accretive to cash flow per share in 2019 and 10% in 2020. Our valuation rises from C$48.2/share to C$/53.8/share as a result.

Year end	Revenue (C$m)	EBITDA* (C$m)	Operating cash flow (C$m)	Net (debt)/ cash** (C$m)	Capex ex acquisitions (C$m)	Yield (%)
12/16	828.5	361.7	509.5	(1,298.9)	(242.4)	5.9
12/17	1,024.4	673.5	593.9	(1,223.8)	(320.4)	5.9
12/18e	1,447.8	865.5	833.9	(1,330.2)	(435.2)	6.1
12/19e	1,841.6	1088.9	1,044.6	(1,228.9)	(561.9)	6.3

Note: *Reported EBITDA includes hedging and FX gains/losses. **Net debt = long-term debt, short-term debt minus cash and equivalents.

Accretive WTI leveraged transaction

Vermilion's WTI exposure increases from c 16% of forecast 2018 production to 32%, with acquired volumes unhedged. The deal increases our valuation sensitivity to oil relative to European gas prices, and decreases exposure to low-netback North American gas prices. Our valuation is based on EIA short-term WTI forecasts of US$58.7/bbl in 2018, trending to US$70/bbl in 2022. A 10% increase/reduction in our price deck would drive a valuation of C$61.2/share/C$46.0/share respectively.

Synergies and material drill bit upside

Spartan's asset base offers synergies with Vermilion's existing south-east Saskatchewan (Sask) asset base. This includes pipeline and infrastructure optimisation, which should drive down unit opex as well as drilling/completion economies of scale, leading to reduced unit F&D costs. Synergies also exist across the areas of engineering, geoscience and corporate overhead. Our drilling inventory NPV_{10} benefits from the inclusion of a subset of Spartan's 2,100 net conventional and unconventional drilling locations. This inventory comprises south-east Sask open hole locations where IRRs are estimated at 113-192% and fracked Midale and Torquay at 55-80%, all based on Spartan estimates.

Blended valuation of C$53.8/share

Our valuation methodology is outlined in further detail in our recent initiation note and uses a combination of P/CF, EV/EBIDAX, Gordon's growth model and SOTP based on sustainable FCF and drilling inventory NPV_{10}. The addition of Spartan drives a valuation upgrade of 11.6% to C$53.8/share, as we include higher forecast cash flows for 2019 and the NPV_{10} of Spartan's drilling inventory.

10 May 2018

Price	**C$44.4**
Market cap	**C$5452m**
	US$/C$1.29
Net debt (C$bn) at 31 March 2018	1.3
Shares in issue	122.8m
Free float	94%
Code	VET
Primary exchange	TSX
Secondary exchange	NYSE

Share price performance

%	1m	3m	12m
Abs	5.3	3.7	(3.5)
Rel (local)	2.6	0.2	(13.4)
52-week high/low		C$40.3	C$30.0

Business description

Vermilion Energy is an international E&P with assets in Europe, North American and Australia. Management expects FY18 production to average 86-90kboed after incorporating the acquisition of Spartan.

Next events

Q2 results	30 July 2018

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Edison profile page

Vermilion Energy is a research client of Edison Investment Research Limited

Spartan acquisition metrics

Spartan's asset base consists of high-netback (C$38.4/boe), light oil production covering 480,000 net acres in Saskatchewan, Alberta and Manitoba. Production in 2018 is expected to average c 23kboed from a 2P reserves base of 113.5mmboe (Sproule 20 Feb 2018) and the acquisition includes control of producing infrastructure as well as 2D/3D seismic datasets that offer synergies with existing assets. Post-acquisition, Vermilion guides to group production of 86-90kboed for FY18 (previously 75-77.5kboed) with an exit rate in excess of 100kboed.

Vermilion acquired Spartan under an all-share deal for a total consideration of C$1.4bn. This compares to Spartan's last reported post-tax proven NPV_{10} value (Sproule price deck of US$55/bbl WTI in 2018 rising to US$70/bbl in 2020) of C$1.16bn and 2P valuation of C$1.7bn (both excluding debt of C$175m). We note that the valuation is highly levered to the oil price, with estimated FY18 production biased 91% towards oil and 2P reserves 92% towards oil and NGLs. Spartan volumes are unhedged.

