The Upside of Down

BEAUTY, IT'S SAID, IS IN THE EYE OF THE BEHOLDER. AS IT HAPPENS, SO IS OPPORTUNITY

BY TODD COYNE
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I**N HIS 20-PLUS YEARS AS THE COMPANY'S** CEO, Rick George took Suncor from a struggling upstart to an industry behemoth. And while his tenure was clearly a success, along with the good he saw plenty of the bad and the ugly in his two decades at the top. That might explain why he's not as down on the current price environment as many of his decidedly greener peers. And while he's not suggesting that low oil prices are a good thing, he's not confusing a few storm clouds with the sky falling either. "There are some things that are actually quite helpful in this," George says. Trying to spot rainbows in the midst of a downpour might not be for everyone. But it will forever be more practical than complaining about the weather. With that in mind, here are a few of the most sterling of silver linings out there today. >>

THE PAUSE THAT REFRESHES

If there's one thing the industry can agree on, it's that there will come an end to the bloodletting eventually. Given time, higher commodity prices will return – they always do. As Canada's finance minister Joe Oliver argued during a speech to the Calgary Chamber of Commerce in January, "The solution to low prices is low prices." With that flourish of reciprocal reasoning, the finance minister had – albeit too flippantly for some – conjured up a cure from within the disease. But whether one agreed with the government's *laissez-faire* low-price solution or not, the market would need time above all to heal. And until then, the slowdown in production does offer its own reward, namely downtime. The pause in the breakneck pace of development is a chance for oil and gas producers to take stock of operating costs and tool up their workforce, if necessary. As it happens, George thinks that a good stock-taking was probably long overdue. "The industry has not been particularly good at controlling costs, especially as crude oil was rising," he says. "So this is a good chance to reset the bar and try to drive costs down – that's for contractors, suppliers and everyone's expectations for the industry. That's one definite benefit."

Given that the annual slowdown of spring breakup is now upon us anyway – during what was already shaping up to be one of the worst Canadian drilling seasons on record – many proactive companies are taking the time to re-evaluate everything from labor costs to project efficiency, looking for potential savings. "When oil is at $107, it's pretty easy to allow those costs to escalate and that's what we saw happen," says ATB Financial chief economist Todd Hirsch. "This is an opportunity for costs to come down, because a year ago everyone in the industry was talking about the big challenge being cost escalation. I think 2015 offers companies the chance to wrestle some of those costs back to reality."

A BUYER'S MARKET

There are two sides to every trade, and few environments capture that more effectively than the floor of an industrial auction house. For the buyer it's often a happy place, an opportunity to add some new piece of machinery or equipment that can help a business grow. For the seller, on the other hand, the occasion is decidedly less upbeat: the liquidation of a non-core asset, at best, or a desperate attempt to find enough cash to keep the lights on, at worst. As president of the Calgary-based Energy Auctions, the only hock house in Canada dealing exclusively in oilfield production equipment, Marlon Ellerby has seen a lot of both lately. "I was just on the phone for an hour with another company trying to figure out what they're going to do," he says. "My phone has not quit. So many companies are liquidating just to make payroll, I'm probably the busiest company in the [oil] patch right now."

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That's good news for Ellerby – and for bargain hunters, too. And that hunt extends well beyond the floors and websites of auction houses. For those companies that held strong balance sheets and little debt coming into the oil price slide, the current market is in some ways better than $100 oil. Primarily, it forces weaker competitors – which may still hold solid assets but are otherwise overleveraged and can't properly fund their development – to sell for less than they'd ever feared. Last June, for instance, Artek Exploration's stock was trading at an all-time high of $4.48 on the Toronto Stock Exchange. By January, some seven months later, the stock had lost more than 70 per cent of its value, falling to a low of $1.32. In February, the Calgary-based company, which just days before had increased its proved and probable reserves by 33 per cent, was bought by Kelt Exploration for $307 million in shares.

It's the kind of transaction that isn't reserved for the big producers, either. Ellerby says he's watched opportunities for ownership or partial ownership trickle down to just about anyone with capital to spare – including those in the hardware resale business. "I know three companies first-hand that came to a group of [auction] companies and offered up equity in their company just to get cash so they could meet payroll," Ellerby says. "It got around to us but I never got involved in it. I'm still not putting any money out right now." »

TIMING IS EVERYTHING

Ellerby's reluctance to put up cash isn't necessarily a sign of pessimism, though. It may be a mark of prudence. After all, the value of a transaction is often only found in hindsight, when the trajectory of prices post-sale determines the difference between a deal and a dud. Take Encana's recent purchase of Athlon Energy, which cost the company US$5.93 billion in cash and US$1.15 billion in the debt it assumed in order to acquire the Permian Basin producer. Those assets may well prove to be an accretive addition for Encana shareholders, but they would have looked a whole heck of a lot more accretive if Encana had waited six months to pull the trigger.

Waiting might be the prudent thing to do right now, according to Derek Flaman, a lawyer with Torys LLP who specializes in private equity funds and energy investments. He describes the current environment as "the calm before the storm," and says it's only a matter of time before too many loans come due for too many leveraged companies and the storm begins to blow in earnest.

"You've still got all these vendors that have built up their businesses and spent a lot of time and energy and money getting to the point where they thought they were in a great spot and they're sort of unwilling to believe that the commodity prices that we're in are going to continue to stay where they are," Flaman says. "I think they may be a little overly optimistic in thinking that prices are going to improve more quickly than the rest of us think they're going to." That optimism, he says, is on a collision course with the natural pessimism of bankers, bondholders and other financiers. "Prices certainly will get better, but some people can't wait around," he says. "Even though they would like to hang on, it's not necessarily up to them." For prospective – and patient – buyers, of course, that's exactly the kind of situation they're waiting for.

SKILLS, TOO, PAY THE BILLS

One area of downturn-era investment that can benefit both employer and employee is training. "We hear this time and time again; that there is inadequate training – safety training, equipment training," says Hirsch. "And the problem is when companies are so busy and they're running their labor at overtime as it is, there just isn't time to send them off on safety training courses. So now they'll have an opportunity." It may seem counterintuitive – spending cash to train workers at a time when money is scarce and workers are plentiful – but it's worth the investment for those that can afford it. "For a lot of companies, that cash flow is restricted right now," Hirsh says. "But for those companies that are in better shape financially, this is a golden opportunity to use this downtime to invest in their training – skills training and safety training, particularly."

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George agrees with Hirsch's pro-training principle – "You never can spend enough time on training," he says – and he's a man who understands the merits of countercyclical investing, given that he did it repeatedly at Suncor. But his experience has also taught him that companies can rarely spend their way out of trouble once they've spent their way into it. "It's this part of the cycle that really helps industry get back and focus on the bottom line and focus on margin, which means if you can't expand revenue because of commodity prices, then you have to work on the fundamentals of cost control."

And while the fundamentals of cost control often include cutting staff, Mark Scholz, the president of the Canadian Association of Oilwell Drilling Contractors, says that some on his side of the industry are going into make-work mode in an effort to keep talent close by. "A lot of guys are trying their best to keep as much of their equipment out there working so that they don't lose those seasoned guys," he says, noting that companies don't want to lose their best people the way they did during the last downturn. "In 2009, when we went through this, we lost a ton of good people and they never came back to the business." The balance they'll have to strike this time is in keeping the best staff around long enough until it's once again well worth everyone's while. AO