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Endangered species: Canadian small oil and gas companies under pressure to merge or die

(Financial Post) – *Banks and creditors are running out of patience with a now six-year downturn in the Canadian oil industry.*

Small- and mid-sized oil and gas companies in Canada are going the way of the dodo bird.

"The 20,000-barrel-per-day producer in Western Canada is an endangered species. We don't see that changing for some time," said Adam Waterous, CEO of the Waterous Energy Fund, which has been deploying private equity capital in recent years to buy up small oil companies, including the $750-million purchase of Pengrowth Energy Corp. in Nov. 2019.

If the small oil producer is an endangered species, Waterous is the trophy hunter. In six transactions he has built a company now called Strathcona Resources Ltd. into one of the largest private-equity owned producers in North America with production of more than 60,000 bpd.

Now, Strathcona is eyeing more underpriced assets in the Canadian oilpatch.

Investors and analysts expect a mergers and acquisition wave as the oil price depression since last March and COVID-19 were just the latest in a series of crises that has squeezed the life out of many companies. It has come to a stage where banks and creditors are, in some cases, running out of patience with a now six-year downturn in the Canadian oil industry.

Exasperated by paltry returns, they are cutting off funding in some cases and pushing companies to either restructure or sell out to larger companies.

Many companies including Obsidian Energy Ltd. have launched 'strategic reviews' and put themselves for sale, while others such as Bow Energy Ltd. and Cequence Energy Ltd. have filed for creditor protection.

In certain cases, Paresh Chari, senior analyst and vice-president at Moody's Investors Service, said he has seen mid-sized energy companies have their borrowing bases re-determined or seen credit revolvers cut to less than what's drawn on the debt facility, which has effectively forced them into bankruptcy.

To get out of the quagmire, companies are scrambling to find partners to become bigger and — hopefully — more solvent.

"I think you're going to see that trend of smaller companies trying to get into bigger companies," Chari said, noting that banks and creditors have been less willing to lend to intermediate producers and are more likely to demand a restructuring, merger or sale of the company.

The same issue has not plagued the larger companies in the Canadian oilpatch, with Suncor Energy Inc., Canadian Natural Resources Ltd., Cenovus Energy Inc. and Husky Energy Inc. tapping the debt market with little trouble this year, Chari said.

It's the smaller producers that are feeling the heat from impatient bankers and financiers.

"In terms of returns for both equity and debt-holders from energy companies has been so poor for a number of years that the market doesn't necessarily have the confidence that these companies will be good stewards of their capital," Chari said.

As creditors' patience runs out, a handful of opportunistic acquirers, such as Waterous, are buying up assets at bargain basement valuations.

"Consolidation has never been more urgently needed than right now," Waterous said in a recent interview, noting that small energy companies have been shut out of both debt and equity markets and without access to capital, they are "effectively orphaned businesses."

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As an example of the bargains available, his fund's deal last year for Pengrowth was struck at a 77 per cent discount to the oil company's share price.

On Aug. 13, Waterous Energy Fund acquired a 45 per cent stake in Osum Production Corp., a 20,000-bpd oilsands producer, from U.S. private equity giants Blackstone Group Inc., Warburg Pincus LLC and Singapore's sovereign wealth fund GIC Private Ltd.

Waterous declined to say whether he intended to purchase the remaining 55 per cent of the company and fold it into Strathcona Resources, but said that his private equity fund was attracted to Osum because of the similarities to the assets it had acquired from Pengrowth.

As creditors push oil producers to sell assets or sell themselves outright, there's been an uptick in Canadian oilpatch deals over the summer. Since June, there have been five M&A deals valued at $828 million, according to FP Data, taking year-to-date figures to $1.65 billion across 23 deals. In contrast, there were 42 M&A deals during the same period valued at $15.47 billion.

This week, Whitecap Resources Inc. used its stock to buy Manulife Financial-backed NAL Resources in a deal worth $155 million. Whitecap believes it's in a position to do more deals.

"At this point in time, we believe that rather than drilling out your inventory for very limited return, there's potential to increase your inventory through acquisitions," Whitecap President and CEO Grant Fagerheim said on a conference call with analysts after announcing the NAL deal. "We'll continue to be active in looking for other opportunities to strengthen our company for the longer term."

