DAILY OIL BULLETIN

September 25, 2013

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# "Failed Process" Or "Unrealistic Expectations"?

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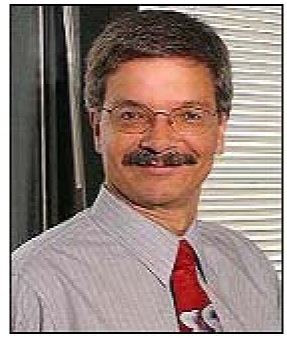
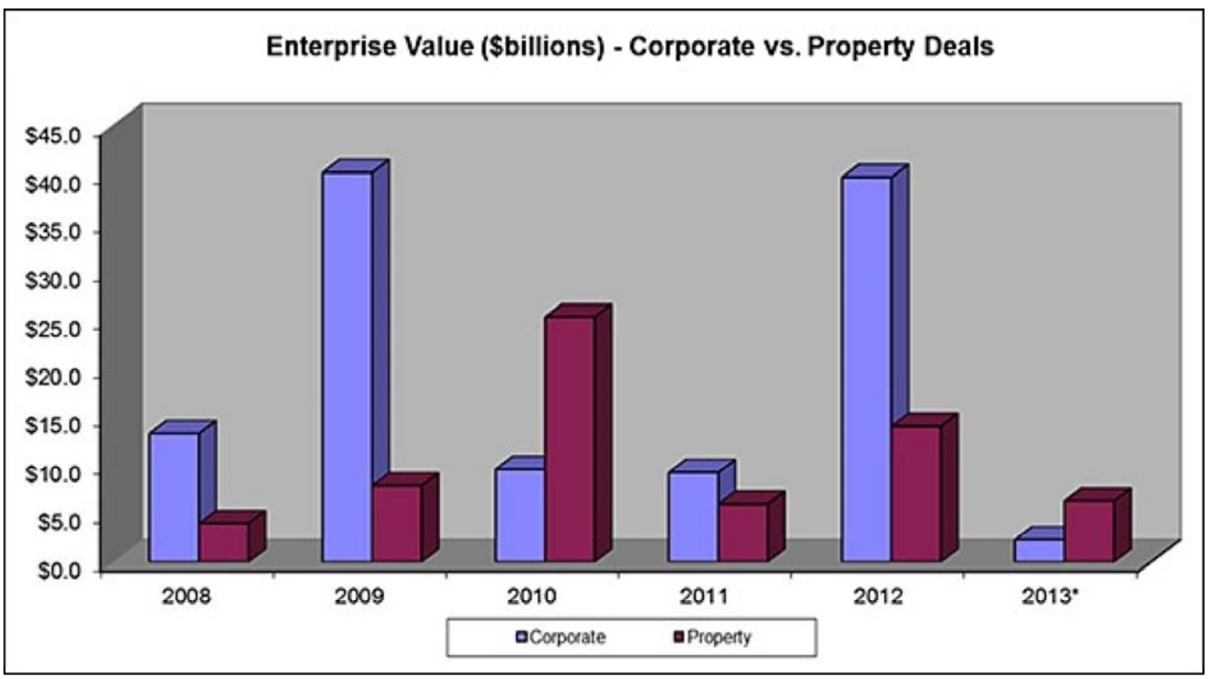


Common discussion in the mergers and acquisitions ("M&A") world recently has centred around the large number of M&A processes that have been rumoured to be "*failed processes*" due to the fact that they have failed to result in a transaction. In light of the fact that the total value of all M&A activity in the first quarter of 2013, at a paltry $752 million, was its lowest level in almost 20 years, many believe there is truth to these rumours.

The perception was not helped much by the slight recovery that has occurred since the first quarter, with a total of $3.5 billion in M&A value in the second quarter and the larger total that is building in the third quarter. The year-to-date total is still far below the corresponding totals of recent years. In a "*typical*" year, our industry sees from $20-$60 billion in total M&A value and, while all of the values are not yet in, almost three quarters of the way through 2013 we have seen less than $10 billion worth of deals to date.

**Total Enterprise Value of Transactions ($ Billions)**
**2008-2012 (full years), 2013 (nine months)**




In fact, many M&A processes are doomed to fail before they even begin, due to unrealistic expectations of the outcome by both the vendor and its agent. The key to a successful process is understanding the state of the current M&A marketplace prior to listing a property for sale and then expecting a reasonable outcome in light of this market. Let's look at a common non-oil and gas industry example to illustrate this.

Many of us have had the distasteful experience in the housing market of having a real estate agent promise that they can sell our house for a certain price, then, after listing it and **not** selling it, advising us that the market must be soft and we should lower the asking price. The house is ultimately often sold for a reduced price.

