Is Merger and Acquisition Activity in the Patch in Danger?

Description

Merger and acquisition activity continues to heat up in Canada's oil patch after a disappointing 2013. During that year, M&A deals fell a massive 81% compared to 2012 to be valued at $13.1 billion, primarily because of softer crude prices, rising costs, and unclear regulatory guidelines. But with crude prices improving, M&A activity in the patch is heating up and 2014 is shaping up to be a monster year.

However, there are growing concerns about how rising costs, increased environmental regulation, and uncertainty over the application of foreign investment rules will impact the patch and M&A activity in 2014.

Foreign energy majors are already voicing some concern

Overseas energy companies are growing increasingly nervous about rising costs and the federal government's opaque application of foreign investment rules. Federal government foreign investment regulations enacted in 2012 after **CNOOC's** (TSX: CNU)(NYSE: CEO) acquisition of Nexen remain unclear and have created some ire among foreign energy companies.

Shamsul Azhar bin Abbas, the chief executive of Malaysian government-controlled **Petronas**, has already expressed concerns regarding the fiscal and regulatory environment in Canada's energy patch. He recently stated that Canada must be careful not to follow in the path of Australia, where regulatory and fiscal policies coupled with rising costs saw an investment boom in the country's liquefied natural gas industry fizzle out.

The costs of doing business in Australia skyrocketed as its LNG industry boomed between 2004 and 2012, and there are signs the same will happen in Canada. It was this experience that caused Petronas to express its reluctance at proceeding with an LNG export terminal proposed for Canada's west coast.

But Spanish energy giant **Repsol** has taken a different approach, seeking to invest US$2 billion in the development of an LNG export terminal on Canada's Atlantic coast to allow the export of Canadian LNG to Europe. This interest comes at a time when Europe and the member states of the EU are seeking to wean themselves off of Russian energy exports, with the conflict in the Ukraine being a key driver.

This will be a boon for natural gas producers such as **EnCana** (TSX: ECA)(NYSE: ECA), **Canadian Natural Resources** (TSX: CNQ)(NYSE: CNQ), and **Pengrowth Energy** (TSX: PWT)(NYSE: PWE) as they seek alternate export markets from the U.S. for their natural gas.

Massive increase in M&A activity in the first quarter of 2014

But investment activity doesn't stop there; despite the market being awash with Canadian oil and gas assets, acquisitions continue to gain momentum. For the first quarter of 2014, M&A deals in the patch hit $8.4 billion, or more than double the $4.1 billion in deals completed in the patch in the first quarter 2013. The largest deal during the quarter was Canadian Natural Resources' acquisition of **Devon Energy's** (NYSE: DVN) conventional oil assets in Canada for $3.1 billion.

But it isn't all top-end companies playing the acquisitions game, as relatively new intermediate oil producer **Whitecap Resources** (TSX: WCP) acquired a range of light oil properties from **Imperial Oil** (TSX: IMO)(NYSE: IMO).

A key driver of this leap in M&A activity is higher crude prices, with WTI up by 10% over the last year and Brent 7% for the same period.

What does this mean for investors?

Such a significant upswing in M&A activity in the patch highlights growing confidence in the industry, with stronger crude prices set to increase revenue, operating cash flow, and net income.

This growth in cash flow will see more deals made as players in the patch seek to further develop and grow their core asset bases.

I would expect to see solid gains in share prices across the patch, but particularly in the prices of integrated energy majors like Canadian Natural Resources, **Suncor** (TSX: SU)(NYSE: SU), **Cenovus** (TSX: CVE)(NYSE: CVE), and **Husky Energy** (TSX: HSE).

These companies have seen their share prices undervalued by the market for some time. But their size, deep pockets, and increased capital investment will allow them to significantly grow both crude production and their asset bases. Canadian Natural Resources has committed to increasing capex by 12% while Suncor's has grown 7% and Cenovus' by 1%. In contrast, Husky's, at $4.8 billion for 2014, remains unchanged compared to 2013. However the company's growth plans remain on track and significant production growth is expected during 2014.

When coupled with their downstream businesses, which allow them to better manage margins, investors should see a significant improvement in their full-year bottom lines compared to 2013.

Clearly, 2014 is shaping up to be a sizzler, with M&A activity set to significantly outstrip 2013. But despite higher oil prices, growing operational cash flow, and better margins, unclear regulatory guidelines and growing costs are a threat to further growth for Canada's energy industry.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:CVE (Cenovus Energy Inc.)
2. TSX:IMO (Imperial Oil Limited)
3. TSX:SU (Suncor Energy Inc.)
4. TSX:WCP (Whitecap Resources Inc.)

Category

1. Investing

Date
2025/07/07
Date Created
2014/05/29
Author
mattdsmith