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Juniors, Trusts Will Continue To Consolidate, Analysts Say

by Lynda Harrison

The number of start-up junior oil and gas companies will see a sharp reduction in 2008, while the list of existing oil and gas companies will shrink with a spate of mergers, driven either by dire financial straits or the financial community's ongoing attraction to larger companies, say analysts.

Announced changes to the Alberta royalty regime, which punishes all but the lowest-productivity wells, has also played a part, says **Gary Leach**, executive director of the **Small Explorers and Producers Association of Canada** (SEPAC) which will probably see quite a few members disappear this year.

SEPAC expects there will far fewer junior oil and gas companies at the end of 2008 than exist today, he said, citing faded optimism by small producers, would-be producers and investors over uncertainty about future gas prices and last year's royalty review.

"Right now, attracting investor interest for the junior sector is not easy," said Leach.

It's going to be a busy year for mergers in the junior sector, agreed **Alan Tambosso**, president of **Sayer Energy Advisors**. Many of the newer, less established ones are going to be swallowed up, while other companies are realizing that smaller is not better, so they need to be bigger to survive and to attract capital.

The investment community is looking for larger companies in which to invest, said Tambosso.

He predicts there will be about 100 corporate transactions made between juniors this year, compared to the roughly 80 transactions (worth more than $5 million each) made in 2007.

A lot of small companies have not delivered a return on investment, while some of those that are able to attract capital will probably be the ones doing the acquiring, he said.

"It's still a buyers' market because there's lots of product and not lots of capital to buy," he said.

Companies are being financed with flow-through shares and those funds cannot be used for acquisitions, Tambosso noted, further limiting the capital available for acquisition deals. "That's why we think you'll see share consolidation of companies. In other words, companies buying their peers for shares," said Tambosso.

In 2007, many trusts began to prepare for 2011 when the new federal tax takes effect by consolidating, and that trend will continue, analysts agreed. Trusts will be converting back to the corporate structure and will need to acquire drilling opportunities and income tax pools, said Tambosso.

In 2007, **Rundle Energy Partners** closed 45 transactions between oil and gas companies, worth about $500 million, in what's considered a "pretty active" year, said **Mark McMurray**, managing director. He expects Rundle's business to be at least as good this year.

McMurray said his company saw more than 100 companies looking to make acquisitions during the fourth quarter of 2007. During all of 2007 Rundle had more than 300 active buyers, he added.

Junior companies are now analyzing their year-end 2007 results and McMurray anticipates many of them will have reserves write-downs due to the lower gas prices they received last year. At the same time, bank lines are going to be at their limits so they'll have very few alternatives, he said. Write-downs are also expected because of the new royalty structure.

There's a lot of uncertainty in the marketplace right now, mostly because of the past year's performance, he said.

McMurray believes it's both a buyers' and a sellers' market this year. Some oil-weighted companies have been selling assets as part of their business strategy and sharing the benefits with shareholders, and he expects that to continue in the coming few months. "We're at a historic high for oil (prices). We've got some very well-positioned companies that have met their business plans and have the luxury of selling at the top of the oil cycle."

Juniors will be looking to balance their oil and gas assets through merger and acquisition activity, and to grow so that they move into a new peer group and get more attention from capital markets, he said.

"Because, certainly in the current marketplace, the more senior of the juniors, if I can use that term, are getting capital market support," said McMurray.

Trusts will be both acquirers and sellers of assets this year, ahead of the 2011 deadline for the changes to how they will be taxed, McMurray predicted. "They're not asleep at the switch and they're not a dying breed," he said. "They're going to be an evolving breed."

A number of the trusts' business models are going to change, he added.

Slower activity in the service sector in 2007 will mean increased mergers and acquisitions for that segment of the industry in 2008, said one analyst. Service and supply companies that are financially leveraged will be looking to be acquired, said **Todd Garman**, oilfield services analyst with **Peters & Co. Limited**.

Robert Fitzmartyn, vice-president of institutional research at **FirstEnergy Capital Corp.**, agreed M&A activity will increase this year, much of it depending on the price of natural gas, which his firm is becoming "slightly" more optimistic about.

FirstEnergy is expecting a gas price of $6.30 AECO this year, and a "sizable increase" into 2009, said Fitzmartyn. "LNG [liquefied natural gas] is certainly going to come into play with that. There's lower supply from Canada just as a result of lower activity," he said.

Expect to see private equity continuing to the enter the market in 2008, similar to the recent transaction involving **NuVista Energy Ltd.** and the **Ontario Teachers' Pension Plan**, (DOB, Jan. 7, 2008), said Fitzmartyn.

Another trend to watch for in 2008 is the increased interest by Canadian companies in international assets, said Tambosso. The financial community seems to be interested in financing international ventures right now, in part because of the recent announcements about tax and royalty changes domestically, as well as the maturing of the Western Canadian Sedimentary Basin. There are also higher costs for both acquisitions and oilfield services in Western Canada that are cheaper elsewhere.

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