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Sayer's Outlook For 2018 M&A Activity

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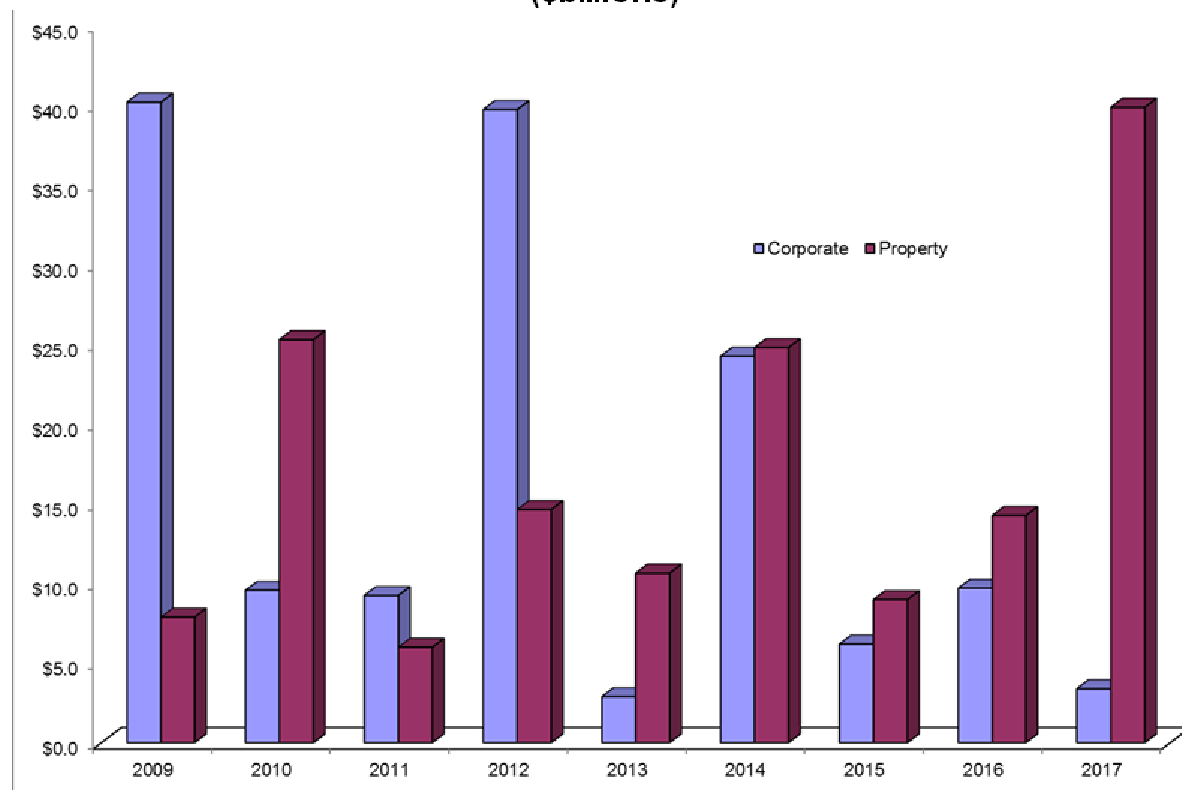
In spite of prolonged low commodity prices, when considering only the total value of mergers and acquisitions ("M&A") activity, 2017 was an above average year for M&A activity in the Canadian oil patch. While the nature of transactions may change somewhat, even with the worst of the most recent oil price onslaught apparently behind us, Sayer Energy Advisors forecasts that there will be significantly less M&A activity, in total dollar value, in 2018 than there was in 2017.

The total value of M&A activity in 2017 was approximately $43 billion, up significantly from the $24 billion total in 2016, well up from the $15 billion in total value in 2015 and close to the $49 billion seen in 2014. By the measure of total value of activity, last year was a "very good" year for M&A; however, there were a couple of large deals early in the year which padded the total value.

Shortly after the announcement by Canadian Natural Resources Limited in March 2017 that it was acquiring a 70% interest in the Athabasca Oil Sands Project for approximately $12.6 billion, Cenovus Energy Inc. announced the acquisition of oil sands and Deep Basin assets from ConocoPhillips Co. for approximately $17.7 billion. These two transactions combined were valued at just over $30 billion, roughly 70% of the total M&A value of all of 2017.



Aside from the large amount of M&A activity in the first quarter due to the two previously-mentioned transactions, 2017 was a relatively slow year for M&A activity, with only approximately $13 billion in activity, spread evenly at roughly $3-$4 billion in activity per quarter. Contributing to the lower than normal total was the relatively low total value of corporate transactions at a meagre $3.4 billion.

