

Canada's energy market showing signs of renewed life

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The Canadian oil and gas sector has experienced turbulent times as of late.

With oil prices going from over \$100 per barrel to sub-\$50 per barrel as a result of oversupply, Canadian energy companies have suffered. Total declines in market capitalization among Canadian oil and gas companies from July 2014 to February 2016 are estimated to have exceeded \$230 billion, according to data from S&P Capital IQ. Challenged with survival, many producers have been forced to make changes to perform in challenging market conditions.

Additionally, conditions have led many investors to reconsider the market. Sovereign wealth funds and state-owned enterprises, which had a huge appetite for Canadian oil and gas assets just a few years ago, have slowed spending or exited the Canadian market, as have some large foreign strategic acquirers.

In March 2017, Netherlands-based Royal Dutch Shell (RDS) announced its US\$8.5-billion oil sands asset sale to Canadian Natural Resources, which is among the largest in the history of domestic oil and gas transactions. It is noteworthy, however, that this was part of a previously announced US\$30-billion divestment program for RDS. "This transaction is significant for Canadian Natural Resources as it increases the reliability of underlying sustainable cash flows," President Steve Laut said in a statement published in the *Financial Post*. "It allows focus on the key operating strengths."

Also in March, [ConocoPhillips agreed to sell its FCCL Partnership interest](#) in an oil sands play and certain Western Canadian natural gas assets to Cenovus Energy for \$12.74 billion. The ConocoPhillips divestment was the third major oil sands disposition to a Canadian company to be closed or announced in 2017.

Each of Athabasca, Canadian Natural Resources and Cenovus saw sufficient future value in controlling a broader asset base to justify increasing their oil sands ownership and, contrary to reports that foreign capital is fleeing the oil sands, each of Statoil, RDS and ConocoPhillips took back significant positions in the share capital of the purchasers who acquired their interest.

There's no question the Canadian oil and gas industry is experiencing a challenging period after years of growth; however, while some might see this inflection point as a time to get out of the market, others, like Cenovus and Canadian Natural Resources, see it as an opportunity to go deeper into the Canadian energy space at the right price and before the market makes a recovery, which is inevitable.

Despite today's market conditions, there are other positive signs. In early March, Prime Minister Justin Trudeau reaffirmed his commitment to the oil and gas industry after some comments he made earlier in the year were called into question. "No country would find 173 billion barrels of oil in the ground and just leave them there. The resource will be developed," said Trudeau, speaking at CERAWEEK, a conference with international energy industry leaders and government officials.

Additionally, U.S. President Trump's granting of a permit for construction of the Keystone Pipeline will be a boon to Canada's oil sands as they make their way to U.S. refineries and ultimately to market. Trudeau also approved the Trans Mountain Pipeline expansion project. In exchange for approvals, Kinder Morgan, the owner of the pipeline project, agreed to pay British Columbia's government between \$25 million and \$50 million per year for 20 years to go into a fund for environmental protection.

In response to the shake up and Canada's commitment to the industry, there are many highly skilled professionals launching or readying to launch their own energy startups. Highly experienced CEOs, CFOs, COOs and engineers are forming management teams to create new companies that are looking for opportunities to create value in the oil and gas industry. These new companies are also looking for private backing on a deal-by-deal basis. And their strategy is working.

Since private equity investors recognize the Canadian energy market is still volatile, but nonetheless ripe for investment, many have shown a steady interest and are backing new companies, frequently with equity lines of credit of between \$100 million and \$500 million. PE firms fund the growth transactions through capital calls, often with a five-year timeline for drawdown. The goal is to be the first money in and with oil prices low and many assets up for sale, now is an optimal time for that.

Many of Canada's largest pension funds, such as the Canada Pension Plan Investment Board and the Ontario Teachers' Pension Plan (OTPP), have closed deals this way, as have several local and foreign PE firms.

For example, Aspenleaf Energy, comprised of a team formerly from Shell Canada, and led by President and CEO Bryan Gould, was founded to acquire and exploit light oil and liquids-rich gas assets in Western Canada.

It is backed by ARC Financial Corp, a Canadian energy private equity firm, and Ontario Teachers'. The two investors provided Aspenleaf with a \$365 million line of equity to buy assets and grow them. In 2015, Aspenleaf took Arcan Resources Ltd. private, a company engaged in the exploration, development and acquisition of petroleum and natural gas located in Canada's Western Sedimentary Basin.

Similarly, in 2016, RimRock Oil and Gas was founded by a team formerly from Talisman led by James Fraser. Warburg Pincus has funded RimRock US\$500 million to seek oil and gas opportunities in Canada and the United States.

Osler, Hoskin & Harcourt LLP acted as legal counsel to both Aspenleaf and RimRock, and several other similar management teams in the recent past, including Northern Blizzard Resources, which completed its initial public offering in 2014, Steel Reef Infrastructure Corp. and Kanata Energy Group, among others.

The formation of these new companies and their unique capital structure is partially a result of how expensive drilling has become due to the use of new technologies. Purchasing a well can cost multiple times more than traditional wells, and of course there's always the possibility that any well won't produce results. Companies that formerly drilled alone or without private capital now need the funding PE firms and pension funds can supply.

Another reason is that these companies often grow by acquisition. Picking up on this trend of highly talented teams with a need for significant capital, U.S. PE firms, such as Apollo Global Management, NGP Energy Capital Management, Pine Brook Partners, Riverstone Holdings and Warburg Pincus LLC, have all used this strategy to fund Canadian oil and gas teams.

Other asset managers are just gearing up for the recovery. At the end of last year, U.S. hedge fund manager Bridgewater Associates started raising new capital for its Pure Alpha fund, which touts oil and gas as a large portion of this portfolio. Other firms are also gearing up. For example, in March 2017, Fengate Real Asset Investments closed its first fund, LPF Equities Fund, with \$300 million in committed capital. The Canadian investor has already invested in Cricket Energy Group, a provider of residential and commercial energy services and solutions.

Another positive sign is the number of PE-backed energy companies, such as BOS Solutions Holdings (fluids management), Source Energy Services (frac sand) and STEP Energy Services (coiled tubing and fracturing services), have recently seen fit to test the equity markets with a proposed, or in the case of Source, a recently completed, initial public offering.

All of this suggests that while 2017 is off to a slow start in terms of deal volume, as opposed to the impressive size of announced energy M&A deals, the Canadian oil and gas market is seeing signs of life and private equity firms are uniquely positioned to take advantage of the emerging opportunities.