DOB EXCLUSIVE

M&A Slow As Companies Consider Strategic Alternatives In An Attempt To Survive

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The number of distressed Canadian exploration and production companies entering into a strategic alternatives process is likely to continue to rise as the COVID-19 pandemic's devastating impact on market conditions continues to reverberate and survival mode takes hold.

Stephanie Stimpson and **Chris Christopher**, Calgary-based partners with **Torys LLP**, say survival continues to be top-of-mind for oil and gas sector management teams and boards.

“The pandemic and the dramatic drop in demand hit when the industry was already stressed and facing a lot of pressure on the pricing side. We saw commentary after prices went negative in April asking, ‘Is this industry facing an existential crisis?’”Stimpson said.

“While the industry will certainly survive and oil will remain an important part of the energy mix, it is possible that companies — and particularly those with a lot of debt — they may not survive.”

In recent weeks some companies either announced or updated their respective strategic alternatives plans, which is a process to identify and pursue potential strategic options and alternatives to maximize value for stakeholders.

The effect of the pandemic can be seen directly in data from the supply side for the Canadian oil and gas M&A market, said **Eoin Coyne**, senior analyst at *Evaluate Energy*.

“Prior to the COVID-19 pandemic there was an average of 24,000 boe/d of assets being marketed for sale in Canada — in March, April and May combined there was a total of just 13,000 boe/d put up for sale, with the vast majority of this emanating from strategic alternatives processes,” he said.

Coyne added: “I expect more assets to enter the market now that the oil price has bottomed out and private equity will feature more prominently as buyers due to their position of not having to tap into the debt or equity markets to raise capital. A recent example of this can be seen from **Longshore Resources Ltd.**, an **ARC Financial Corp.-** backed company, acquiring (https://www.dailyoilbulletin.com/article/2020/6/8/longshore-transformational-transaction-creates-pre/) **Rifle Shot Oil Corp.**, **Steelhead Petroleum Ltd.** and **Primavera Resources Corp.**”

On June 1, junior producer **Cequence Energy Ltd.** announced that it had filed for creditor protection and **Delphi Energy Corp.** did so in April. A distressed sale of **Bellatrix Exploration Ltd.** closed June 1.

Those entities are examples of a growing group of companies (https://www.dailyoilbulletin.com/article/2020/4/29/will-we-see-an-increase-in-consolidation-in-2020/) that are dealing with distressed balance sheets and little, if any, access to capital markets.

Tom Pavic, president of **Sayer Energy Advisors**, said that so far during the pandemic merger and acquisition (M&A) activity has been slow to develop.

"It's pretty quiet right now. There hasn't been a lot of activity and I think in the near future that will probably continue," he said.

"When prices are volatile we find it very difficult to get transactions done. So I think once things start to get back to some sense of normal and we see some sort of consistency in oil prices you might start to see some more activity and possibly more consolidation."

On a positive note, according to Pavic, there's been a slight uptick of interest in the natural gas space than there has been in recent years.

"There's a bit of a more positive or optimistic vibe on natural gas. I guess one thing we can point out is once this COVID-19 pandemic started, especially over the last month or six weeks, we've heard of more companies looking to do or acquire natural gas than we have in a long time," he said.

'Creative' deal making could ensue

Stimpson said merger and acquisition activity in the Canadian oil and gas industry will likely look somewhat different post-COVID-19, especially on the E&P side where deals could take on a decidedly "creative" tone given the stingy debt and equity markets.

"We expect to see an uptick in M&A as the year unfolds, with more distressed companies and opportunistic buyers stepping in," she said.

"In terms of the type of deals we'll see, I think private equity and the pension funds will continue to invest in the right kinds of assets that they've been interested in and had an appetite for over the last several years, like the infrastructure and midstream assets," Stimpson added.

"And as among the producers, we'll likely see companies getting more creative and trying to do deals that don't require a big cash outlay or increased debt levels — companies doing deals with share consideration and structuring joint ventures and asset exchanges."

