VM Wealth Management Limited

Bond Analysis: Frontera Energy Corp. 7.875% 2028 (6M 2023)

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FRONTERA ENERGY

- **Bond Recommendation:**

Conservative Risk Appetite: UNDERWEIGHT

Moderate Risk Appetite: MARKETWEIGHT

Aggressive Risk Appetite: OVERWEIGHT

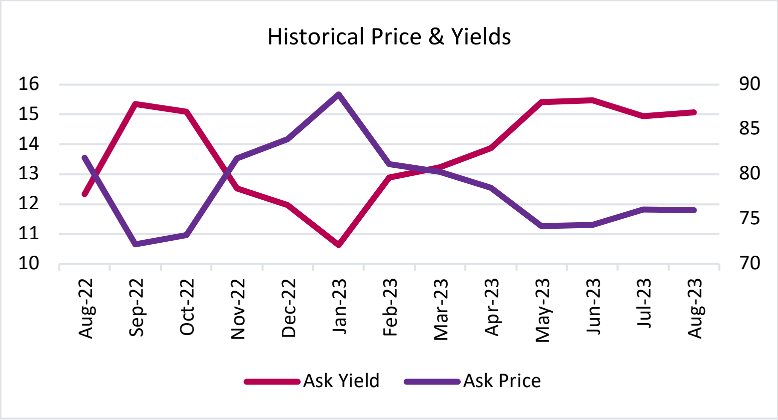
ABOUT THE COMPANY

Frontera Energy Company (FEC) is a Canadian publicly traded corporation engaged in activities encompassing the exploration, development, production, transportation, storage, and trading of oil and natural gas across South America.

The company's operations extend to investments in upstream and midstream facilities. It's varied asset portfolio holds stakes in 39 exploration and production blocks in Colombia, Ecuador, and Guyana. Additionally, FEC possess pipeline and port infrastructure in Colombia. The company's common shares are listed and traded on the Toronto Stock Exchange, identified by the " FEC " ticker.

Despite the recent moderation in revenue and earnings, FEC continues to display low leverage and strong liquidity, demonstrating a manageable debt burden for the foreseeable future.

Frontera Energy Corp: Bond Term Summary	
Parent Company	N/A
Issuer	Frontera Energy Corporation
Currency	USD
Issued Amount	400,000.00 (M)
Issue Date	06/21/2021
Tenor	7 years
Ask Yield to Maturity (As of August 31, 2023)	Approx. 15.064%
Coupon	7.875%
Credit Rating (S&P)	B+
Outlook (S&P)	Positive
Maturity Type	Callable on: 06/21/24 @103.938 06/21/25 @101.969 06/21/26 @ 100.000
Maturity	06/21/2028
Day Count Basis	30/360
Use of proceeds	Capital Expenditure, General Corporate Purposes, Refinance



Recommendation: FECCN '28s are a favourable choice due to their higher upside potential, given their higher yield than peers such as Gran Tierra and Geopark. In recent years, FEC has experienced improved fundamentals, contributing to improved credit metrics. With oil prices expected to remain elevated at around \$60-\$80 over most of the bond's remaining life, we believe FECCN presents an **OVERWEIGHT** option for investors with an **AGGRESSIVE** risk appetite.

ECONOMIC OVERVIEW (COLOMBIA)

For the six months ended June 30, 2023 (6M23), FEC derived approximately 96.2% of its total revenues from oil and gas sales in Colombia. On January 20, 2023, Standard & Poor's (S&P) affirmed Colombia's credit rating at 'BB+' with a stable outlook, reflecting its stable democracy and political institutions which have sustained predictable economic policies for many years, despite several economic shocks. The rating also incorporates the country's monetary policy flexibility based on inflation targeting and a flexible exchange rate, which remain key economic buffers against external shocks. The Colombian economy experienced a swift rebound from the pandemic, achieving approximately 8.0% GDP growth in 2022. The easing of pandemic-related restrictions, advantageous export prices for commodities like oil and minerals, and proactive fiscal measures facilitated this recovery.

However, S&P anticipates the growth momentum to slow down to around 1.0% in 2023, primarily due to elevated interest rates and the possibility of decreased oil prices. Thereafter, growth is projected to eventually revert to Colombia's typical trend rate, slightly surpassing 3.0%, over the next few years. These projections are in line with that of the International Monetary Fund (IMF) which has forecasted Real GDP growth of 1.0% and 1.9% in 2023 and 2024 respectively. Risks to the country's outlook include economic growth falling below expectations, unexpected fiscal slippage, persistently large current account deficits, climate change, natural disasters and external shocks.