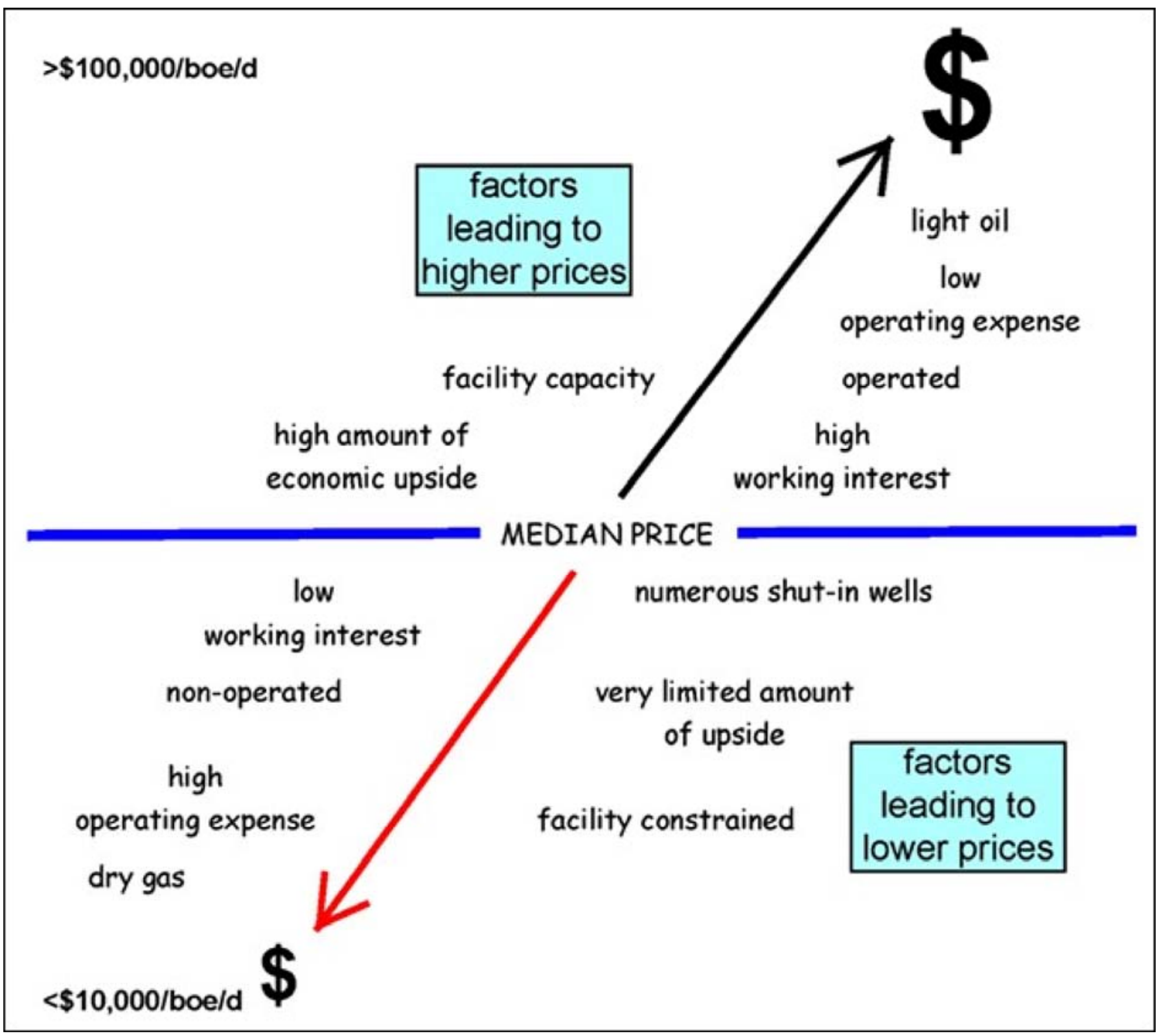
The only winner in this scenario is the agent, who got the listing and ultimately the commission on the sale by giving the homeowner false hope.

The homeowner, only knowing the market in general, and relying on the advice of the agent, entered into the process with an unrealistic expectation of value and settled for a disappointingly lower price.

The selling price of a house in Mount Royal would be expected to be significantly higher than the median price of all homes sold in Calgary, while, conversely, the selling price of a starter home on the outskirts of the city would be expected to be significantly less than the median price. If a seller of a starter home is expecting the median price, he or she is going to be sorely disappointed. Conversely, no one in Mount Royal would settle for the median price for their home. In both instances, understanding the intricacies of the local market would set the seller's expectations at a reasonable level, increasing the chances of a successful outcome.

In the oil and natural gas M&A marketplace, like in the housing market, all properties are not created equal. Prior to listing an asset for sale, the vendor and its agent should examine the attributes of the property in comparison to other properties in order to see how the expected price relates to the commonly quoted "*median price*" for M&A transactions.

As shown on the following chart, factors such as commodity type, working interest level, operating expense, facilities ownership, degree of upside, capacity of facilities to handle upside, number of shut-in or abandoned well liabilities, etc. all affect the selling price of an asset. The selling price of an asset can be significantly higher or lower than the median price; understanding this is critical to managing expectations in a sales process.

