

As printed in

NATIONAL POST

Royalty rush breeds new kind of juniors

The old hands got bogged down in bureaucracy and don't want to do it again: Start up, sell, start up

PAUL HAAVARDSRUD – January 6, 2003

GRANT FAGERHEIM OF KETCH RESOURCES: "More time can be spent on creating value versus servicing it."

CALGARY - It seemed like a fairly routine oil patch deal at the time, but as it turned out, ARC Energy Trust's takeover of Startech Energy two years ago was a transaction that paved the way for a whole new breed of junior oil companies

Today, Impact Energy Inc., a junior play spun out of the Startech deal, is the oldest of a growing number of firms spawned directly from the break-out of the oil & gas royalty trust sector.

In the past six months, at least six new junior "ExploreCo's" have emerged from the remnants of trust deals, a trend analysts don't see stopping as long as the market's appetite for royalty trusts continues.

In deals last year involving Storm Energy Inc., Vermilion Resources Ltd., Ketch Energy Ltd., Paramount Resources Ltd., Elk Point Resources Inc., and KeyWest Energy Corp., existing shareholders received a combination of royalty trust units and shares in a newly formed -- and in several cases as-yet-unnamed -- exploration company.

While acquisition-hungry royalty trusts are willing to pay big money to gobble up producing wells, their concentration on exploiting assets means they typically place little value on exploration lands. Enter the suddenly available old management team.

In what has proven to be a convenient solution to a potentially sticky problem, freshly displaced management teams take up a slice of production from the royalty trust to provide cash flow, fold that in with the unwanted -- but still valuable -- explorations lands, and offer investors new companies with familiar roots.

While it's impossible to make a blanket statement about the probability of success for any equity type, let alone junior oil plays, generically speaking the firms spun out of trust transactions do have some built-in features that analysts note could give them a leg up on other start ups.

"The management already knows the assets, they know the infrastructure in the area, and they already have an inventory of drilling locations that has probably been built up when it was with the existing company," explained Peter Doig, an analyst at National Bank Financial in Calgary.

"They can really hit the ground running, they start drilling, they have no debt, they have a little bit of production, and they have cash flow coming right out of the chute."

Grant Fagerheim, president and chief executive of Ketch Resources Ltd., the exploration company spun out after Acclaim Energy Trust bought Ketch Energy for \$390-million in the fall, has experienced first-hand the perks of being able to start over.

"It's a much smaller, tighter shop," Mr. Fagerheim said. "You're doing less administration, and more actual time can be spent on creating value versus servicing it."

Oil and gas wells in western Canada show a production decline in the area of 20% a year. That means a company producing 10,000 barrels of oil equivalent a day must find 2,000 boe/d just to offset the decline -- never mind showing any growth.

Ketch Energy had production of 13,000 boe/d when it was bought by Acclaim. While Mr. Fagerheim said the company hadn't yet hit the wall, it was certainly looming.

In that light, starting up at Ketch Resources -- with 1,700 boe/d of production and 58,000 net acres of undeveloped land -- has been a comparative treat.

In less than six months, production at Ketch Resources is at just over 3,000 boe/d and the shares are up more than 60%. "Most of these guys started up companies, they got big, big, big and bogged down in the bureaucracy of running a business," Mr. Doig said. "They don't want to have to worry about which office tower to move into, how many floors to get, who gets the corner office, what color phones does everybody want, and all of the [human resources] problems." Whereas in the past start-ups had ambitions of reaching a production level of 50,000 or 100,000 boe/d, the realities of finding oil in the maturing western Canadian basin have changed the parameters of the game. "The start-up now is saying, let's just keep it where it's only the 10 of us; we don't have to get any bigger and we'll just continue to make money," explained Mr. Doig. "We'll start up, sell, start up, sell, and as long as the financial markets are willing to give us money, we'll do it." Oil executives are also now much more aware of having an exit strategy from day one, said Mr. Fagerheim. Junior plays are looking to increase production to the point where the operation has value to someone else, whether it be a bigger exploration outfit or a trust.

© 2003 National Post

"Reprinted with permission from The National Post"



www.frontstreetcapital.com
1-800-513-2832