The emergence of Canadian gas divestments
Challenges and success factors
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Over the last two years, we've seen a marked increase in the number of gas divestments taking place in Canada's oil and gas sector. A number of forces are driving companies to shed assets and rethink their business strategies and portfolio management approach. Driving these decisions are uncertain natural gas prices, sustained high oil prices, an increase in North American gas production, reduced gas demand from the US, and market access challenges.

Executive summary

Over the last two years, we've seen a marked increase in the number of gas divestments taking place in Canada's oil and gas sector. A number of forces are driving companies to shed assets and rethink their business strategies and portfolio management approach. Driving these decisions are uncertain natural gas prices, sustained high oil prices, an increase in North American gas production, reduced gas demand from the US, and market access challenges.

Figure A

Henry Hub natural gas price
(US dollars per million Btu)

Source: Short-Term Energy Outlook, April 2014.
The majority of analysts agree that North American natural gas prices will continue to remain flat over the next several years. Henry Hub natural gas prices have hovered around $4/mmbtu – with the exception of an increase during January–March due to cold weather across North America. The forward curve for AECO – the Alberta gas trading benchmark – for gas delivered within Alberta remains in the $3.50–$4.00 range with no real significant gains even in the high price scenario.

The massive gas resource base driven mainly by the shale gas revolution unfolding in North America is in part responsible for creating this downward pressure on gas prices. Increased well productivity in major plays across the continent is contributing to abundant gas supplies across North America. Marcellus, Horn River, Montenay and Utica, to name a few, are expected to grow to 25% of North American supply.

Divestment deals are a balancing act between competing buyer and seller demands. Buyers and sellers must agree on common goals and align and understand each other’s motivations to ensure success.

**Summary points**

1. North American natural gas supply is expected to grow over the next 20 years with the emergence of unconventional gas plays creating pricing pressures and less US demand for Canadian gas.
2. Canadian producers face tough decisions around whether to produce for less, squeeze more capital and operating costs out of their systems, sell assets, adopt a wait-and-see approach while trying to maintain licenses, focus on liquids-rich gas, or stop producing.
3. Many companies are rebalancing their portfolios by divesting off natural gas and focusing on a more oil-weighted production mix.
4. Divestment success for both the buyer and the seller depends on four critical dimensions: deal strategy, cost management, speed and risk mitigation.
5. Companies must ensure they understand the people, process, system, asset and third-party obligation components of a transaction to ensure a smooth transition and a phased approach.
Current environment

Figure B below shows the massive growth in gas supply expected over the next 20 years, in part creating a continued cap on prices.

Exacerbating this challenge is decreased demand from the US – Canada’s principle export customer. In recent years, the country has increased domestic natural gas production at the expense of imports from Canada. Increased estimated ultimate recovery (EUR) and the discovery of new resource plays in the last five years has led to a resource base in excess of 1,000 tcf commercial at prices in the $4 mmbtu range.

Abundant North American natural gas resources are spawning the creation of an LNG export industry in both the US and Canada. Export options are emerging on multiple fronts. Canadian companies are already in the process of securing new demand contracts, particularly on the liquefied natural gas (LNG) front. But realizing the value for these assets is years away with several obstacles to be overcome in the meantime, including infrastructure constraints, gaining regulatory approval and First Nations support, work force constraints, and complex capital programs where execution challenges abound.

In the meantime, Western Canada exports to the US are expected to stabilize in 2014 at an average of 5.5 bcf per day.
Canadian producers now face tough decisions around whether to produce for less, squeeze more capital and operating costs out of the system to remain profitable, sell assets, adopt a “wait-and-see” approach while trying to maintain licenses, focus on liquids-rich gas, or stop producing all together and shut in wells. The picture isn't all bad, however. With every challenge there is often an opportunity waiting.

All-time low prices for gas reserves are a buyers’ dream for companies with a long-term outlook and approach to capital development and execution, bullish expectations for gas price recovery, and confidence that LNG in Canada will move forward.

That’s where divestments come into play. We’re witnessing an increasing volume of divestments in the market and EY expects this portfolio rationalization effort to continue. Companies have historically viewed divestitures as a sign of distress, but some might say that it is effective portfolio management. They are now seen as strategic transactions to raise or release capital and realign business objectives. But, too often companies devote inadequate resources to these transactions, potentially leaving money on the table or overlooking other strategic opportunities.

Sellers must be transparent about costs, prepare thorough and accurate financial statements, and provide sufficient and appropriate information in a timely manner to potential buyers. On the other side of the equation, buyers face their own unique set of challenges: valuing the assets, performing diligence on the seller’s financial and operating statements, and maintaining and continuously updating their own deal analyses and models. Buyers must also prepare for Day 1 and overall integration to ensure long-term success.

