EDISON

Vermilion Energy

8.2% dividend yield secure at strip

Investor day

Oil & gas

Vermilion's investor day highlighted its self-funded growth and income business model. Management's commitment to providing shareholders a sustainable dividend is supported by a deep and diverse portfolio of assets resilient to a volatile commodity price environment. Project inventory supports a recycle ratio of over 2.5 times and the short-cycle nature of growth capex means spend can be rapidly diverted to projects that offer the highest returns or are curtailed. Our base case valuation falls to C$54.5/share (from C$57.9/share), largely driven by a global E&P sector de-rating. The share price is well supported by an 8.2% yield, which we believe is fully covered (in addition to growth capex) at c 20% below our base case commodity price forecasts for FY19.

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	(1298.9)	242.4	4.5
12/17	1024.4	673.5	593.9	(1223.8)	320.4	5.7
12/18e	1534.6	693.2	876.0	(1716.2)	504.4	8.1
12/19e	1856.6	1169.9	1076.0	(1593.8)	527.6	8.2

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

Dividend secure; ability to flex growth capital

Based on our analysis, we believe both dividend and growth capital are secure at commodity prices up to 20% below our base case forecasts (20% below our base case implies a price deck of WTI US$51.9/bbl and Brent US$57.5/bbl for FY19). If average oil prices remain below these levels, we would expect management to restrict capital spend to projects that generate the highest returns, while maintaining leverage below 2.5 times net debt to fund flows from operations (FFO).

North American E&P sector de-rating

The Canadian E&P sector has de-rated by over 30% since our initiation on Vermilion in March 2018, which we believe is driven by a recent correction in the crude price and the huge disconnect at which Canadian heavy crudes trade relative to global benchmarks. We note that across Vermilion's oil portfolio the volume weighted discount to WTI is just US$2/bbl, given its exposure to Brent and light sweet blends in North America.

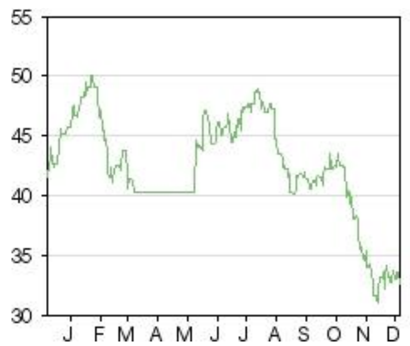
Valuation: Base case C$54.5/share

Our updated valuation falls from C$57.9/share to C$54.5/share (down 6%) and is based on a blended approach using FY19 P/CF, EV/EBIDAX and multiple of free cash flow (FCF) plus NAV 5Y plan. Although we make modest changes to our FY19 FFO, down 1% at C$1201m, a key reason for the decline in our valuation is lower multiple ranges justified by a global E&P sector de-rating.

6 December 2018

Price	**C$33.7**
Market cap	**C$5139m**
	US$/C$1/30
Net debt (C$bn) at 30 September 2018	1.7
Shares in issue	152.5m
Free float	94%
Code	VET
Primary exchange	TSX
Secondary exchange	NYSE

Share price performance



%	1m	3m	12m
Abs	(4.6)	(19.4)	(24.4)
Rel (local)	(4.4)	(14.3)	(20.7)
52-week high/low		C$50.1	C$31.1

Business description

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

Next events

Q418 results	January 2019

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Edison profile page

Investor day key points

Vermilion Energy ran an investor day in Toronto on 27 November 2018, highlighting activity across its core operating business units that collectively drive the company's strategy of self-funded growth and income. Vermilion retains a geographically diverse conventional/semi-conventional asset base with price exposure to a varied set of oil and gas commodity benchmarks. Importantly, unlike a number of its Canadian peers it has zero exposure to heavily discounted Western Canadian Select heavy crude, which trades a significant discount to WTI, and across the group Vermilion realises an average oil price at just c US$2/bbl discount to WTI. We believe the stock's recent de-rating does not reflect the diversity of the company's asset base and ability to continue to fund both dividend and growth capex based on commodity prices up to 20% below our base case forecasts.

