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Varcoe: As revenues surge, Canadian producers can 'choose more things off the menu' — including acquisitions

'There isn't going to be one single strategy for what companies do with their cash flow these days'

Chris Varcoe • Calgary Herald
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FILE PHOTO: Oil barrels are pictured at the site of Canadian group Vermilion Energy in Parentis-en-Born, France, October 13, 2017. PHOTO BY REUTERS/REGIS DUVIGNAU

Like a customer sitting down at a restaurant, Canadian petroleum producers are faced with several options as energy prices continue to rise and revenues climb.

Vermilion Energy announced Monday it has acquired junior producer Leucrotta Exploration for $477 million in cash, its second major acquisition within four months, giving it an entry into the Montney formation.

Many producers have spent the past year focused on paring down debt and returning money to investors through increased dividends and share buybacks.

However, with oil and natural gas prices continuing to climb this year, companies have more alternatives ahead and can pursue several paths at once.

“There isn’t going to be one single strategy for what companies do with their cash flow these days,” said Michael Tims, vice-chair of Matco Investments.

“Because commodity prices are stronger than what people originally envisioned and the cash flows are much larger, they can — to a degree — choose more things off the menu.

“They don’t have to just solely increase the immediate returns to shareholders. They can also, if they want, spend more on existing assets and they can look at acquisitions.”

Since the start of the year, oil prices have risen by 40 per cent. Oil closed Monday just below US$106 a barrel for West Texas Intermediate crude, while U.S. benchmark gas prices remain high, closing at US$5.54 per million British thermal units.

The Canadian industry is expected to see record revenues of $225 billion and after-tax cash flow of $143 billion, according to ARC Energy Research Institute.

Vermilion, which operates in both Europe and Western Canada, has largely prioritized strengthening its balance sheet since oil prices crashed in early 2020 and its net debt topped $2 billion.

In November, it announced a $556-million deal to acquire a bigger stake in the Corrib natural gas project, located off the coast of Ireland. It has now agreed to pay Leucrotta investors $1.73 per share, plus they will receive a share in a new junior energy company.

Leucrotta produces about 4,400 barrels of oil equivalent (boe) per day in the Montney region of Alberta and British Columbia. Vermilion expects to increase output from the properties to about 13,000 boe per day next year.

The Calgary-based company said it would increase its exploration and development budget for the year to $500 million, as it invests $75 million on its new assets.

However, president Dion Hatcher said Vermilion is still going to cut its debt levels down to $1.2 billion in the second half of the year, and will reduce net debt below $1 billion by the end of 2022, three years ahead of its initial schedule.

“As we achieve these debt targets, we will evaluate options to increase (the) return of capital, which could include an increase to the base dividend, share repurchases, further debt reduction, or special dividends,” he told analysts during a conference call.

Leucrotta CEO Rob Zakresky said the transaction will see Vermilion acquire part of the junior producer’s Montney lands, including property that’s developed and has energy infrastructure in place.

A new junior company, led by Zakresky, will be spun out and develop properties in the Two Rivers area of northeastern British Columbia, with Vermilion acquiring about 12.5 per cent of the new corporation for about $14 million.

“It just made sense. (Vermilion) is a large company and better capitalized and can draw the value forward on a piece of it,” Zakresky said in an interview. “We are going to go back out and try to build back value into the piece we have left for our shareholders.”

In a note, analyst Travis Wood of the National Bank of Canada said he was a bit surprised by the “frothy purchase price,” but noted the core asset Vermilion bought is high quality. Shares in Vermilion fell $2 Monday to close at $27.20, while Leucrott’s stock jumped 65 cents to close at $1.95.

The Montney is one of the most prolific oil and gas areas in the country. Wells in the region have the ability to pay out quickly, particularly as commodity prices rise.

And higher cash flow levels open up more choices for companies.

Rafi Tahmazian, a senior portfolio manager at Canoe Financial, which owns stock in Vermilion, said he wants to see petroleum producers stay focused on returning money to investors.

However, he isn't against Canadian companies spending more money on capital budgets or on mergers and acquisitions (M&A), as long as they can provide a strong rationale for such a strategy, such as consolidating assets in a core area to drive down costs.

"I want bigger, stronger businesses in Canada," he said. "I think the market is ready for these companies to do it, but not all ships are going to rise."

So far this year, oilpatch deal-making has been relatively slow to lift off.

Canadian producers have announced about $750 million in mergers and acquisitions this year, said Sayer Energy Advisors president Tom Pavic.

During the same period last year, M&A activity hit $7.4 billion, dominated by the $5.1-billion purchase of Seven Generations Energy by ARC Resources.

Pavic anticipates oilpatch acquisitions will pick up this year, noting several large packages of properties are already on the block, including Imperial Oil and ExxonMobil Canada marketing their joint ownership in XTOEnergy Canada — with assets in the Montney and Duvernay— and Enerplus Corp. looking to sell all of its Canadian oil and gas properties.

With producers in a stronger financial position today, two types of companies are emerging in the sector: those playing offence and those on defence, said analyst Jeremy McCrea with Raymond James.

Both can be winning strategies, but companies positioning themselves into the best plays should come out ahead within five to 10 years.

"Companies are still trying to figure out what is the best use of their capital," McCrea added.

"You can do more things. You get an appetizer now and get a desert."

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