New challenges – an opportunity for resilience and resourcefulness

For much of the past two decades, Canada has enjoyed the status of being one of the world’s most active and transaction-rich oil and gas markets. Its abundant and diverse oil, natural gas and oil sands reserves have drawn significant global attention.

Between 2008 and 2014, as global oil prices surged, Canada benefitted from record inbound investment activity and many predicted that Canadian resources would play an increasingly important role in meeting the world’s growing energy appetite.

Fast forward to 2015 and Canadian energy investors, E&P companies and oilfield services providers alike have found themselves facing a new set of challenges and unrelenting industry head winds.

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**Current challenges facing the oil and gas market**

Some of the head winds facing the energy sector include:

- A collapse in global oil prices
- Increasing North American competition fueled by surging US production – in both oil and natural gas – with Canada’s largest customer now its largest competitor
- A lack of market access for Canadian oil and gas outside the US
- A dramatic shift in OPEC production policy – where OPEC no longer appears prepared to act alone as the market balancer
- Increasingly cautious expectations on future energy demand in Asia – especially in China
- An evolving Canadian domestic policy framework that includes higher prices on carbon, rising tax rates, pending royalty changes and uncertainty in project approval processes

Based on these conditions, 2015 transaction activity in Canada plummeted. Energy headlines became dominated by growing industry uncertainty, operational pain and investment caution. The oil and gas industry as a whole found itself in the midst of a significant structural shift – moving from an era of scarcity where capital investment decisions were driven by the perception of resource scarcity – to an era of abundance where acquiring sufficient oil and gas reserves appears cheap and plentiful, and excellence in operational and project execution are among the short list of key success factors.

For many, 2015 quickly became a difficult and turbulent time as traditional energy business models were forced to transform to survive in a new resource-abundant world.

**Canadian upstream oil and gas activity**

The elements for a robust and opportunistic transaction period are emerging.

However, in the midst of the turmoil, all is not lost. Transactions continue to get done and an underlying sense of opportunism – not to be confused with optimism – has emerged. While the price expectations gap between buyers and sellers, and patient capital providers, kept many transactions from seriously advancing in 2015, the dynamics of a very robust transaction period appear to be coming into place.

To understand the place of Canada’s energy industry – and potential opportunity – in context with current market conditions, one must understand that:

- Canada still has abundant, world-class under-developed energy resources – the asset has not changed.
- On balance, Canada remains a politically stable operating jurisdiction.
- Canadian operators are focused on driving costs from the system. Many experts estimate the scale of current cost savings at 20% to 30% (or more) of pre-2015 levels. Looking forward, we expect Canadian projects to remain very competitive with US projects on a breakeven cost comparison basis as these cost savings flow through.
- Globally, capital is plentiful. And the dramatic decline in the Canadian dollar makes Canadian assets look relatively less expensive to US and international buyers. Even if it flows into Canada as “distressed capital,” it will be attracted to the Canadian market and facilitate increased transaction activity.
- Canadian energy companies are highly resilient and innovative – the Canadian industry will adapt and winners will emerge with new models and structures to succeed in our new era of energy abundance.

Canadian operators are becoming more globally competitive and are focused on driving down costs.
So, why will Canadian transaction activity accelerate in 2016?

Because companies have to take action

Some companies under severe liquidity pressure will be forced to transact, whether driven by lenders, shareholders, activists and/or management. Many will clear at the clearing price, and the clearing price will be lower as the forward price curves flatten and 2014 hedges have rolled off. The growing consensus of lower for longer will also bring price expectations between buyers and sellers closer together.

In 2016, sellers may become more willing to accept stock-based deals as a way to provide shareholders with upside leverage from a combined business and even the strongest companies will focus on aggressive portfolio rationalization as they build their 2016 capital plans around living on cash flows. The court-approved CCAA restructuring of Laricina Energy that saw the Canadian Pension Plan Investment Board take an 89% interest in the struggling Canadian oil sands producer and the multiple carve-out divestitures by Penn West Petroleum totaling over CAD$800 million in 2015 are two examples of potential templates for 2016’s “have to” transactions.

Because there is opportunity for the strong

Those companies with strong balance sheets and stable operations will create and pursue opportunistic transactions to secure attractive assets at depressed prices. Many may find it increasingly hard to resist taking advantage of the opportunity to grab quality assets held by financially weak sellers.