We summarise eight key points from the Vermilion's analyst day below:

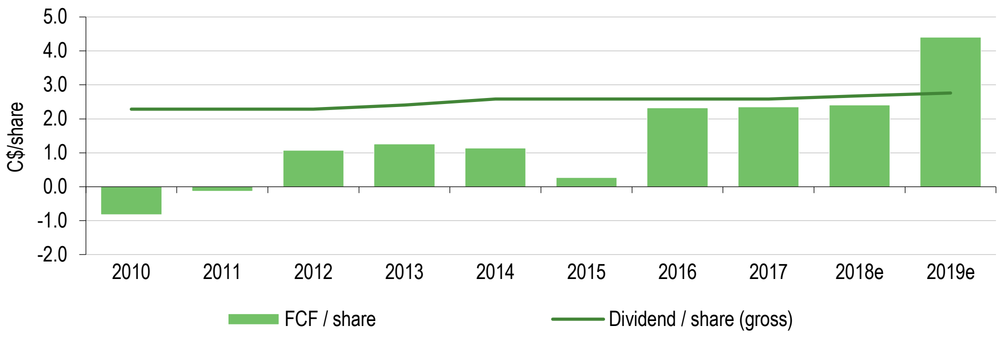
- **Sustainability and HSE remain at the core**

Ensuring the health and safety of employees is a core value of virtually every operator and Vermilion is no exception. Management emphasised the importance of both safety and environmental responsibility, flagging how business unit managers were obliged to ensure these factors always took priority over profitability. However, Vermilion's disclosure of stage one and stage two emissions under the carbon disclosure product (CDP) set it apart from its listed peers, with disclosed data showing a continued reduction in emissions intensity. Vermilion reduced its emission intensity (scope one and scope two emissions) by 44% from 2014 through to 2017 with the CDP awarding the company an A rating, putting it in the top 4% of energy companies globally (based on the disclosures made to the CDP).

- **Capital efficiency**

Vermilion Energy highlighted increasing capital efficiency across the group as it leverages a decline in service pricing and continues to benefit from increased operational efficiency including a material reduction in drilling days. An increase in FCF per share to our forecast FY19 C$4.4/share is significantly above levels seen during the last oil price peak (FCF is defined as FFO minus exploration and development (E&D) capex and does not include inorganic capex associated with the acquisitions). FCF remains heavily geared to commodity price assumptions but even at current strip Vermilion expects FCF for FY19 to exceed C$3.0/share. Assuming prevalent commodity price volatility constrains service price cost inflation, we believe current levels of capital efficiency should be sustainable at least in the short term.

Exhibit 1: Growth in FCF per share*



Source: Vermilion Energy. Note: *Company estimates at 19 November 2018 based on strip pricing at FY19 FCF/share of c C$3.0share.

■ **Growth capital at risk if commodity prices fall; dividend secure**

Management flagged the order of priority for the use of FCF in the event of sustained lower commodity prices. Importantly for income investors, growth capital is likely to be curtailed ahead of a dividend reduction (Vermilion's dividend has never been reduced before). We take a look at dividend coverage in the event that oil prices remain at current strip or fall further later in this note. Our base case uses an EIA short-term commodity price forecast for FY19 FFO of C$1,201m; under this scenario, total forecast capex of C$528m and gross dividend of C$422m are fully covered.

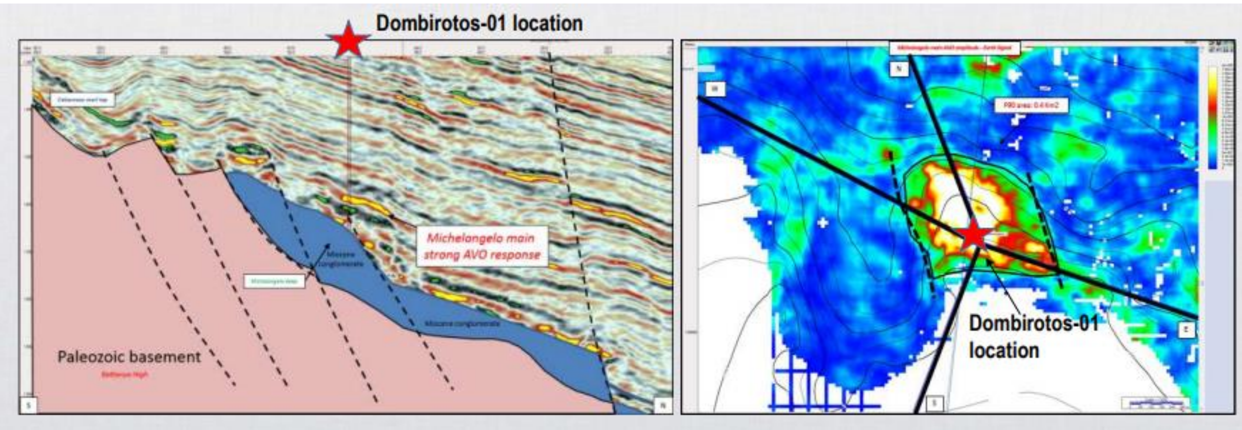
■ **Bias towards onshore, short-cycle assets provide for significant capital flexibility**