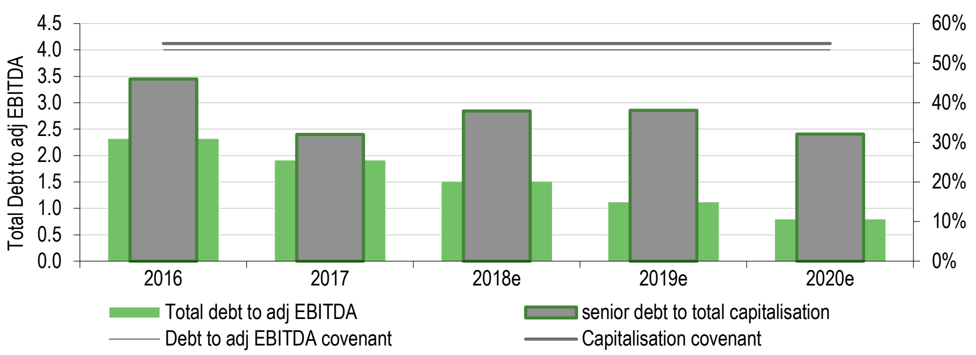
Exhibit 1: Spartan NPVs at 31 December 2017

	Net Present Value of Future Net Revenue										
	Before Income Tax Discounted at Various Rates					After Income Tax Discounted at Various Rates					BT Unit Value (discounted at 10% ($/BOE))
Entity Description	**0% M$**	**5% M$**	**10% M$**	**15% M$**	**20% M$**	**0% M$**	**5% M$**	**10% M$**	**15% M$**	**20% M$**	
Proved											
Producing	1,387,114	1,040,839	841,299	711,040	618,993	1,387,114	1,040,839	841,299	711,040	618,993	$20.80
Developed	16,905	13,573	11,082	9,218	7,802	16,905	13,573	11,082	9,218	7,802	$18.98
Nonproducing											
Undeveloped	682,705	478,541	347,562	258,747	195,610	596,794	424,355	312,092	234,780	178,969	$14.35
Total Proved	2,086,724	1,532,953	1,199,943	979,005	822,405	2,000,813	1,478,767	1,164,472	955,038	805,764	$18.39
Total Probable	1,654,499	1,056,761	756,969	578,873	462,151	1,208,081	771,594	553,740	425,216	341,515	$21.00
Total Proved plus Probable	3,741,223	2,589,715	1,956,912	1,557,878	1,284,557	3,208,895	2,250,361	1,718,213	1,380,254	1,147,279	$19.32

Source: Spartan Energy

Acquisition costs of C$19.2/boe (1P) and C$12.3/boe (2P) compare to Vermilion trading at C$27.8/boe at the time of our recent initiation (priced at 5 March 2018). Management estimates a reduction in leverage from 2x net debt to FFO to 1.4x for FY18. As the transaction is largely equity funded, we see a reduction in debt-based leverage metrics, remaining well within existing debt covenants. Vermilion maintains ample liquidity with over C$1.8bn of committed facilities (C$1.4bn of committed credit facilities and c.C$400m of long term notes) and C$1.36bn drawn as of end Q118.

Exhibit 2: Leverage metrics versus existing debt covenants

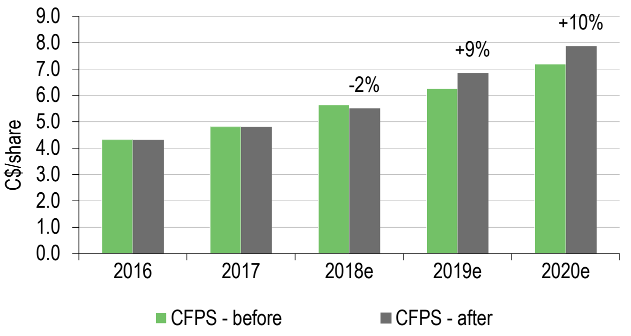


Source: Edison Investment Research

Cash flow per share accretion

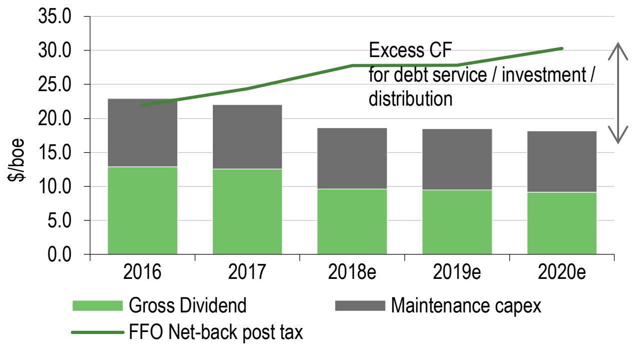
After incorporating Spartan in our model, we see cash flow per share accretion of 9% in FY19e and 10% in FY20e after completion of the acquisition in mid-June 2018. A 2% downgrade in our 2018 cash flow per share (CFPS) forecast is driven by lower underlying production than previously forecast after marking to market for Q118 actuals. Cash flow from the Spartan asset base is expected to more than cover the incremental dividend on new Vermilion shares and an increase in group capex of c C$105m.