Expect 2016 to include those transactions where companies seek to leverage their balance sheet strength to shift spending to acquire production and reserves for a fraction of the price of a full scale exploration-to-production model. Increasing shareholder activism will also likely influence the behaviors of all Canadian energy players as boards will increasingly be challenged to unlock value. Suncor Energy’s CAD$6.6 billion unsolicited takeover bid for Canadian Oil Sands may be the start of a growing transaction trend. While pending at the end of 2015, it highlights the potential opportunity for well-positioned and well-capitalized buyers, and the risk that some large independent Canadian energy companies could face when oil and stock prices have collapsed.
Because of innovative access to capital

Innovative capital structures have always played a key role in the Canadian oil and gas transactions market. In 2015, the presence of “capital structure innovators” grew to take advantage of illiquid capital markets.

Some of the largest Canadian energy transactions of 2015 – PrairieSky Royalty’s CAD$1.8 billion acquisition of royalty interests from Canadian Natural Resources Limited and Ontario Teachers’ Pension Plan acquisition of royalty interests from Cenovus Energy for CAD$3.3 billion to form Heritage Royalty – are good examples of industry efforts to surface value through structured transactions. Expect activity involving new capital structure innovators and royalty interest vehicles to increase in 2016 as producers look for capital and as investors look for returns. While the size of future royalty transactions may vary, manufactured royalty deals will likely continue.

In the midstream space, we expect deal activity to accelerate in 2016 as E&P companies look to monetize midstream assets to de-leverage balance sheets and fund capital programs. Plentiful capital focused on the midstream space has created competition and driven valuations up – and creativity will emerge to match complex and diverse objectives.

For cash-strapped upstream businesses, the short-term cash accretive nature and strong valuations of the possible sale of midstream assets will outweigh other operational and strategic considerations (at least in the short term). The Veresen/KKR/Encana midstream alliance consummated in 2015 may be an early example of more creative midstream transactions and partnerships to come in 2016.

Because synergies will matter

Almost universally the oilfield services (OFS) sector is facing immense challenges. Unrelenting pressure from the upstream sector to reduce costs has dramatically reduced margins for almost every OFS operator and threatened the viability of many OFS companies. This pressure will not relent in 2016 – even if commodity prices unexpectedly strengthen – as the upstream players will likely first use excess cash flows to repair their balance sheets before increasing spending.

To survive, many foresee the need for dramatic consolidation and rationalization in the OFS space. Part of the value this consolidation would bring to the OFS sector is the ability to realize significant synergies in field operating costs, in administration and overhead expenses and in the need for maintenance and growth capital expenditures.

The fast-evolving nature of drilling, completion and ongoing operations in the Canadian unconventional oil and gas space will lead to the development of new business models to efficiently and effectively serve diverse and under-exploited unconventional resources, including both SAGD oil sands operations and the multi-well pad operations that are emerging in shale oil and gas plays. Expect to see more transactions similar to the CAD$527 million merger of Trinidad Drilling and CanElson Drilling as companies look for ways to realize on synergies and improved efficiencies to strengthen the operational and financial resiliency of the combined businesses.

Pressure on the OFS space will not relent in 2016 and transactions will focus on achieving real cost synergies.
Is the Canadian oil and gas industry up to the challenges?

Participants in the Canadian oil and gas sector were badly bruised in 2015. Looking into 2016, challenging market conditions appear set to continue, and it is likely that some companies will not survive. Decisions around the Capital Agenda are driving management, board and investor discussions as all players sort through their critical and complex choices around the availability, allocation and cost of precious capital in the midst of this structural shift in the industry.

Learn more about the Capital Agenda at capitalinsights.ey.com.

While multiple divergent views will be articulated on the nature, scope and pace of 2016 transaction activity, all participants will likely agree that in the new resource-abundant world, three key implications – costs matter, everything is global and innovation is key – will drive actions:

- **Costs matter** in a very structural way – as the industry struggles to be economic in a new lower-priced commodity world. Increases in regulatory (royalties, taxes and carbon levies), technology (more complex well completions and operating processes) and social acceptance costs will continue to pressure the industry.

- **All capital allocation decisions need to be made in a global context** as capital flows globally and Canada’s oil and gas industry must be competitive on a global basis to attract capital.

- **Innovation will be key to effectively managing costs and competing globally**, and innovation will be in terms of technologies, business processes and capital structures.

Is the Canadian oil and gas industry up to the challenges? We think so.

Resilience, resourcefulness and world-class assets will allow recovery to take hold in 2016, and accelerated transactions will be a core part of that transformation.

The state of the oil and gas industry

From scarcity to abundance ...
Learn more

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EYG No. DW0597
1800172
ED None

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