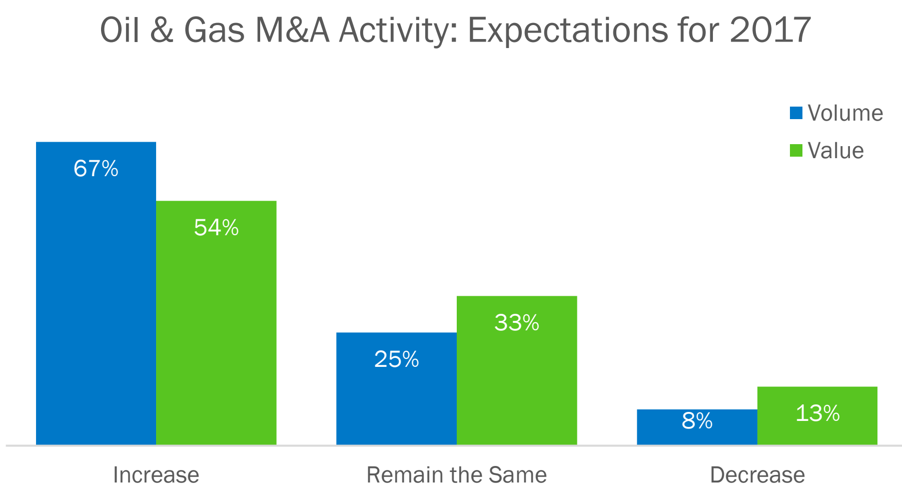
Insight Article: Canadian Oil and Gas: Challenges, Solutions, and an Optimistic Outlook

Last week yielded a blockbuster deal in the Canadian oil patch: Cenovus Energy announced the acquisition of ConocoPhillips Co.'s oil sands assets for the mega price of C$17.7 billion. The deal arrived on the heels of Canadian Natural Resources Ltd.'s C$11.1 billion acquisition of oil sands assets from Royal Dutch Shell Plc, and reflects the ongoing oil sands consolidation by major Canadian companies.

This activity is consistent with findings in a recent Mergermarkets/Tory's report relating to expectations for the Canadian Oil and Gas sector in 2017. Respondents to the survey were optimistic about deal activity for the current year, with 67% expressing a belief that volume would increase.



There are two challenges likely to drive Canadian M&A through 2017:

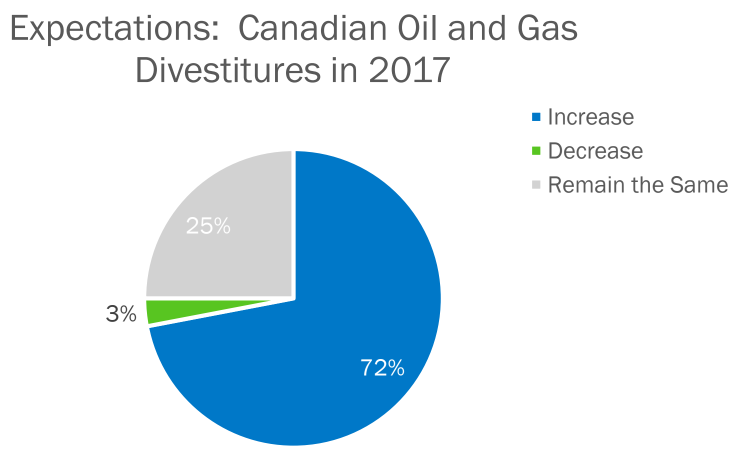
1. Lower commodity prices;
2. Regulatory pressure to reduce emissions[1].

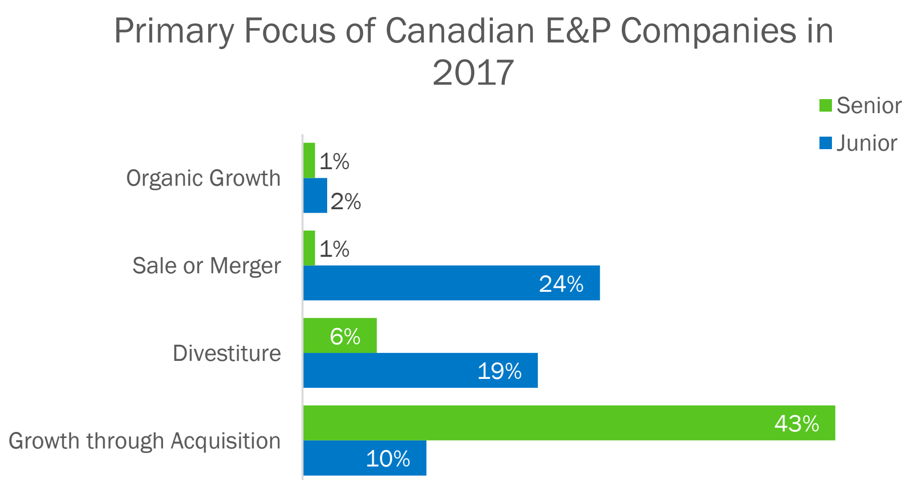
To address both of these challenges, Exploration and Production ("E&P") companies are looking to new technologies to reduce costs and emissions. Schlumberger's 2016 acquisition of the coiled tubing assets from Calgary-based Xtreme Drilling and Coil Services serves as an example. The deal was done for the specified purpose of increasing operational efficiency. With the persistence of commodity price uncertainty, we expect to see more of this activity through 2017. As is noted in a recent McKinsey article, Preserving the Downturn's Upside, cost savings created through operational efficiencies are most likely to be sustainable in the long term, a clear motivator in a world of uncertainty.

A further consequence of sustained, lower commodity prices is an increase in plans for divestment, particularly amongst junior E&P companies that are typically facing higher levels of debt and reduced

[1] With the Paris Agreement on climate change now in force, Canada will try to reduce greenhouse gas emissions to 30% below 2005 levels by 2030. In addition, Alberta has introduced new legislation with a broad impact on emissions reduction. The federal government has also introduced a federal benchmark for pricing carbon emission.

cashflow. As luck would have it, this heightened intent to divest marries seamlessly with the plans of senior E&P's to focus on growth through acquisition.





With senior E&P's likely to be busy on the deal front, how will those acquisitions be funded? Now that oil prices are hovering in the US$45-55 range, banks are more comfortable to lend to the sector and unsurprisingly, more respondents expect to look to the debt market in 2017 over the previous year (37% compared to 28%). Additionally, we can't forget about the significant private equity (PE) dry powder… and neither have the oil companies. Forty-four percent of respondents expect to look to PE investors for financing in 2017.

So there you have it. With relatively stable oil prices, albeit at lower levels than the soaring US$100+ from years gone by, there is a rational optimism about deal activity in the coming months. There is the harmonious combination of intent to divest and acquire, and most significantly, a need to engage in acquisitions to reduce operating costs and carbon emissions. It's been a positive start to the year for the Canadian Oil & Gas sector, and we expect more of the same to come.