By reviewing any transaction from the perspective of both buyer and seller, executives can avoid surprises, gain a clearer understanding of where value can be created or destroyed and, by following through, make a good deal even better. At the end of the day, it is about maximizing value for both parties.

Figure D

North America weighted-average 1P deal pricing, by reserves weighting (asset deals only)

Source: IHS

Gas-weighted deals
Liquids-weighted deals
## Canadian divestments

### Devon Energy Canada

Devon Energy Corp shed its Canadian conventional assets to Canadian Natural Resources Ltd. for $3.1 billion on 1 April 2014.

The company retained its thermal heavy oil, Lloydminster and Horn River assets. The deal should generate net proceeds of US$2.7 billion after taxes, including US levies for repatriating the funds to the US. Devon plans to use the money to repay debt from its Eagle Ford acquisition that closed in February. More transactions involving the company’s South Texas, East Oklahoma, Arkoma Basin and Rockies gas assets are on the horizon, according to Devon’s CEO.

### Suncor Energy

In April 2014, Suncor agreed a $1 billion asset sale to Centrica and Qatar Petroleum. The sale of the Wildcat Hills property, northwest of Calgary, brings Suncor’s total divestiture tally to $2.8 billion since its union with Petro-Canada. Suncor reported the closure of its previously announced divestment of a major portion of its Western Canada-based conventional natural gas assets. The properties were sold to CQ Energy Canada Partnership, a joint venture between Qatar Petroleum International and the UK’s Centrica plc. The deal falls in line with Suncor’s increased focus on core oilsands operations. The company is planning to use the net proceeds to invest in projects with high growth potentials, repurchase shares and pay dividends.

### Crew Energy

In April 2014, Crew Energy Inc. announced an agreement to sell certain petroleum and natural gas assets (75% natural gas), primarily in the Deep Basin of Alberta, in exchange for approximately $222 million in cash.

The gas divestment includes current production of 7,000 boe per day (75% natural gas) based on field estimates. The divestment involves total proved reserves of 34.1 million boe (71% natural gas), total proved and probable reserves of 60.4 million boe (71% natural gas) and 254,000 net acres of land.
Encana

Encana announced that it would sell its Jonah Field Operations in Wyoming to an affiliate of TPG Capital for $1.8 billion. “This transaction is consistent with our strategy. With the divestment of Jonah, we are unlocking value from a mature, high-quality asset and allowing our teams to focus on our five core growth areas and continue with execution of our new strategy,” said President and CEO Doug Suttles. Encana’s Jonah field comprises a total productive area of about 24,000 acres and more than 1,500 active wells. The transaction also includes more than 100,000 acres of undeveloped land adjacent to Jonah, known as the NPL.

Talisman Energy

In March 2014, Talisman Energy completed the divestment of part of its Montney assets, in northeast British Columbia, to Progress Energy Canada Ltd. The sale of approximately 127,000 net acres, resulted in a cash payment of $1.5 billion. Completion of this transaction, along with other recently closed deals, has resulted in more than $2 billion of divestments for Talisman Energy in the past 12 months. Further streamlining of the company portfolio is expected as Talisman Energy intends to sell long-dated, capital-intensive assets worth $2 billion in the coming 18 months. Management stated that the funds generated from these divestments would be used to strengthen the company’s balance sheet.
Challenges

Divestment success depends on four critical dimensions: deal strategy, cost management, speed and risk mitigation.

Key questions

Ensuring a smooth transition process begins by asking the following questions:

1. What information do you need from the buyer in order to deliver the carve-out assets in the most efficient manner possible?
2. What will the seller’s post-transaction organization look like?
3. Who will be on the joint steering committee for carve-out/integration and for the transitional services? What will be the mandate and objectives of these committees?
4. Who will be the focal point for each of the streams of work on the buyer and seller side? How will they engage with their counterparts?
5. What are the specific objectives and carve-out plans for each of the individual work streams? How do we ensure this minimizes costs to seller?
Ensuring long-term success – both on the buy and sell side – requires companies identify and address a number of common challenges. Carve-outs are often complex and demand adequate resources to add value to both sides of the transaction.

- Lack of a transparent and compelling rationale for the proposition story
- Buyers cannot seamlessly reconcile among audited financials, management reporting and deal basis financials.
- Seller not prepared to support deal basis carve-out numbers with underlying drivers and metrics
- Fluctuation of in-scope assets, liabilities, employees and contracts
- Unfavorable purchase price adjustments mechanisms and targets
- Seller did not contemplate who the buyers might be and what they may need.
- Seller stayed with the wrong bidder too long.