The Whitecap-NAL deal was also an example of just how far valuations in the energy sector have fallen as Whitecap was able to buy NAL for just 1.5-times the target's annual cash flow, National Bank Financial analyst Travis Wood said in an interview.

"That valuation caught many by surprise. I don't know if I would expect more of that type of valuation necessarily. It's hard to grapple with how many of those (deals) are out there," Wood said.

Obsidian, which is heavily indebted and in the middle of a strategic alternatives process, publicly requested Bonterra Energy Corp. on Aug. 31 to agree to a merger. Without access to capital, Painted Pony Energy Ltd. sold out to Calgary-based major Canadian Natural Resources Ltd. on Aug. 10 for $111 million in cash and the assumption of $350 million of debt.

Analysts say Kelt Exploration Ltd.'s $510-million deal on July 23 to eliminate its debt by selling 140,000 acres of natural gas lands in British Columbia to Houston-based ConocoPhillips Co. was also motivated by debt and liquidity considerations.

Equity values for smaller energy companies have fallen sharply in recent years, and have been pushed lower by the coronavirus-induced oil price collapse this year. The enterprise value for many oil and gas companies is now controlled by their debt holders, said Michael Zuk, managing partner at Athena Capital Markets in Calgary.

"As equity markets are shut off from these guys, we are going to see more M&A but it's not going to be the friendly Canadian M&A. It's going to be more of the backs-against-the-wall type," Zuk said.

However, since the Canadian oilpatch has been under pressure as a result of weak prices and lack of export pipelines in the past decade, there are fewer domestic companies that are in a position to acquire distressed companies through this most recent cyclical trough.

"You could count them on one hand," Zuk said about mid-sized Canadian oil and gas companies with the financial wherewithal to buy their troubled peers. Headwater Exploration Inc. and Spartan Delta Corp., which recently bought insolvent Bellatrix Exploration's assets for $87.6 million out of Companies' Creditors Arrangement Act proceedings, are among the few companies in a position to buy.

Other intermediate oil and gas producers that could be acquisitive in this cycle are Whitecap (even after the NAL deal), Torc Oil and Gas Ltd. and potentially Enerplus Corp., according to Eric Nuttall, a Toronto-based portfolio manager and partner with Ninepoint Partners.

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However, he said he's not investing in intermediate oil and gas producers based on deal potential.

"M&A is a really, really tough investment thesis to focus a fund around. The most logical transactions don't transpire," he said.

Instead, Nuttall said he's looking to invest in companies that aren't over-leveraged and can generate cash in excess of their expenses at current prices. He believes the Canadian energy industry is undervalued relative to oil stocks in other countries and relative to other industries. The S&P Capped Energy Index is down 37 per cent year-to-date, compared to a 2.65 per cent decline of the main Canadian index.

"You need to know the debt maturities and makeup of the banking syndicate," Nuttall said. "I wouldn't make up a portfolio full of companies at the whim of bankers who might push you to sell your crown jewel."

Rounding out the list are opportunistic private equity companies that are closely watching equity valuations falling and the pressures accumulating on small- to mid-sized energy companies.

Right now, there are an estimated $1.2 billion in assets being publicly marketed for sale in the Canadian oilpatch, with many more assets for sale that haven't been publicly announced, Sayer Energy Advisors president Tom Pavic said.

Despite the abundance of assets on sale, making deals with the sole intention of getting bigger and attracting more market interest alone has not worked in the Canadian energy sector in recent years. Deals structured in ways that reduce debt for small- and mid-sized companies will likely be rewarded, Pavic said, citing Whitecap's transaction as an example.

The industry now expects an uptick in oil and gas deals in the coming weeks as commodity prices have stabilized following a tumultuous first half of the year, in which both Canadian and North American oil prices dipped into negative territory for the first time ever.

"When you get wild volatility, it's very difficult to transact," he said, noting that some would-be acquirers waited until the energy markets stabilized to strike deals. "You've got some semblance of stability in commodity prices, especially for oil in and around US$40 (for West Texas Intermediate). That's a big key."