Vermilion's FY19 capital programme and five-year outlook is dominated by incremental investment in existing assets (facility modifications and workovers) and by onshore drilling activity rather than large one-off capital projects. These short-cycle investments will offer significant flexibility if commodity prices fall. This dynamic portfolio of investment opportunities enables Vermilion to re-direct capital to those that offer the greatest return at any specific point in the commodity cycle.

■ **Central and Eastern Europe (CEE) exploration, appraisal and redevelopment underappreciated**

While we place little value on Vermilion's net acreage position and prospective resource in the CEE region, the company holds an extensive land position and is working up prospects in proven basins. Vermilion's interest in Hungary totals 664,000 acres and a discovery made in February 2018 (tested at 5.8mmscfd) is already in commercial production. Several analogues have been mapped on 3D seismic, including the compelling Dombirotos-1 prospect, which is due to drilled in Q119.

Exhibit 2: South Battonya Dombiratos prospect – strong AVO response



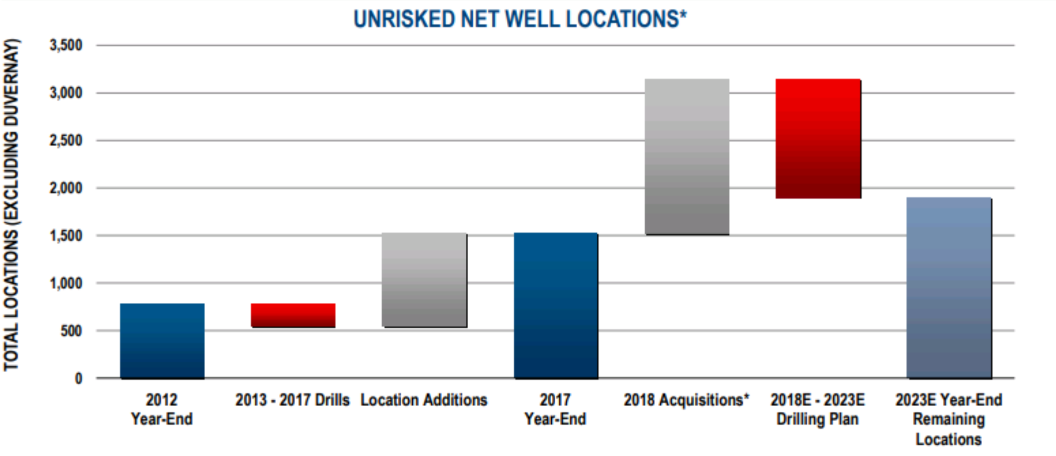
Source: Vermilion Energy

Vermilion is now the largest onshore exploration licence holder in Croatia with 2.35m net acres. A proven oil play extends across Vermilion's acreage, which remains relatively unexplored by modern technology. Vermilion also sees potential for a shallow gas play analogous to the Pannonian sandstone in Hungary. In Slovakia Vermilion has exposure to a low-risk redevelopment play with five dry gas fields located on its Tmava exploration licence and several un-drilled fault-blocks located on 3D seismic. Drilling in Hungary, Croatia and Slovakia is expected in 2019 and management sees potential to take CEE net production from c 0.6kboed today to over 5kboed by 2023.

■ **Deep project inventory**

Vermilion retains a deep inventory of drilling locations, which has more than doubled since the acquisition of Spartan in 2018. Although from a numerical perspective drilling inventory is dominated by locations that target North American crude, a number of the highest return and shortest payback opportunities target gas in Europe. A recent pull-back in WTI should further elevate European gas projects in the group's ranked drilling inventory. Three-year 2P finding and development (F&D) and reserve acquisition costs of C$8.87/boe are competitive versus peers and enable a strong return on capital with a 2017 F&D operating recycle ratio (operating netback divided by F&D cost) of 2.8x.