Exhibit 3: CFPS accretion post Spartan acquisition



Source: Edison Investment Research

Exhibit 4: Spartan delivers excess cash flow for debt service and selective investment

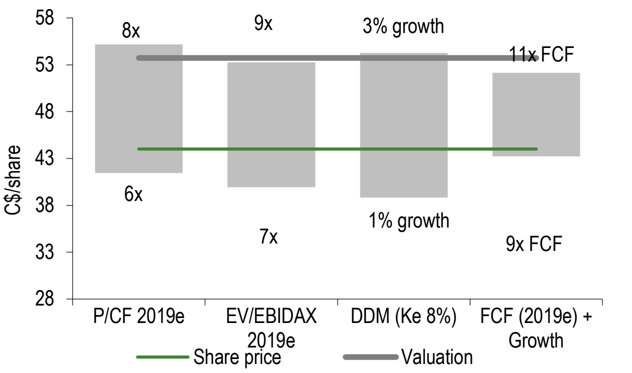


Source: Edison Investment Research

Valuation increases from C$48.2/share to C$53.8/share

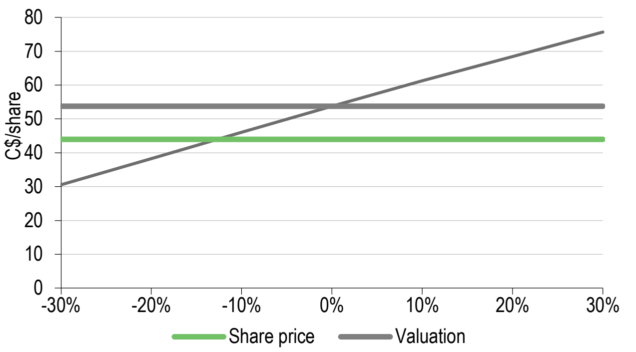
Our valuation increases by 11.6% to C$53.8/share after including the Spartan asset base and acquisition consideration. Our valuation is based on four valuation approaches, as shown in Exhibit 5 and described in our recent initiation note. Our valuation range stands at C$40.8-53.8/share and we expect Vermilion to trade towards the top end of this range based on its track record of reserves and production growth, peer-leading dividend yield, low F&D costs, and commitment to emission disclosure and reduction. We provide a valuation sensitivity to the underlying commodity price in Exhibit 6 below.

Exhibit 5: Valuation range C$40.8-53.8/share



Source: Edison Investment Research. Note: Ke = required rate of return.

Exhibit 6: Valuation sensitivity to commodity price FY19e*



Source: Edison Investment Research. Note: *Base case commodity benchmark prices in Exhibit 7.

Commodity price leverage and valuation

Benchmark commodity prices for FY19 are a key sensitivity to our group valuation. Exhibit 7 below indicates this sensitivity by flexing our commodity price inputs for 2019 by ±30%. Our valuation varies from C$30.5/share to C$75.7/share over this range, with the market implied discount to our commodity price deck for 2019 at c -12%.

Exhibit 7: Midpoint valuation sensitivity to commodity price input for FY19 (base case in bold)

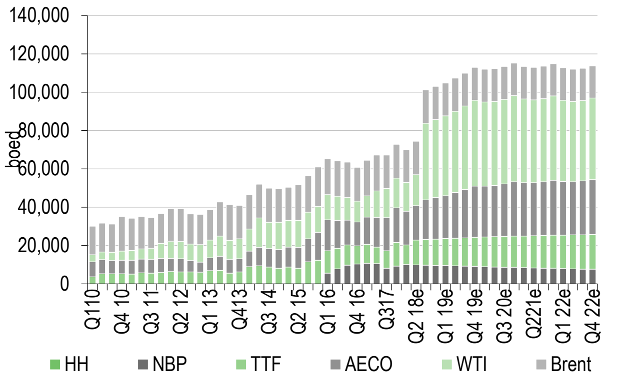
Brent/(US$/bbl)	**43.9**	**50.1**	**56.4**	**62.7**	**68.9**	**75.2**	**81.5**
WTI/(US$/bbl)	41.1	46.9	52.8	**58.7**	64.5	70.4	76.3
NBP (C$/mmbtu)	4.9	5.6	6.3	**7.0**	7.7	8.4	9.1
AECO (C$/GJ)	1.2	1.4	1.5	**1.7**	1.9	2.0	2.2
TTF (C$/GJ)	4.9	5.6	6.3	**7**	7.7	8.4	9.1
	-30%	-20%	-10%	**0%**	10%	20%	30%
C$/share	**30.5**	**38.3**	**46.0**	**53.7**	**61.2**	**68.5**	**75.7**

