Daily Oil Bulletin

Oilpatch Deals Continue As Vermilion Acquires Private Producer; M&A Value Considerably Higher In Q1

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Oilpatch merger and acquisition (M&A) activity continued on Tuesday as **Vermilion Energy Inc.** announced it is buying a private southeast Saskatchewan producer, reportedly **Elkhorn Resources Inc.**, for $400 million, as the M&A market has been much hotter year-over-year.

This deal follows one announced on Monday involving **Whitecap Resources Inc.** and **Imperial Oil Limited** (DOB, March 17, 2014 (http://www.dailyoilbulletin.com/article/2014/3/17/whitecap-buying-certain-imperial-assets-private-pr/)), and a string of others. In another major deal this year, **Canadian Natural Resources Limited** entered into an agreement to acquire **Devon Canada**'s Canadian conventional assets, excluding Horn River and the heavy oil properties, for an aggregate cash consideration of $3.125 billion (DOB, Feb 19, 2014 (http://www.dailyoilbulletin.com/article/2014/2/19/canadian-natural-acquire-devon-assets-313-billion/)). Earlier this month, **Tourmaline Oil Corp.** agreed to acquire **Santonia Energy Inc.** (DOB, March 4, 2014 (http://www.dailyoilbulletin.com/article/2014/3/4/tourmaline-acquire-deep-basin-player-santonia-ener/)).

"We're getting close to $8 billion in M&A value for the first quarter of this year," said **Tom Pavic**, vice-president of **Sayer Energy Advisors**. "In comparison, at this time last year, we had $750 million.

"The biggest driver has been capital raised," he added. For the first quarter this year, "there's been over $2.2 billion in equity raised" in comparison to roughly $700 million at the same time in 2013.

"One big deal sort of swings it, too, which was the Canadian Natural/Devon deal," Pavic said. "It just seems like there's more capital and there's more investor interest in the industry now."

More oilpatch deals likely relates to a bit better access to capital for buyers, plus new reserve reports are now generally available, added **Don Rawson**, managing director of institutional research with **AltaCorp Capital Inc.**

"It is often hard to get deals done with stale reserve reports, so this gets in the way of some transactions," he said.

Geoff Ready, senior analyst, oil and gas with **Dundee Capital Markets**, said that improving commodity prices has helped to bridge the gap between buyers' and sellers' expectations. "Also, the equity markets have opened up to allow companies to raise capital to buy assets."

Details of Vermilion deal

The Vermilion deal announced on Tuesday includes a cash and share consideration of $345 million plus the assumption of $55 million in debt.

In aggregate, the private company's shareholders will receive $172.5 million -- 50 per cent -- of the consideration in the form of cash, to be funded from existing credit facilities and $172.5 million, the other half, in the form of Vermilion shares. Based on a five-day weighted average trading price of $63.81 per Vermilion share, approximately 2.7 million Vermilion shares will be issued pursuant to the terms of the arrangement.

In an e-mail response to the *DOB*, Vermilion stated that the acquisition delivers "low decline, high netback light oil focused assets, [it's] free cash flow positive, self-funding for development.

"[There's a] solid base for future expansion through freehold and Crown leasehold opportunities and potential consolidation."

Holders of approximately 60 per cent of the private company's shares, on a fully-diluted basis, have entered into support agreements with Vermilion, pursuant to which they have agreed, among other things, to vote all "Privateco shares" beneficially owned or controlled by them in favour of the arrangement. In addition, the board of the private producer has unanimously approved the arrangement and recommended that its shareholders vote in favour of the arrangement. The arrangement remains subject to customary conditions, including receipt of applicable court, Privateco shareholder and regulatory approvals, and is expected to close on or about April 29, 2014, allowing the private company's shareholders to receive Vermilion's anticipated April 2014 dividend, which is expected to be paid on May 15.

As a result of the acquisition, Vermilion is revising its 2014 production guidance to between 47,500 and 48,500 boe per day, assuming eight months of contribution from the assets. Following the acquisition, the company is revising its guidance for exploration and development capital expenditures by $35 million, from the current $555 million to $590 million for 2014.

The assets are comprised of high netback, low base decline, light oil producing assets in the Northgate region of southeast Saskatchewan. The assets include approximately 57,000 net acres of land (approximately 80 per cent undeveloped), seven oil batteries and preferential access to 50 per cent or greater capacity at a solution gas facility that is currently under construction. Production from the assets is projected to be approximately 3,750 boe per day (97 per cent crude oil) during 2014. More than 90 per cent of the current production base will be operated by Vermilion.

Elkhorn's website states that the company has assembled a highly focused and dominant land position in the Northgate area of southeast Saskatchewan. *DOB* statistics show that Elkhorn has rig released nine wells so far in 2014, all horizontals and all located in Saskatchewan with total depth zones including the Midale,Torquay and Frobisher. For 2013, the company rig released 34 wells, also all in Saskatchewan.

Asset reserves

Total proved and proved plus probable reserves attributed to the assets at Feb. 28, 2014, are 10.3million boe (81 per cent crude oil and natural gas liquids) and 16.5million boe (81 per cent crude oil and natural gas liquids), respectively, based on an independent evaluation by **GLJ Petroleum Consultants Ltd.** Vermilion has currently identified approximately 175 (152 net) potential drilling locations targeting the Midale, Frobisher, Bakken, and Three Forks/Torquay formations. Approximately 45 per cent of the locations remain unbooked and are not reflected in the GLJ report. The majority of production and development drilling opportunities are from the

Midale formation, with additional opportunities identified in the Frobisher, Bakken and Three Forks/Torquay formations. The assets demonstrate a low annual decline of approximately 18 per cent and are expected to provide cash flow that will fully fund the continued growth of the assets.

The acquisition is accretive on a fully-diluted per share basis for all pertinent metrics including production, fund flows from operations, reserves and net asset value. Making no deduction for undeveloped land value, transaction metrics equate to $38.92 per boe of 1P reserves, $24.20 per boe of 2P reserves and $106,700 per flowing bbl of production.

Based on Edmonton light benchmark 2014 strip pricing of US$88 per boe, the current after-tax cash flow netback for the assets is estimated at approximately $60 per boe.Using the 2P finding and development cost (based on the reserves in the GLJ report) of $24.20 per boe, the assets are expected to deliver a 2P after-tax fund flows recycle ratio of 2.5 times.Using the same pricing assumption, total acquisition cost (including assumed debt) is approximately 4.9 times estimated annualized 2014 fund flows from operations of approximately $81 million.

New core area

The acquisition creates a new core area for Vermilion in the Williston Basin. The company has been evaluating producing entry opportunities into this prolific area for an extended period of time, but had not previously been able to structure a transaction that met the stringent requirements of our dividend growth model.

Specifically, the assets exhibit the three hallmark characteristics of Vermilion's sustainable growth-and-income model, the company stated: high margins, low base decline rates and strong capital investment efficiencies on future development. In addition, the assets are geographically complementary to recent leasing activity the company has conducted for Mississippian development in southwest Manitoba.

"We believe the multi-horizon, horizontal well techniques employed in this area are well-suited to the expertise we have established during development of our Pembina-area assets in Alberta," the company stated. "We also believe that the fiscal and regulatory policies in Saskatchewan and Manitobacreate an appropriately supportive environment for investment."

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