Exhibit 3: Unrisked net well locations



Source: Vermilion Energy

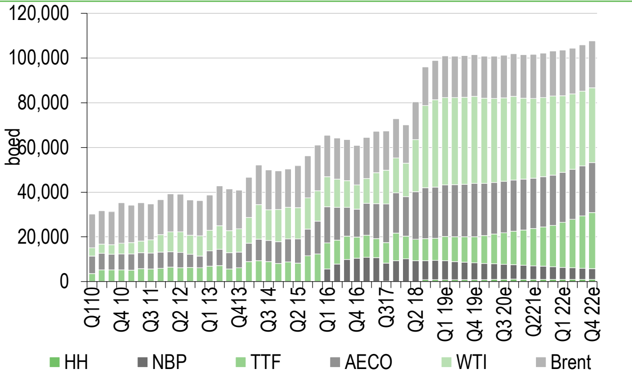
- **Compelling European gas fundamentals**

Despite a recent dip in global crude prices, European gas prices have remained at multi-year highs and are likely to rise as we enter the Northern hemisphere's winter. Key drivers of recent price strength include declining domestic production, strong demand as conventional coal is displaced and in support of intermittent renewable sources. Coal to gas switching provides support at c US$7.5mmbtu, a floor that has risen over 2018 due to a spike in EU carbon prices. Spot Asian LNG prices c stand at c US$10/mmbtu and Europe is likely to attract spot cargoes if TTF is priced close to this, providing for a price cap. Strong margins from European gas sales will soften the blow of a recent dip in global crude prices.

- **Key growth areas in 2019 – driven by recent acquisitions**

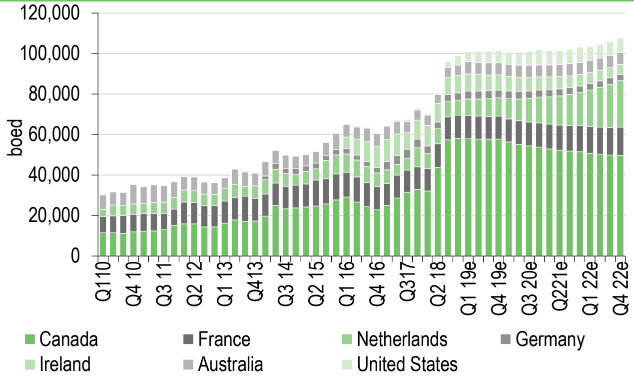
Key growth areas in 2019 include Netherlands gas, Canada and the US on inclusion of a full year of production from acquired assets. Canadian drilling is focused on Saskatchewan light oil and Lower Mannville condensate rich gas. Management sees potential to enhance net-back through the reduction of unit operating costs of the Spartan assets as operational teams are re-organised and combined with Vermilion's legacy Saskatchewan workforce. Depressed service costs and operational efficiencies, including a significant and sustainable reduction in drilling days, provide strong returns even in a US$55/bbl WTI oil price environment with company forecast after-tax payouts of 1.2 to 1.6 years (IRRs in excess of 50%). US production growth is driven by the August 2018 acquisition of a land position in the Powder River Basin, with in-fill potential in the Turner sandstone targeting light oil. Returns are again attractive with company forecast after-tax payouts of 1.7 to 1.9 years and IRRs in the 44% to 55% range. Our production forecast for FY19 of 101kboed is towards the lower end of company guidance of 101–106kboed.

