Warren Buffett Has Just Signaled it Is Time to Start Investing in Oil

Description

Deal activity in the global energy patch has declined significantly in recent years, since the slump in crude began in late 2014. For the first quarter 2019, a mere US$9.8 billion of new merger and acquisition (M&A) deals occurred among upstream oil and gas companies globally, which was roughly a quarter of the almost US$40 billion for the same period a year earlier.

Deal-making activity is intensifying

Nonetheless, M&A activity in North America's energy patch is heating up once again. Integrated energy giant **Chevron** made a US$33 billion tilt for **Anadarko Petroleum**, and it appears that it is about to be trumped by **Occidental Petroleum**, which has made a US$38 billion cash and stock bid for Anadarko.

In a somewhat surprising move, the world's greatest investor Warren Buffett has backed Occidental's bid. His company **Berkshire Hathaway** has committed to a US$10 billion equity investment in Occidental to finance its bid for Anadarko. The board of Anadarko indicated that Occidental's offer is superior to Chevron's, meaning that it could be approved. The complementary fit of Occidental's and Anadarko's assets would allow the combined entity to extract significant value for investors.

The eruption of a bidding war for a large upstream exploration and production company involving Buffett indicates there could be more megadeals ahead, making now the time to start investing in North America's energy patch.

Investment in Canada's energy patch will soar

While oil has moved higher since the start of 2019 to see West Texas Intermediate (WTI) gaining around 43% and trading at over US$64 per barrel, many Canadian upstream oil explorers and producers have failed to keep pace. This has sparked growing speculation that a round ofconsolidation could take place in the energy patch, as larger, cashed-up companies seek to takeadvantage of the price disconnect with many Canadian energy stocks trading at less than book value.

Late last year, integrated energy major **Husky Energy** made a tilt for intermediate oil sands producer **MEG Energy** (TSX:MEG). While that deal was rebuffed by MEG, it is easy to understand why the company was targeted by Husky. MEG has copious oil reserves of over two billion net barrels, which are worth $53 per share after tax — almost 10 times greater than the upstream oil producer's market value. This highlights the considerable potential held by its flagship Christina Lake operation and is further underscored by the steam-to-oil ratio of 2.2 — one of the lowest and most efficient in the industry.

The significant disconnect between the value of MEG's oil reserves and its market price explains why it is trading at less than half of its book value.

It should be noted, however, that only around 11% of MEG's net oil reserves are categorized as proved developed with the remainder being undeveloped. The amount of capital required to develop oil sands to the point where oil can be commercially extracted is considerable. The uncertain outlook for Canadian oil sands also explains why another bidder didn't emerge for MEG and why Husky walked away from the deal when it expired earlier this year.

Deals in the oil sands weren't restricted to MEG, smaller intermediate oil sands company BlackPearl Resources was acquired by **International Petroleum** in a $675 million deal late last year. While there is considerable speculation that **Cenovus Energy** could emerge as a takeover target, it is unlikely; with an enterprise value of over $26 billion, that would be a large target to digest. The quality of Cenovus's oil sands assets combined with the significant headwinds facing Canada's oil sands also make it less-than-attractive target.

What does it mean for investors?

Clearly, M&A activity in the North American energy patch is heating up. Buffett's considerable interest in Occidental coupled with his $488 million investment in integrated energy major **Suncor Energy** earlier this year indicates that he is becoming increasingly bullish on oil. That is a difficult signal to ignore when Buffett's considerable investing success and reputation is considered.

It will be smaller Canadian upstream explorers and producers that own quality assets, possess proven operations, and are trading at steep discounts to the value of their oil reserves that will be the most likely targets. That could include **Surge Energy**, which has an enterprise value of under $900 million and proven plus probable oil reserves with a net asset value of $5.58 per share, which is almost four times greater than its market value.

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