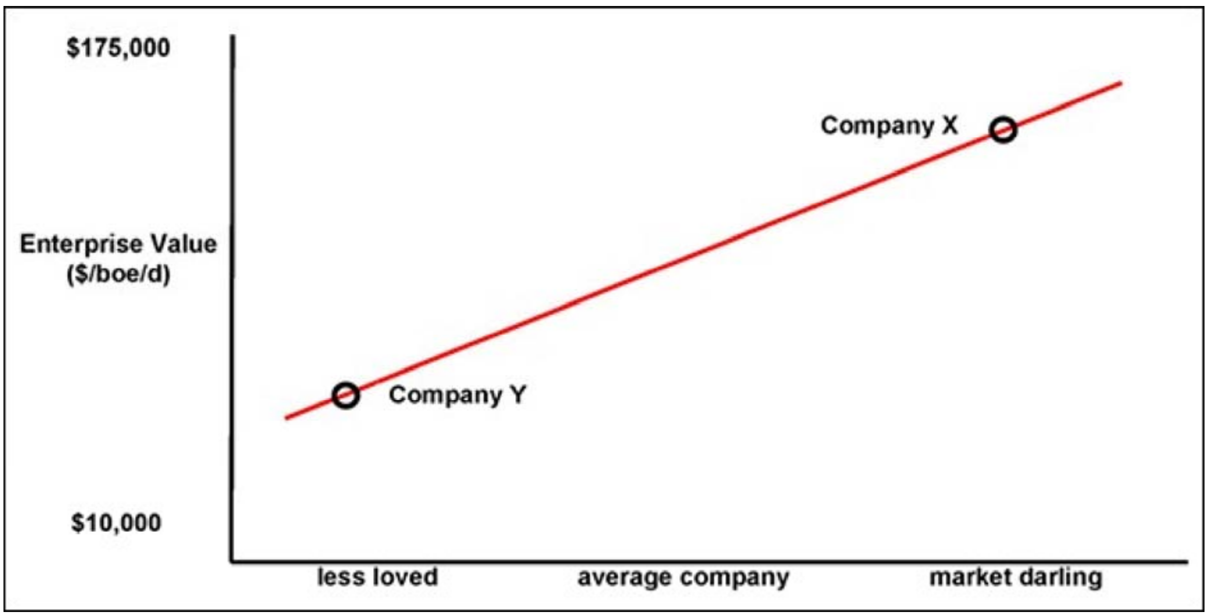


Cost of capital must also be considered in pricing an asset for sale. In a non-core property divestiture, a vendor is typically selling its lower-end assets, not its crown jewels. In the case of a publicly-traded company, its trading price will in large part be determined by the nature and quality of its core assets. The non-core assets which it wants to sell would presumably be worth significantly less than the gems.

Let's use as an example, *Company X*, which is trading at an enterprise value of over $150,000/boe/d, likely due to the strength of its tremendous holdings in a hot resource play. *Company X* decides to sell some of its lower end assets and *Company Y* wants to buy them. The basics are in place for a transaction to occur, as we have both a willing seller and a willing buyer.

If it has only conventional oil and natural gas assets, *Company Y* might be trading at a relatively low enterprise value of say $30,000/boe/d. As a result of this relatively high cost of capital, if it pays any more than its trading price of $30,000/boe/d for the asset, it is a dilutive transaction to *Company Y*.

If *Company X* does not recognize that it is NOT trading at $150,000/boe/d on the strength of its non-core asset and it is willing to sell this asset for a price which *Company Y* can afford to pay, a deal can happen. If *Company X* insists on selling its asset for no less than its trading multiple of $150,000, there is no way that it will be able to sell the asset, especially not to *Company Y*.




Another factor which affects the outcome of a sales process is the lending value of the sales property. If *Company X*'s lender has assigned a non-core property a lending value which is well outside the current market value of the property, *Company X* cannot possibly agree to the sale of the property unless it wishes to step backwards in its net debt position. In this current capital constrained market, not many companies are willing to take on additional leverage just to part with a non-core property.

The lending value to market value difference has been a common issue affecting M&A transactions in the past several months, particularly relating to natural gas properties. Market values of natural gas properties, which have recently been based on low multiples of current net operating income, have drastically fallen while reserve values, which are based on forecast operating income using escalating price forecasts, have not fallen as hard. Lending values, which are for the most part based on reserve values, have remained significantly higher than the market values of natural gas assets, stalling many potential M&A transactions. As lenders reduce loan ceilings for junior producers, loan values should fall more in line with asset market values. This should spawn an increase in M&A activity involving both natural gas properties and oil properties, particularly for those juniors. With equity markets frozen, many juniors that are faced with reduced loan capacity will be less likely to reject offers that help to get the balance sheet onside.

There are many more factors to be considered in pricing an asset or a company for sale. Absent a realistic expectation of value when entering into a process, the process is doomed to fail from the start. A proper understanding of how the attributes of the property or company that is being sold stack up against other recent sales will give a process a fair chance of achieving a satisfactory outcome.

In light of this analysis of "*failed processes*" vs "*unrealistic expectations*", most readers are probably asking why the level of M&A activity is so low to date in 2013? Clearly, this is not the only reason for a precipitous drop in the value of all deals. There have been a number of factors affecting this, some of which are obvious, some of which are not so obvious. A discussion of this will be the topic of a future article.

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