Source: Edison Investment Research

Shift in commodity exposure

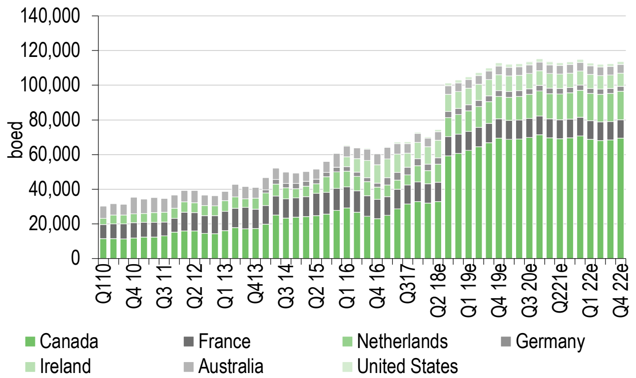
As a result of the acquisition of Spartan, Vermilion's commodity exposure increases its bias towards WTI away from European gas and low-netback North American gas prices. 2018e production (Vermilion mid-case guidance) shifts from 46% (Brent, WTI and NGLs) to 53%, Canadian gas drops from 24% of expected production to 22%, and European gas from 30% to 25%. Our production profiles below show our forecasts by geography and commodity post transaction.

Exhibit 8: Production split by commodity



Source: Edison Investment Research

Exhibit 9: Production split by geography



Source: Edison Investment Research

Risks and sensitivities

Key company-specific risks and sensitivities include:

- Political risks: Vermilion is exposed to fiscal and political changes in countries of operation. We see the greatest risk to operations in Europe, where the French Parliament recently approved a law banning all new exploration and production of oil and gas from 2040. This is in addition to a ban on fracking, which came into place in 2011.
- Dividend risks: Cash dividends are paid at the discretion of the Vermilion board of directors and can fluctuate. Dividend payments will depend on the outlook for commodity prices, operational performance, fund flows from operations and anticipated capex spend. As such, we expect gross cash dividends to be maintained, with potential to be increased over our forecast period.

Key sector-specific sensitivities include:

- Commodity price sensitivity: We provide a valuation sensitivity (Exhibit 7 to key benchmark prices in the valuation section of this note. As with most companies in the E&P sector, valuation is highly sensitive to the underlying commodity price.
- Subsurface risk: Estimates of 1P and 2P reserves are underpinned by assets that are already in production, hence uncertainty about the reserve range is likely to be well defined. As with all companies in the sector, reserves and resources are defined by distributions and the amount of oil and gas recovered can differ from published point values.
- Funding risks: Vermilion is relatively unlevered and cash generative and, based on current capex plans, we do not see funding as a risk. We forecast Vermilion to be significantly cash generative over the forecast period, with minimal risk to debt coverage, capex spend or dividend payout.

Financials

Edison versus consensus post acquisition

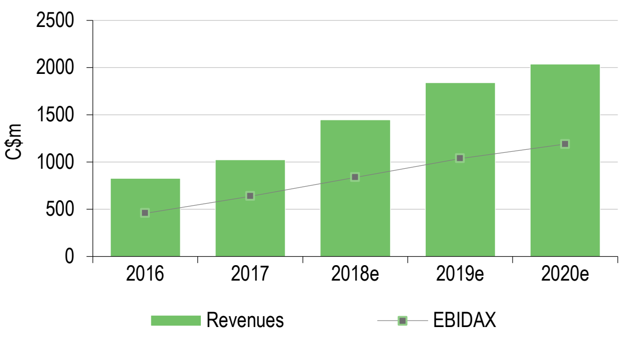
Our forecasts are higher than Bloomberg consensus for 2018 and 2019, as we include the positive impact of Spartan and assume continued drilling activity across the company's asset portfolio in line with its announced 2018 capex programme. It is unclear how much incremental activity consensus includes over and above maintenance capex in future forecasts and not all analysts included in Bloomberg consensus have updated their forecasts to reflect the acquisition of Spartan. We would expect consensus to rise as forecasts are revised.