SIX MONTHS ENDED JUNE 30, 2023 (6M23)

USD (In Millions)	FY 2019/20	FY 2020/21	FY 2021/22	6M22 June 30, 2022	6M23 June 30, 2023
Revenue	648.5	894.1	1,270.70	598.6	540.2
EBITDA	12.7	421.5	838.7	316.5	200.9
Interest Expense	42.1	42	40.7	20.6	21
Total Equity	764.8	1,448.90	1,589.30	1,536.80	1,684.50
Long Term Debt	344.1	411.8	392.5	401.9	496.9
Short Term Debt	197.5	151	115.9	128.4	33.7
Total Debt	541.6	562.8	508.4	530.3	530.6
Operating Cash Flow	226.6	327.4	620.4	361.5	184.4
Total Debt to Equity (%)	70.8%	38.8%	32.0%	34.5%	31.5%
Total Debt to EBITDA[1] (X)	42.6	1.3	0.6	1.7	2.6
EBITDA Margin (%)	2.0%	47.1%	66.0%	52.9%	37.2%
Debt Service Ratio[2] (X)	0.1	2.2	5.4	3.7	5.3
Interest Coverage Ratio (X)	0.3	10.0	20.6	15.4	9.6

Sound Results Continue Despite Lower Oil Prices and Other Challenges

For the six months ending June 30, 2023 (6M23), FEC's revenues (net of Royalties) declined to $540.2 million from the $598.6 million recorded in the previous year for the same period. This represented a 9.8% decline year-over-year (YoY) and was driven by decreased crude oil and gas sales in Colombia. The Company's production during the first quarter of 2023 was affected by social protests and

[1] Annualized EBITDA used for Interim Results

[2] DSR = EBITDA/(Annualized Interest Expense + Short Term Debt)

road blockades in some parts of Colombia, impacting oil production in those areas. In the second quarter, there was an improvement in production, mainly because of successful development drilling, increased water handling capacity and the resolution of some blockades. This was offset by a lower average Brent benchmark oil price during the six months which declined by 24.0% YoY. The decrease in crude oil prices during 2023 compared with the same period of 2022, was mainly due to: (i) a potential recession in the main worldwide economies and a decoupling of US/European and Chinese economies which negatively impacted market expectations regarding worldwide economies and expectations for future crude oil price increases, and (ii) the impact of US/European sanctions on Russia's crude oil production was lower than market analysts' assumptions. Total operating costs for FEC increased to $189.2 million from $156.2 million, caused by higher production, energy, and transportation costs as well as a stronger domestic currency, the Colombian Peso (COP). Due to the foregoing, EBITDA declined to $200.9 from $316.5 in the previous year, representing a YoY decrease of 36.5%. Additionally, the EBITDA Margin decreased to 37.2% from 52.9%

Strong Liquidity, Low Leverage

Debt-to-EBITDA (annualized) increased to 2.6x from 1.7x in the previous year. Typically, a Debt-to-EBITDA ratio below 3.0x is desirable. The Interest Coverage ratio (ICR) decreased to 9.6x from 15.4x. Normally, an ICR above 2.0x is acceptable. Therefore, despite some weakening, both metrics indicate that EBITDA remains adequate in supporting overall debt and in covering interest payments as they fall due. Unrestricted cash finished 6M23 at $180.2 million compared to $289.8 in the previous year. Total cash ended the period at $214.0 million. Lower cash is due to the company's investment in Guyana.

OUTLOOK

Potential Favourable Results from Guyana Exploration

A potential catalyst nears due to favourable analysis results from exploration in Guyana. This would be a strong catalyst for the company and support its bond valuation. FEC has concluded the necessary exploration work in Guyana as mandated by its exploration license. However, the analysis outcomes for the findings in the drilled wells are anticipated to be available in the next 2-3 months. Consequently, there is a degree of ambiguity surrounding the company's discoveries until a more precise estimation of potential resources can be determined. Notably, FEC discovered 210 feet of net pay in its second well in Guyana. Net pay refers to the thickness of a rock formation or reservoir within an oil or gas well that contains economically viable hydrocarbons (such as oil and natural gas). In other words, it's the portion of the rock layer that holds valuable resources and can be economically productive. The term "net pay" considers the part of the formation that is both porous (allowing fluids to flow through) and permeable (allowing fluids to move within the rock). It is a critical factor in determining the commercial viability of an oil or gas well, as it indicates how much of the drilled reservoir contains resources that can be extracted and utilized for energy production.