Exhibit 4: Production by commodity benchmark



Source: Edison Investment Research, Vermilion Energy

Exhibit 5: Production by geography



Source: Edison Investment Research, Vermilion Energy

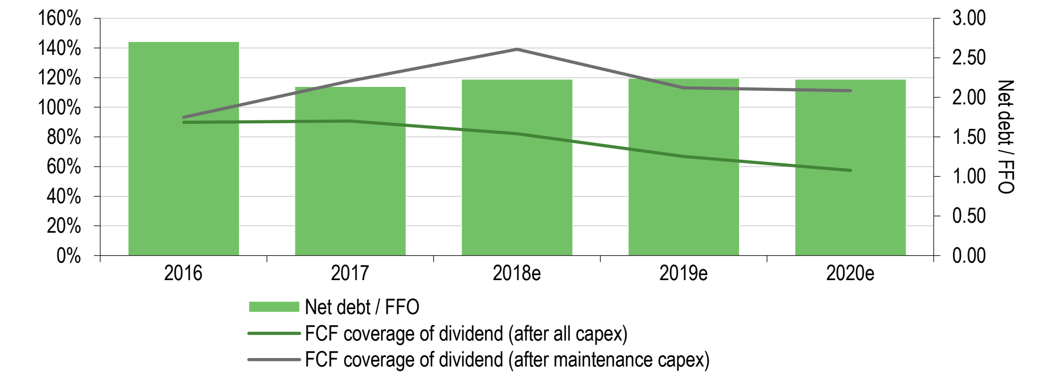
Dividend coverage and sensitivities

Ability to sustain growth and distributions

Vermilion's ability to sustain historic levels of growth in production, reserve/resource additions and servicing debt and dividend payouts relies on it generating sufficient levels of cash flow from operations. Management is keen to stress that growth capital is likely to be curtailed ahead of a reduction in dividend if the company is free-cashflow negative. We assume leverage is capped at net debt to FFO of 2.5 times in our sensitivity analysis.

At 20% below our base case commodity price forecasts (FY19e FFO of C$809m), we believe FCF post-maintenance capex still covers Vermilion's dividend but not 100% of estimated growth capital. Nevertheless, assuming capex spend is unchanged we still expect to see net debt to FFO at c 2x in FY19. We feel this scenario is sustainable and the dividend is secure. A material reduction in growth capital is unlikely given Vermilion's balance sheet and strong returns generated on high-graded investment options.

Exhibit 6: 20% reduction in base case commodity price forecasts*

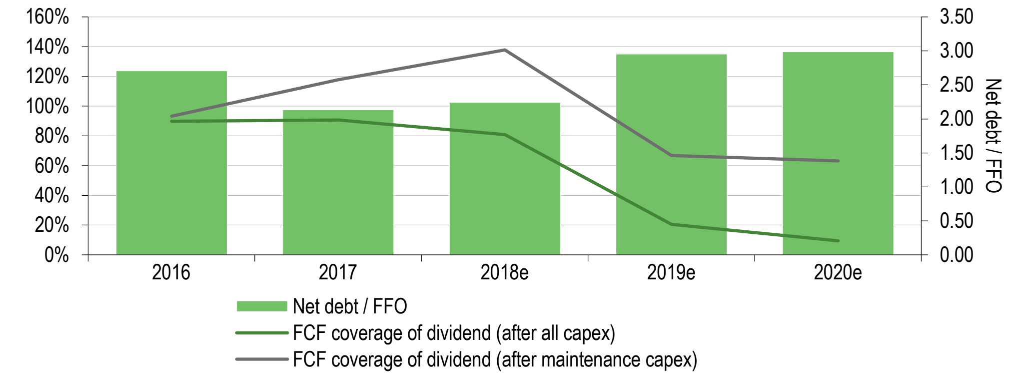


Source: Edison Investment Research. Note: *20% below equates to WTI US$51.9/bbl, Brent US$57.5/bbl, TTF C$5.8/GJ

At 30% below our base case commodity price forecast (C$614m FFO), the reduction in FCF is more dramatic and whilst we believe FCF after maintenance capex will cover 70% of gross dividend a significant increase in financial leverage would be required in order to fund growth capex. In the event of capex being sustained leverage is likely to rise to c 2.9 times net debt to FFO. In this case we believe that growth capex is likely to be reduced on lower return projects, or completely curtailed if management believe a lower commodity price is likely to be sustained. In summary, we believe at current spot prices dividend, maintenance capex and growth capex is likely to be sustained.

However, if oil prices are at an average Brent c US$50/bbl in 2019 we could see a material reduction in growth capex.

Exhibit 7: 30% reduction in base case commodity price forecasts *



Source: Edison Investment Research. *30% below equates to WTI US$45.4/bbl, Brent US$50.3/bbl, TTF C$4.4/GJ

FY18/19 forecast update

Key changes to forecasts

The table below highlights key changes to our forecasts for FY18 and FY19, which reflect actuals through to Q318 and updated production and commodity price expectations for FY19. We use EIA last-published WTI and Brent forecasts for FY19 of US$64.9/bbl and US$71.9/bbl respectively and a long-term oil price of Brent US$70/bbl. Our base case NBP and TTF assumptions for FY19 are C$9/mmbtu and C$9.5/GJ. Our oil price forecasts are above the futures strip, hence we address valuation later in this note and provide sensitivities to these underlying assumptions.