Exhibit 10: Edison forecast versus Bloomberg consensus

C$M	Edison		Consensus		Delta	
	2018e	2019e	2018e	2019e	2018e	2019e
Production	87.3	109.0	83.4	94.1	5%	16%
Revenues	1448	1842	1410	1590	3%	16%
Adj EBITDA*	894	1118	857	961	4%	16%
EBIDAX	837	1038	N/A	N/A		
FFO	887	1104	N/A	N/A		
CFPS	5.5	6.9	6.2	6.8	-11%	1%
Capex ex acquisitions	435	562		478		18%

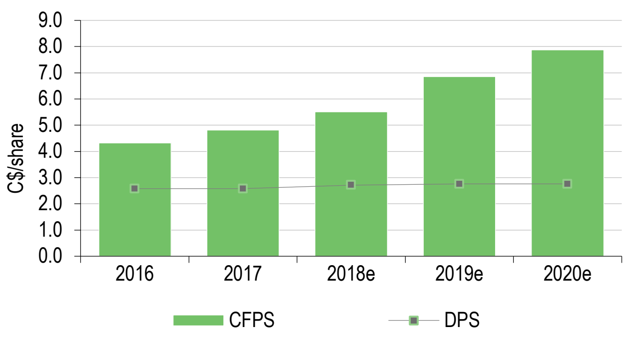
Source: Edison Investment Research, Bloomberg. Note: *Adjusted for non-cash items.

Exhibit 11: Revenue and EBIDAX forecasts



Source: Edison Investment Research, Vermilion Energy

Exhibit 12: CFPS and DPS forecasts



Source: Edison Investment Research, Vermilion Energy

Exhibit 13: Financial summary

C$m	2016	2017	2018e	2019e	2020e
Dec	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	829	1,024	1,448	1,842	2,038
Cost of Sales	(262)	(286)	(444)	(604)	(635)
Gross Profit	567	739	1,004	1,237	1,403
EBITDA	362	673	866	1,089	1,254
Operating Profit (before amort. and except.)	(166)	182	204	263	403
Intangible Amortisation	0	0	0	0	0
Exceptionals	0	0	0	0	0
Other	0	0	0	0	0
Operating Profit	(166)	182	204	263	403
Net Interest	(57)	(57)	(60)	(57)	(50)
Profit Before Tax (norm)	(223)	124	144	206	353
Profit Before Tax (FRS 3)	(223)	124	144	206	353
Tax	63	(62)	(57)	(80)	(93)
Profit After Tax (norm)	(243)	104	126	126	260
Profit After Tax (FRS 3)	(160)	62	87	126	260
Average Number of Shares Outstanding (m)	116	121	144	152	153
EPS - normalised (C$/share)	(2.1)	0.9	0.9	0.8	1.7
Dividend per share (C$/share)	2.6	2.6	2.7	2.8	2.8
Gross Margin (%)	68	72	69	67	69
EBITDA Margin (%)	44	66	60	59	62
Operating Margin (before GW and except.) (%)	(20)	18	14	14	20
BALANCE SHEET					
Fixed Assets	3,861	3,713	3,810	3,546	3,232
Intangible Assets	275	293	298	323	323
Tangible Assets	3,433	3,338	3,414	3,124	2,810
Investments	153	82	99	99	99
Current Assets	226	262	304	305	343
Stocks	15	17	22	22	22
Debtors	132	166	166	166	166
Cash	63	47	89	90	129
Other	17	32	27	27	27
Current Liabilities	(291)	(363)	(385)	(385)	(385)
Creditors	(218)	(258)	(294)	(294)	(294)
Other short term liabilities	(73)	(105)	(91)	(91)	(91)
Long Term Liabilities	(2,218)	(2,069)	(2,303)	(2,228)	(2,010)
Long term borrowings	(1,362)	(1,270)	(1,419)	(1,319)	(1,073)
Other long term liabilities	(856)	(798)	(884)	(909)	(937)
Net Assets	1,578	1,543	1,426	1,237	1,180
CASH FLOW					
Operating Cash Flow	510	594	834	1,045	1,207
Capex	(242)	(320)	(435)	(562)	(538)
Acquisitions/disposals	(99)	(28)	(1,372)	0	0
Financing	(17)	(4)	1,241	(5)	(5)
Dividends	(105)	(200)	(306)	(377)	(379)
Net Cash Flow	47	41	(38)	101	285
Opening net debt/(cash)	1,346	1,299	1,224	1,330	1,229
HP finance leases initiated	0	0	0	0	0
Other	0	34	(68)	0	0
Closing net debt/(cash)	1,299	1,224	1,330	1,229	944

Source: Company accounts, Edison Investment Research. Note: Edison calculates net debt as long-term debt, plus short-term debt minus cash and cash equivalents. We assume completion of the proposed Spartan acquisition at the planned closing date of 15 June 2018.

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