A Stronger Second Half Expected in 2023

Anticipated improvements are expected for FEC's performance for the second half of 2023 (2H23) compared to the initial six months. This projection stems from the near-completion of Guyana's planned capital expenditures (CAPEX) and the steadier to potentially higher average Brent crude oil prices. The daily production average of nearly 42,000 barrels of oil equivalent per day (boepd) in the first half of the year exceeds the midpoint of the production guidance for this year. This production rate is expected to remain consistent in the latter half, contributing to cash generation. Cash flow is predicted to remain stable in the latter half of the year, with net leverage staying below 1.5x, despite the possibility of raising additional debt for Guyana's development. Estimates from Oppenheimer & Co. suggest that free cash flow (post-interest payments) should likely be neutral to slightly negative in the second half, contrasting with the approximately negative $135 million in the first half. This shift is driven by an expected 16.0% increase in EBITDA and an expected 32.0% reduction in capex compared to the first half, considering full-year guidance and OPCO's evaluations. Some of the estimates are based on the company's mid-range guidance.

By the year's end, net leverage is expected to show a marginal increase to 0.7x, compared to 0.5x at the end of June, based on the foregoing projected results for the second half of 2023. EBITDA in the latter half of the year is predicted to rise by approximately 16.0% compared to the first half, based on the company's guidance and an expected average Brent price of $80 per barrel. In the year's initial half, FEC successfully executed nearly 80% of the revised investment plans for Guyana. However, less than half of the planned investments for Colombia and Ecuador were completed during the same period. Nevertheless, a substantial portion of the development investment for these regions has been accomplished. The forthcoming investments in Colombia and Ecuador in the second half should be balanced by significantly reduced capex for Guyana. Consequently, capex for the latter half of the year is projected to decrease by 32.0% compared to the first half.

Hedging Protection Mitigates Oil Price Volatility

FEC has taken measures to protect itself from potential declines in oil prices, covering roughly 40% of its projected production until the end of September. This protective strategy involved the utilization of put options, setting a minimum price level at $70 per barrel. Put options are contracts that give the holder (in this case, FEC) the right, but not the obligation, to sell a certain amount of oil at a predetermined price. This predetermined price is called the "strike price" or "floor price." In this case, FEC has set the floor price for its oil at $70 per barrel. This means that if the market price of oil falls below $70 per barrel, FEC can still sell its oil at the higher floor price, protecting its revenues from the impact of the price drop. So, even if the actual market price of oil drops below $70 per barrel, FEC's revenues from the 40% of its production that it has protected using put options will still be based on the higher floor price of $70. This strategy helps FEC manage the uncertainty of fluctuating oil prices and provides a level of financial stability during the specified period until the end of September.

RATINGS ANALYSIS

Standard & Poor’s: B+/Positive

On September 22, 2022, S&P revised FEC’s outlook to Positive from Stable on higher production while affirming the Company’s ‘B+’ rating. The positive outlook also reflects the view that FEC should raise its production to between 43,000 and 48,000 boepd from its Colombian fields and, on a smaller scale, from those in Ecuador. S&P also expects that FEC should maintain debt-to-EBITDA below 1.5x, benefiting from higher crude oil prices and strong operating margins.

Fitch Ratings: B/Stable

On December 2, 2022, Fitch affirmed FEC’s rating at ‘B’ while maintaining a Stable outlook. This credit rating is shaped by FEC’s relatively small production scale and short reserve life. Fitch believes that the company's growth outlook hinges on its ventures in Colombia and Ecuador. However, the concentration of its production, fixed cost structure, and limited ability to adjust investments in response to market volatility also contribute to its credit considerations. On the positive side, its leverage position is favourable, supported by strong liquidity. Despite these factors, Fitch expects free cash flow to remain negative due to its significant capital expenditure requirements. The company plans to finance its capital expenditure internally, which restrains its flexibility to manage investments during uncertain market conditions. In summary, while Frontera benefits from favourable leverage and liquidity, its creditworthiness is constrained by its production profile, cost structure, and limited financial flexibility in the face of market fluctuations. As the company pursues growth through its Colombian and Ecuadorian ventures, Fitch believes that managing these aspects will be crucial in influencing its credit trajectory.

COMPARABLES ANALYSIS

LTM figures as of 2Q23	Units	Frontera (FECNN)	Gran Tierra (GTE)	Geopark (GEOPAR)	Petrorio (PRIOBZ)
Ratings (Mdy's/S&P/Fitch)		**N.A./B+/B**	**N.A/B/B**	**N.A/B+/B+**	**Ba3/BB/BB-**
Bond Issue		7.875% 2028	7.75% 2027	5.50% 2027	6.125% 2026
Yield to Worst		14.70%	14.54%	10.42%	7.35%
Average net production	(boe/d)	41,619	32,079	36,580	61,357
Realized oil & gas price	($/boe)	$71.5	$54.4	$68.8	$85.1
Production Cost (Est.)	($/boe)	$20 -$25	$15 -$20	$20 -$25	$15-$20
Operating Netback	($/boe)	$43.7	$38.2	$42.6	N/A
Oper. Break-even Oil Price (Est)	($/bbl)	$45	$45	$25	$33
2P Production Life	(years)	10.3	12.8	9.6	N/A