Stimpson said that the financial structure of deals will also likely evolve as the industry adjusts to the new norm.

"In terms of purchase price, there might be creativity around earn-outs and contingent payments to bridge the value gap when there's so much uncertainty on what the recovery might look like," she said.

"Another deal parties may pursue in this cash-constrained environment would be where one company sells some of its non-core or legacy assets that have a lot of liabilities. A buyer might be willing to acquire those assets to have synergies with its existing assets or because it has the ability to optimize those assets and defer the liabilities, without the need to pay a lot of cash.

“So those creative deal structures might be on the horizon and will help companies transact without needing to go to the debt markets.”

Christopher said the biggest concern for the Canadian oilpatch is how long will current market conditions last and whether or not investment will return in a meaningful way.

“The downturn of the last five years was too tough for many companies who went bankrupt. Those that remain are going to be asking themselves why an investor would risk dollars in an industry where its main commodity can go below breakeven costs of around $40 per barrel for extended periods of time,” he said during a recent Torys podcast.

“A quick rebound in oil and gas prices would result in improved cash flow and operating metrics and could bring investment back. But industry analysts expect a sluggish recovery and the industry may be more negatively impacted than other sectors once the health crisis subsides and the economy begins to recover.”

An industry perspective

Tristan Goodman, president of the **Explorers and Producers Association of Canada** (EPAC), said his member companies are still in a feeling-out process as they attempt to survive the current industry crisis and await more clarity and full implementation of various federal government initiatives announced in light of the COVID-19 pandemic and its impact on the oil and gas sector.

“So I think you’ve probably got a couple more months. I haven’t seen a lot of consolidation. I do think, unfortunately, it is in some cases a pretty dire situation. So I certainly wouldn’t want to underplay the problems with COVID-19 and …. the demand destruction that we have seen,” he said.

“So I do believe it is very, very difficult for a lot of companies right now. And if this continues for an extended period of time they would not be, in some cases, able to survive.”

While consolidation activity has been sparse, Goodman does believe talks are being had.

“There’s no question that there’s clearly a lot of discussions going on around M&A and looking for opportunities, strategic alternatives and things of that nature. The problem right now is there’s not a lot of liquidity,” he said.

“Deals that would normally go on to buy — not wholly, but in some cases — they simply can’t do that. They may like to do it but there isn’t an ability to grow because they can’t get access to the financial markets because the financial markets are completely frozen.”

Goodman said there are slight differences in the current environment between natural gas producers and their crude counterparts.

“First, I think you have to differentiate if you’re talking about oil or if you’re talking about natural gas. I think clearly that as oil has suffered and solution gas in the United States and elsewhere has come off on that oil side, that’s clearly been positive from the perspective of looking forward on natural gas prices,” he said.

“So that has assisted and provided some stability that is definitely needed for those natural gas producers.”

That said, Goodman isn’t expecting a rush of natural gas-focused M&A.

“That’s one side of the business and I don’t think there’s large activity there nor do I think we’ll see a lot of changes there. You’ll see normal behaviour. Of course we’ll lose some [companies],” he said.

“In Canada it’s still quite difficult from a competitive standpoint to do business in the natural gas sector and we’re not out of the woods really until we get LNG going.”

Goodman said the situation is a “little different” on the oil side.

“I do think you will start to see some changes. It also depends on what happens with some of the federal programs which have been put in place to support workers. Obviously, though, through supporting workers the federal government supports those companies,” he said.

“I think we’ll start to see some benefits from the federal programs. Right now we haven’t seen approvals and things, but I think EDC [**Export Development Canada**] and BDC [**Business Development Bank of Canada**] are trying very hard here,” Goodman added.

“They’re putting in sensible effort in getting the balance right to be protecting taxpayer funds and, at the same time, making sure you can have those companies that can survive and can do well get access to those funds.”

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