Exhibit 8: Old versus new forecasts

	New			Old		Change	
C$m	**2017**	**2018e**	**2019e**	**2018e**	**2019e**	**2018e**	**2019e**
Production	68.0	86.4	101.1	88.4	108.4	(2%)	(6%)
Revenues	1,024.4	1,534.6	1,856.6	1,558.0	1,920.3	(1%)	(3%)
				843.2	1,205.9		
EBIDAX	638.2	715.6	1,237.2	804.6	1,147.6	(11%)	8%
FFO	602.6	833.4	1,200.6	945.8	1,208.3	(12%)	(1%)
CFPS	4.8	5.7	7.0	5.5	7.3	4%	4%
Capex ex acquisitions	320.4	504.4	527.6	502.3	563.2	0%	(6%)

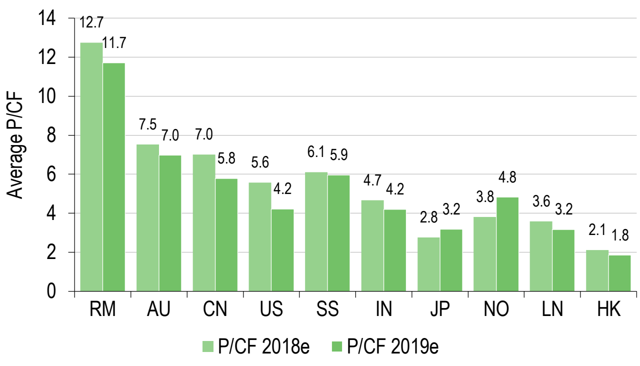
Source: Edison Investment Research

Relative valuation: North American E&P de-rating

Vermilion Energy has seen a significant de-rating relative to the global E&P sector, brought down by a Canadian E&P sector collapse. Since our March 2018 initiation, its Canadian peers have de-rated from 5.8x FY19 P/CF to just 4.0x (down 31%); this compares to a de-rating of 9.8% across our global peer group of 85 companies. We feel Vermilion's relative diversification and minimal exposure to heavily discounted Canadian heavy crudes should provide a basis for it to trade more in line with its global peers.

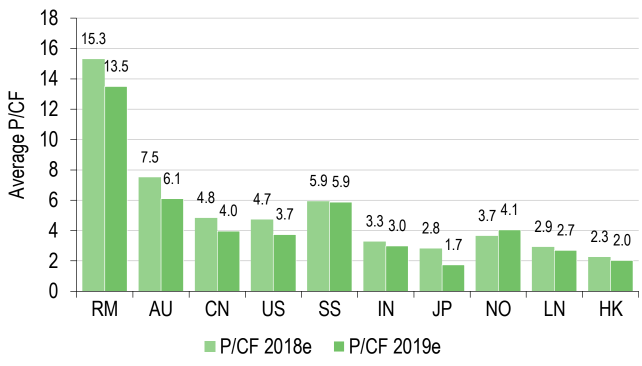
In aggregate, Vermilion's crude is priced at a US$2/bbl discount to WTI, with 36% of oil production price referenced to Brent and North American crudes including light sour blend, mixed sweet blend and Powder River Basin crude trading at a substantial premium to Western Canadian Select.

Exhibit 9: Average P/CF multiples for FY18e and FY19e (as of March 2018)



Source: Edison Investment Research, Bloomberg. Note: US = US, CN = Canada, IN = India, HK = Hong Kong, RM = Russia, NO = Norway, LN = UK, AU = Australia, JP = Japan, SS = Sweden.