### Avoid surprises and protect value during the process
- Issues are identified in advance of buyer participation
- Shareholder tax planning considerations are contemplated

### Minimize disruptions to management’s focus on running day-to-day operations
- Complete rigorous diligence only once
- Data room support is coordinated with the completion of the sell-side report

### Accelerate closing process
- Sell-side reports limit the amount of buyer diligence
- Thorough preparation allows sellers to dictate terms/timing of the process

### Enhance credibility and preparedness
- Diligence efforts prepare the management team for presentations and buyer Q&A sessions
- Prepares management to answer questions thoroughly

### EY value proposition

- Poorly organized or incomplete data rooms resulting in excessive buyer requests for information
- Seller/Buyer’s inability to team together to work through operational separation issues
- Insufficient consideration of customer/vendor/product/employee interdependencies and separation planning
- Did not thoroughly evaluate and comprehensively structure the TSA
- Rushed into the deal and did not consider ways to enhance value
- Allowed the process to result in a lack of focus on operating the business
- Did not have a clear understanding of stranded costs and how to minimize them

6. What are the critical Day 1 activities that each of the workstreams will need to have completed for closing?

7. How will the buyer and seller organize workstream teams to ensure the delivery of critical Day 1 activities? How will progress on these activities be tracked and reported?

8. What are the objectives with regards to TSAs? How will this process be managed from initial contracting of the TSAs through to TSA exit, including the performance tracking and reporting process in between?

9. How will seller ensure that planning activities do not get off-side with the Investment Canada and Competition Bureau review process?

10. How will key issues, risks and decisions be addressed, escalated, tracked and reported?
Considerations

1. People
   - People may not be easily aligned with the new business units (legal entity vs. business unit).
   - Allocation of split heads can result in cherry picking and stranded costs.
   - Seller staff might not want to transition to the buyer and engaging those people during transition may be a challenge.
   - Key talent will always be in demand (both the buyer and the seller might want some of those same people).

2. Business processes
   - Shared services provided to/from during the transition period can vary greatly depending on buyer (corporate vs. private equity), resulting in stranded costs.
   - Interdependencies are generally underestimated and uncovered too late.

3. Systems
   - Who “owns” specific applications can be difficult to determine.
   - What applications will be needed during transition needs to be assessed early on for effective logical separation on Day 1.
   - Access to non-public personal information post close can create data privacy challenges.
   - Day One separation requirements will impact timeline to close deal.

4. Assets
   - Assets (tangible and intangible) may not be easily identifiable by the business unit.
     - Consider whether all royalty interests, entitlements and burdens properly reflected
     - Identify when the most recent title reviews were completed and how comprehensive they were
   - Ownership of shared intellectual property must be determined and separately licensed, if necessary for post close use.
     - Identify whether there are restrictions on the transfer of seismic and well data libraries

5. Third-party obligations
   - All legal obligations need to be identified, which can be extremely challenging if a central repository does not exist.
   - Seller and target need to identify and reach consensus on what is in scope.
   - Business and regulatory licenses are critical for Day 1 readiness.
   - Separation of third-party obligations is a significant undertaking and should be started as soon as possible.
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The EY divestment approach

Ensuring proper value through divestments requires significant due diligence in today’s buyers’ market. Companies fall victim to common divestment pitfalls too often. Most companies do not have in-house capabilities or experience in executing divestitures. That is where we come in. Engaging external advisors, who have the necessary experience, can help you through the process and come out successful in the end.

Our teams can help structure a well-planned carve-out process that can help you boost deal value. Knowing when and deciding which assets, liabilities and intellectual property to sell through divestment or carve-out is a powerful way of managing your negotiation capital. We bring in experience, knowledge, familiarity and objectivity to identify an accelerated road map to migrate off the TSAs for buyers and sellers and to save both parties’ time and money. For buyers, acumen in carve-out acquisitions can dramatically improve the ability to exploit the pipeline of growth opportunities. Leading practices of serial acquirers and sellers have repeatable processes for buying and selling carve-outs. We can work with you to develop a process for your business to give you a competitive advantage.

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<td>• Prepare carve-out financial statements</td>
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Conclusion

The structured changes underway in both the global and Canadian oil and gas market have led several Canadian entities pursue divestments. These transactions are being fueled by increase in gas price, portfolio rebalancing and access to market constraints – and they’re set to continue as companies look for opportunities to maximize cash flow, optimize portfolios and, in some cases, move to a more oil-based energy mix.

As companies consider gas divestment decisions using a well-thought-out divestment process, they can more nimbly address the needs of the market in a timely and efficient way. Knowing when and how to sell or buy assets through carve-outs can become a powerful way of managing capital to increase shareholder value.
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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