# 'Zombie' stocks haunt Canada's oil patch, but buyers aren't biting in worst bear market in a generation

Last year Michael Binnion considered selling some of his company's assets to focus on its core play in Alberta, but then changed his mind as oil prices kept plumbing new lows.

"In retrospect we really wished we had sold," the CEO of Questerre Energy Inc. said last week.

"It's hard for me to envision many people saying 'I would love to sell my oil assets at a price of US$30 per barrel,'" said the Calgary-based Binnion. "So anybody who is selling assets it's because they have looked at all other options and decided that's the best one."

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To sell or not to sell in one of the worst bear oil markets in a generation has gnawed at management teams across Calgary during the past year.

According to Zachary George, an activist hedge fund manager at FrontFour Capital Group Plc. in Connecticut, more than 500,000 barrels per day of Western Canada production are up for sale.

But buyers are biding their time, as valuations are tough to calculate in the volatile environment.

"The amount of wealth that has been destroyed in Calgary is staggering," said George, whose father Rick ran Suncor Energy Inc. for two decades till 2012.

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"In some cases, you see zombie equities that are basically trading at option value with bonds trading in the fifties. Buyers aren't stupid — they see the capital structure and the implied enterprise value. Why should they attribute value to the equity when the market is telling them there is none?"

Yet more assets are coming to the market. Last week, Ernst & Young Inc., the court-appointed receiver of bankrupt company Spyglass Resources Corp., put the company's assets on the block.

LGX Oil & Gas Ltd. has also said it's considering an outright sale of the company. The small Alberta-based operator joins a list of 22 companies in the Canadian oilpatch publicly looking to sell themselves, according to Sayer Energy Advisors, which is acting as LGX's adviser. Another 41 companies are selling a portion of their assets, with many more informally putting feelers out.

"There are many companies looking at alternatives that have not made a public announcement or a formal process," said Alan Tambosso, president of Sayer Energy Advisors.

But activity remains subdued. Last year, Canadian upstream M&A reached $12.4 billion, down 71 per cent from 2014 levels, according to RBC Capital Markets.

This year may be boosted by Suncor's $4.3 billion bid for Canadian Oil Sands Ltd. which had turned nasty, but seems set to reach an amicable closure soon. Despite the rise of activism in the usually-congenial oilpatch, there may be few hostile deals, said Chip Johnston, Calgary-based partner at Stikeman Elliott LLP.

"M&A is also a sign of the good times when the music is pumping and drinks are flowing," Johnston said. "But when capital isn't available and when commodity prices are depressed you don't get the same incentive."

The recent federal and provincial policies related to climate change policies and prolonged reviews of pipelines adds to the gust of headwinds facing the Canadian oilpatch.

But many companies' financial plight could trigger M&A activity. Many firms responded early to the steep decline in oil prices last year by cutting capex, shedding staff, divesting assets and shelving projects. But 2016 is presenting its own set of challenges.

Only nine per cent of Canadian companies have hedged for this year, leaving them exposed to the current depressed market prices, energy consultancy IHS Inc. estimates.

"People now realize that the time to wait for better days may well be over," said Barry Munro, Canadian oil and gas leader at Ernst & Young. "There is a notion of 'have to, need to or want to' as driving M&A behaviors. There's a whole bunch of people that 'have to' transact."

Canadian banks are also getting nervous, as oil and gas players had drawn $45 billion by the end of October, compared to $23 billion in 2010, DBRS Ratings Ltd. data shows.

"The banks — contrary to public belief — have been forceful and they are getting more forceful," Tombasso said, noting the 20 cases of receivership — or Companies' Creditors Arrangement Act (CCAA) — last year, compared to the eight on average in previous years.

Banks may be more motivated to act as they go through the credit redetermination season between February and April and assess their own rising risk profile.

In addition, the new U.S. Dodd-Frank banking law has specific rules for banks on rolling forward problem loans.

"Everybody kind of skated through in the fall (the last credit review period) and there was a big sigh of relief," Munro said. "Nobody believes that they can get through the next cycle in March unscathed. That's put a lot of pressure on folks."

If prices recover in the second half of the year, as some analysts predict, banks may even push for transactions as they would prefer to sell in a stronger market, Munro warns.

With major oil and gas companies and state-owned enterprises struggling to justify new capital commitments to shareholders, the path may be clear for private equity and activist investors that have been prowling around Calgary over the past year.

As much as US$175 billion of private equity and pension funds are considering energy opportunities, BMO Capital Markets estimates.

But valuing assets amid price volatility is proving difficult for many institutional investors.

“You are going to see distressed investment opportunities over activist opportunities,” George said. “If you have the patience and stomach to work through some of the restructuring and CCAA processes, I think there are going to be real opportunities.”