Despite positive rating actions and enhanced creditworthiness in recent years, independent exploration and production (E&P) bonds in Latin America (LATAM) continue to trade at elevated yields. Single 'B' rated issuers exhibit growth potential, trading at yields surpassing 10.0%. Specifically, FEC trades at a higher yield than some comparables despite having a better or similar credit rating from S&P as well as a positive outlook. FEC also has higher net production levels and a higher realized oil & gas price than most. A higher realized price means that the company is receiving more revenue for the oil and gas it produces, which can have several positive effects. We therefore view FEC as potentially outperforming peers.

Favourable performance is projected for the latter half of the year as E&P companies strategically allocated capital expenditures to the initial half. The sector maintains competitive production costs and operational breakeven levels per barrel, offering a buffer against current and expected long-term average oil prices. While the 2P (proven and probable) reserve life is satisfactory for the peer group, vigilant monitoring of reserve replacement and net present value (NPV) of reserves remains essential for investors. Of note, FEC's 2P reserve life is greater than the remaining life of its outstanding global bond due in 2028. The sector also enjoys improved liquidity and reduced leverage since the post-pandemic oil price recovery, bolstering the credit quality and resilience of independent E&P entities against potential oil price decline.

INVESTMENT POSITIVES

1. **Strong Economic Fundamentals:** Colombia's stable democracy, consistent political institutions, and predictable economic policies contribute to a favourable environment.

2. **Swift Economic Recovery:** The Colombian economy rebounded rapidly from the pandemic, achieving around 8% GDP growth in 2022, supported by eased restrictions, advantageous commodity prices, and proactive fiscal measures.

3. **Potential Positive Catalyst:** Positive analysis results from Guyana exploration could significantly boost the company's prospects and enhance its bond valuations.

4. **Hedging Protection:** FEC's utilization of put options to safeguard against oil price declines and its strategic approach to managing currency risk indicate prudent risk management strategies.

5. **Strong Liquidity and Leverage Position:** Despite challenges, FEC maintains a strong liquidity position and favourable leverage metrics, ensuring its ability to meet debt obligations and cover interest payments.

INVESTMENT NEGATIVES

1. **Concentration Risk:** FEC's production is concentrated in specific fields, which exposes the company to operational risks associated with these areas.

2. **Fixed Cost Structure:** High fixed transportation costs increase production expenses, potentially limiting the company's financial flexibility.

3. **Negative Free Cash Flow:** The company is projected to possibly experience negative free cash flow due to substantial capital expenditure requirements and internal capex financing.

4. **Economic Growth Slowdown:** The Colombian economy's growth is anticipated to decelerate in 2023, primarily due to elevated interest rates and the potential for decreased oil prices.

5. **Exploration Uncertainty:** While FEC has completed exploration in Guyana, the analysis results are pending, introducing uncertainty regarding potential resources until more precise estimations can be made.

6. **FEC was formerly a company called Pacific Rubiales, which defaulted on its debt in 2015/2016.** However, management has changed with the involvement of the previous bondholders. The current company CFO was a manager at one of the funds that owned the defaulted bonds. The company has also changed substantially. Part of the reason for the default was high leverage and the fact that Pacific Rubiales had a lease on a field with the same name, a major producing asset. That lease expired, and the company had to return operations to Ecopetrol. We believe FEC's current merits (low leverage and adequate liquidity) and its exploration in Ecuador and Guyana serve as mitigants against a repeat scenario.

CONCLUSION

Although oil prices moderated from highs in 2022, we still expect independent exploration and production (E&P) oil companies such as FEC to benefit from still-elevated prices. These companies sell their entire product in US dollars and are not restricted by a domestic policy that limits fuel price increases in line with international oil prices that major state-owned oil companies are subject to.

FECCN '28s are a favourable choice due to their higher upside potential, given their higher yield than peers such as Gran Tierra and Geopark. In recent years, FEC has experienced improved fundamentals, contributing to improved credit metrics. With oil prices expected to remain elevated at around $60-$80 over most of the bond's remaining life, we believe FECCN presents a balanced risk/return profile for investors as follows:

Conservative Risk Appetite: UNDERWEIGHT

Moderate Risk Appetite: MARKETWEIGHT

Aggressive Risk Appetite: OVERWEIGHT

SOURCES

FRONTERA COMPANY WEBISTE, FRONTERA COMPANY FINANCIALS, FRONTERA SECOND QUARTER MD&A DOCUMENT, REUTERS, FITCH RATINGS, BLOOMBERG, OPPEHNHEIMER & CO., STANDARD & POORS

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DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.