Similar to last year's forecast, Sayer's short term forecast shows continued frothiness in the oil and natural gas industry, which will impact and restrict M&A activity. The frothiness is caused by, among other factors, stressed balance sheets of natural gas producers due to continued low natural gas prices, the possibility of continued robust oil shale drilling activity in the United States, continued political issues both in Canada and in the United States, an ever increasing focus on environmental issues and the ongoing pipeline debate.

In 2016 an unprecedented number of oil and natural gas companies became insolvent, with at least 28 companies entering into receivership, bankruptcy or formal financial restructuring processes. We expected a significant decrease in the number of insolvencies in 2017, likely trending downward to the historical average of approximately eight per year, but, unfortunately, we were wrong. Although the total number of companies hitting the ditch in 2017 was down from 2016, 16 companies went under last year. We expect the downward trend in receiverships to continue, likely heading to the typical number of eight for 2018.

Companies with a strong natural gas focus will face the most serious balance sheet issues. Continued depressed natural gas prices combined with a gloomy outlook for short-term future prices, ongoing egress issues plaguing western Canadian natural gas and a resultant lack of market support for financing natural gas deals will significantly negatively affect short-term natural gas weighted M&A transactions. We do not expect to see many multibillion-dollar natural gas transactions taking place in 2018.

While the recent rise in the price of oil has generated renewed interest in the Canadian energy sector, higher prices do not necessarily translate to more M&A activity. The best scenario for a robust M&A market is one with sustained steady prices. In that scenario, both buyers and sellers can generally agree on the value of an asset or a company. In scenarios with rising or falling prices, such agreement is not always possible, making it difficult for buyers and sellers to get together.

In addition to the expected delta between buyers' and sellers' expectations, many prospective sellers may hold off on putting assets up for sale until they see stabilized prices, avoiding selling into a rising market for fear of missing the peak. This point has been emphasized by the fact that there has been an unusually slow start to the M&A year so far, with a limited number of small-sized offerings on the market. Compounding the lack of product, even if oil properties hit the market, many buyers may avoid transacting as prices are rising for fear of hitting the peak.

The issue of dealing with suspended wells and other such liabilities, encompassed under the Licensee Liability Rating (LLR) umbrella of the Alberta Energy Regulator (AER), will continue to impact M&A activity in 2018. Most severely impacted by these environmental issues will be junior producers, especially those with stressed balance sheets.

More mergers of junior entities should result in 2018, in part as a result of the need to get larger in order to be able to financially handle these growing regulatory and environmental issues. Increased scrutiny by the AER on officers and directors of companies accepting well license transfers will make it increasingly more difficult to get the regulators to approve many well license transfers, increasing the attractiveness of corporate transactions as compared with asset deals.

With the piling on of increasing pressure from environmental lobbyists onto continued relatively low oil prices, we did not expect to see any significant oil sands M&A transactions in 2017. Our prediction was proven to be incorrect early in the year, when, as previously-mentioned, CNRL, Cenovus and ConocoPhillips were involved in two oil sands transactions totaling over $30 billion. We will stick our necks out once again and predict that 2018 will be a slow year for oil sands transactions. While minor oil sands assets may hit the market, we do not expect to see many multi-billion dollar transactions in this sector.

Buoyed by higher oil prices, capital markets should loosen up a bit from the recent tight levels, but will continue to be selective by primarily supporting larger, stronger oil-weighted public entities. Increased capital availability generally translates into more M&A activity and higher prices.

In summary, the aforementioned factors suggest that we should see an interesting M&A marketplace in 2018. We expect to see a significantly lower total value of M&A activity in 2018 than what was seen in 2017. Our total expected M&A value for 2018 is in line with the totals of $15-$24 billion seen in 2015-2016. We should see an increase in the percentage of the total value of M&A activity involving corporate deals, up from 8% of total value last year to as much as 25%-30% this year.

There has been a slower start than normal to the year's M&A activity. As the year progresses, more junior players will consider and conclude mergers as opposed to outright cash sales. It is difficult to envision a significant number of transactions involving dry natural gas assets.

If the price of oil remains higher than last year, high quality assets with credible upside will begin to hit the market. At that point buyers will step up to the plate to move acquisition prices higher, as evidenced by the recently-announced $90.8 million acquisition of a private southeast Saskatchewan producer by Vermilion Energy Inc.

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