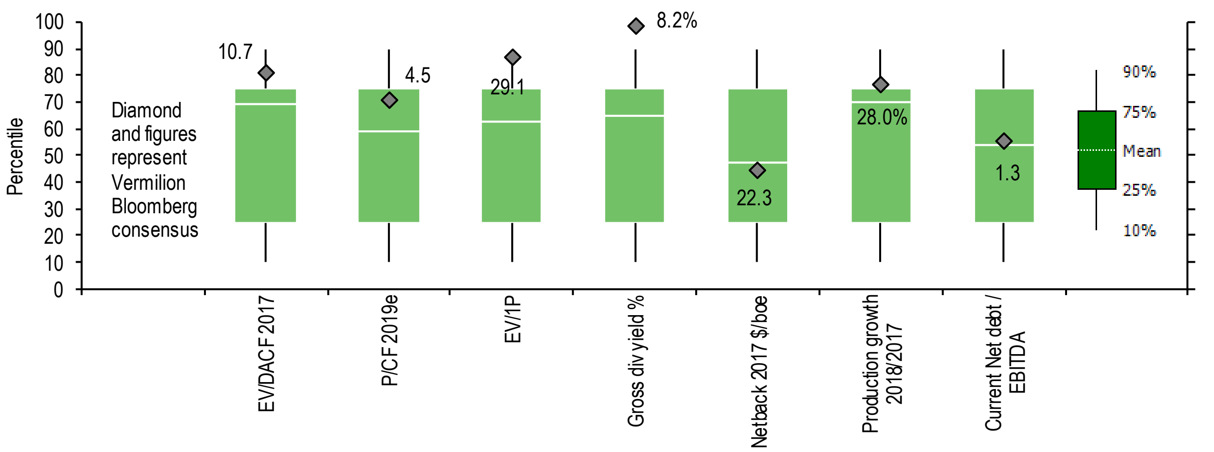
Exhibit 10: Average P/CF multiples for FY18e and FY19e (current)



Source: Edison Investment Research, Bloomberg

Vermilion remains a stand-out company on the basis on dividend yield, lower financial gearing and strong growth.

Exhibit 11: Vermilion versus E&P 85-company peer group on valuation, growth, leverage and yield metrics

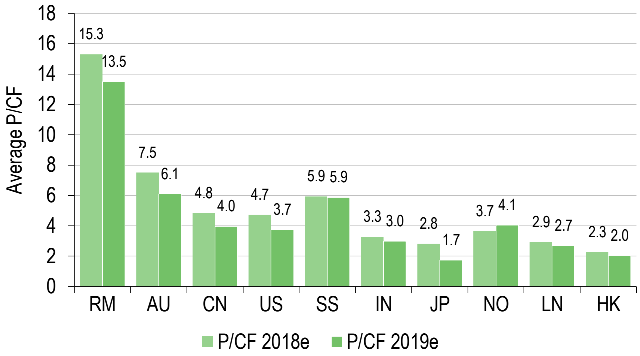


Source: Bloomberg, Edison Investment Research

Edison valuation: C$54.5/share on lower multiple range

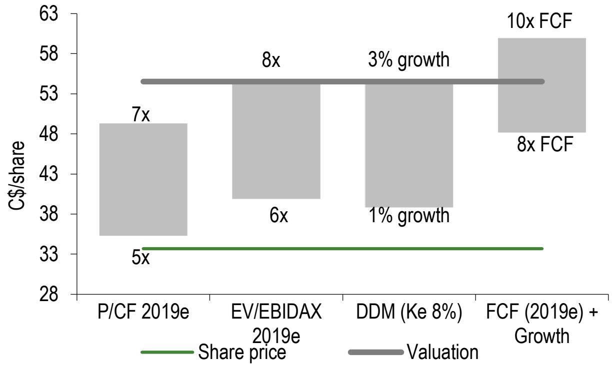
We look across a peer group of 85 global listed E&Ps to establish comparable multiples and operational metrics for companies with similar levels of production and market capitalisation. We find that on the basis of 2019e cash flow (Bloomberg consensus) valuations range from 2x P/CF up to 12x depending on the companies' growth profiles, development pipelines, contingent resource bases and the extent of financial leverage. Given this wide range in peer group cash flow multiples, we have valued Vermilion on the basis of levered and unlevered cash flow metrics, using the Gordon's growth dividend discount model and a SOTP valuation that incorporate maintenance FCF and the NPV of identified growth projects. Our valuation ranges from an average low of C$40.5/share to an average high of C$54.5/share, with an average midpoint of C$47.5/share. We believe Vermilion should trade towards the top end of this range based on its defensive qualities, high netbacks, low F&D costs and OECD operations with low subsurface risk. We have reduced the multiple ranges we use in our valuation to reflect a recent global sector de-rating.

Exhibit 12: Average P/CF multiple by exchange for selected peer group



Source: Edison Investment Research, Bloomberg consensus data. US = US, CN = Canada, IN = India, HK = Hong Kong, RM = Russia, NO = Norway, LN = UK, AU = Australia, JP = Japan, SS = Sweden.

Exhibit 13: Valuation range



Source: Edison Investment Research

Valuation commodity price sensitivity

A key sensitivity to our group valuation is the benchmark commodity price for FY19e. Exhibit 14 below indicates this sensitivity by flexing our commodity price inputs for 2019 by ±30%. Our valuation varies from C$34.8/share to C$73.3/share over this range, with the market implied discount to our commodity price deck for 2019 at c 38%.

Exhibit 14: Valuation sensitivity to commodity price input for FY19 (base case in bold)

Brent/(US$/bbl)	**50.3**	**57.5**	**64.7**	**71.9**	**79.1**	**86.3**	**93.5**
WTI/(US$/bbl)	45.4	51.9	58.4	**64.9**	71.3	77.8	84.3
NBP (C$/mmbtu)	6.3	7.2	8.1	**9.0**	9.9	10.8	11.7
AECO (C$/GJ)	1.1	1.2	1.4	**1.5**	1.7	1.8	2.0
TTF (C$/GJ)	6.7	7.6	8.6	**9.5**	10.5	11.4	12.4
	-30%	-20%	-10%	**0%**	10%	20%	30%
C$/share	**34.8**	**41.2**	**47.9**	**54.5**	**60.9**	**67.1**	**73.3**

Source: Edison Investment Research

Exhibit 15: Financial summary

C$m	2016	2017	2018e	2019e	2020e
Dec	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	829	1,024	1,535	1,857	1,879
Cost of Sales	(262)	(286)	(412)	(536)	(536)
Gross Profit	567	739	1,122	1,321	1,344
EBITDA	362	673	693	1,170	1,193
Operating Profit (before amort. and except.)	(166)	182	79	423	461
Intangible Amortisation	0	0	0	0	0
Exceptionals	0	0	0	0	0
Other	0	0	0	0	0
Operating Profit	(166)	182	79	423	461
Net Interest	(57)	(57)	(68)	(72)	(67)
Profit Before Tax (norm)	(223)	124	11	351	394
Profit Before Tax (FRS 3)	(223)	124	11	351	394
Tax	63	(62)	(18)	(35)	(39)
Profit After Tax (norm)	(243)	104	(13)	316	355
Profit After Tax (FRS 3)	(160)	62	(7)	316	355
Average Number of Shares Outstanding (m)	116	121	141	153	153
EPS - normalised (C$/share)	(2.1)	0.9	(0.1)	2.1	2.3
Dividend per share (C$/share)	2.6	2.6	2.7	2.8	2.8
Gross Margin (%)	68	72	73	71	71
EBITDA Margin (%)	44	66	45	63	63
Operating Margin (before GW and except.) (%)	(20)	18	5	23	25
BALANCE SHEET					
Fixed Assets	3,861	3,713	5,557	5,337	5,166
Intangible Assets	275	293	314	354	374
Tangible Assets	3,433	3,338	4,985	4,725	4,534
Investments	153	82	258	258	258
Current Assets	226	262	313	384	383
Stocks	15	17	28	28	28
Debtors	132	166	248	248	248
Cash	63	47	13	83	82
Other	17	32	25	25	25
Current Liabilities	(291)	(363)	(630)	(630)	(630)
Creditors	(218)	(258)	(429)	(429)	(429)
Other short term liabilities	(73)	(105)	(201)	(201)	(201)
Long Term Liabilities	(2,218)	(2,069)	(2,757)	(2,636)	(2,455)
Long term borrowings	(1,362)	(1,270)	(1,729)	(1,677)	(1,561)
Other long term liabilities	(856)	(798)	(1,028)	(959)	(894)
Net Assets	1,578	1,543	2,484	2,455	2,464
CASH FLOW					
Operating Cash Flow	510	594	876	1,076	1,102
Capex	(242)	(320)	(504)	(528)	(560)
Acquisitions/disposals	(99)	(28)	(308)	0	0
Financing	(17)	(4)	(5)	(22)	(22)
Dividends	(105)	(200)	(331)	(404)	(406)
Net Cash Flow	47	41	(271)	122	115
Opening net debt/(cash)	1,346	1,299	1,224	1,716	1,594
HP finance leases initiated	0	0	0	0	0
Other	0	34	(221)	0	0
Closing net debt/(cash)	1,299	1,224	1,716	1,594	1,479

Source: Company data, Edison Investment Research

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New Zealand

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