COMMENTARY

BETTER RESOURCE ALLOCATION AT THE INDUSTRY LEVEL IS THE ONLY WAY FORWARD FOR CANADIAN OIL & GAS

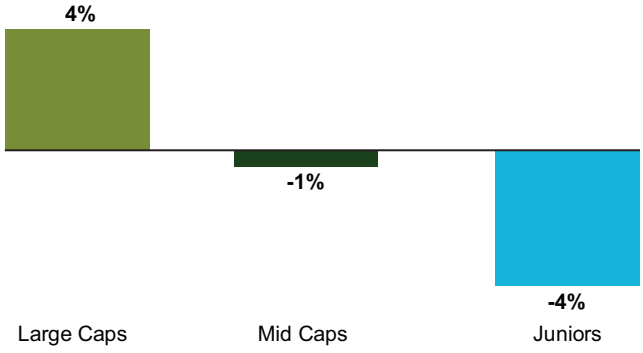
July 2020

Marakon
Management Consulting at
Charles River Associates

The short-lived oil price war and demand destruction caused by COVID-19 has put the Canadian oil and gas sector under significant pressure. Potential government support for the industry has been hotly debated, with some prominent politicians even going as far to say it should be left to die.[1] According to Statistics Canada, Natural Resources Canada, from 2014–18 the oil and gas sector contributed over $100bn per year to Canada's GDP, including tens of billions in direct payments to governments, and income taxes paid by its hundreds of thousands of workers.[2] To continue to be a source of prosperity for Canadians, the industry needs to be more profitable. Minimum thresholds for investment need to go up. It is not enough to assume a bounce in commodity prices will 'save the day.' Better resource allocation at the industry level is the only way forward, and failure to do so (quickly) is likely to lead to continued low returns, threatening the long-term viability of the industry.

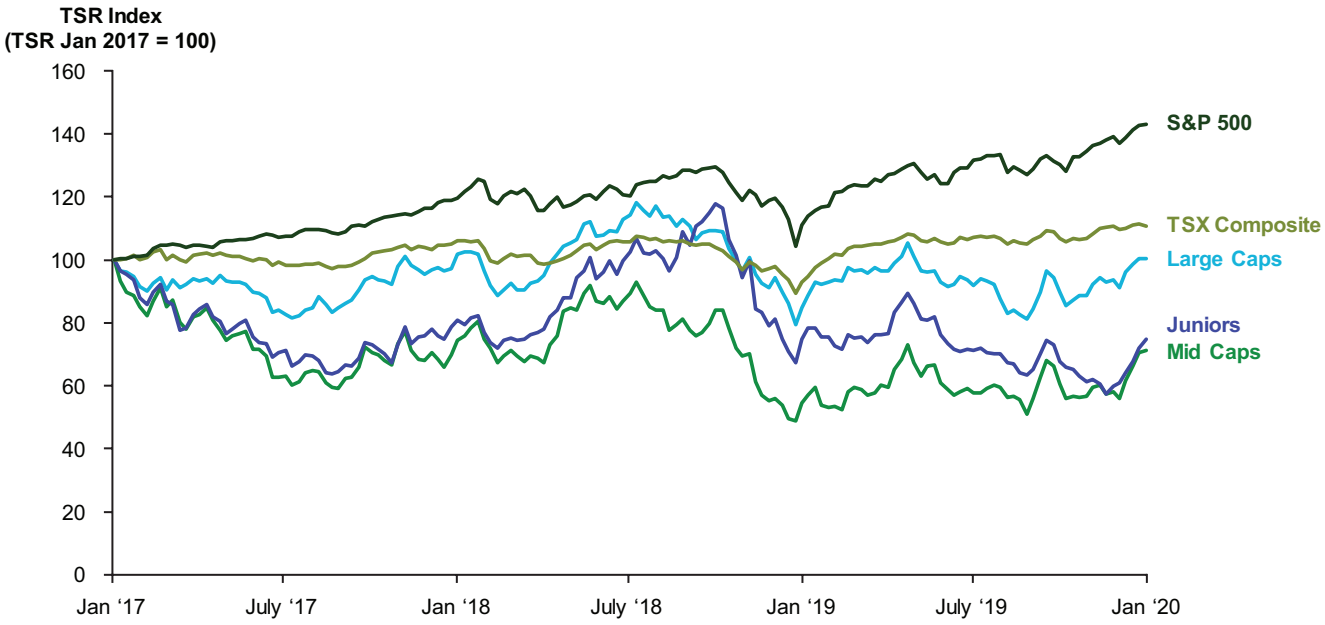
While the oil price war and the COVID-19 pandemic have had a dramatic impact on the industry, challenges have been mounting for some time. For years companies have struggled to generate returns above the cost of capital, or stable free cash flow growth. As a result, capital markets have dried up, with investors and lenders increasingly unwilling to fund further investments (a trend not limited to Canada). These factors weigh significantly on market performance, which has lagged the broader S&P/TSX. Clearly some of the challenges have been driven by external factors (e.g. market access), but the industry needs to adapt to the realities of the current environment.

Exhibit 1: Avg. Return on Invested Capital ('17–'19)



Source: Marakon analysis and company reports

Exhibit 2: Total Shareholder Returns by Segment (2017–'19)



Source: Marakon analysis and company reports

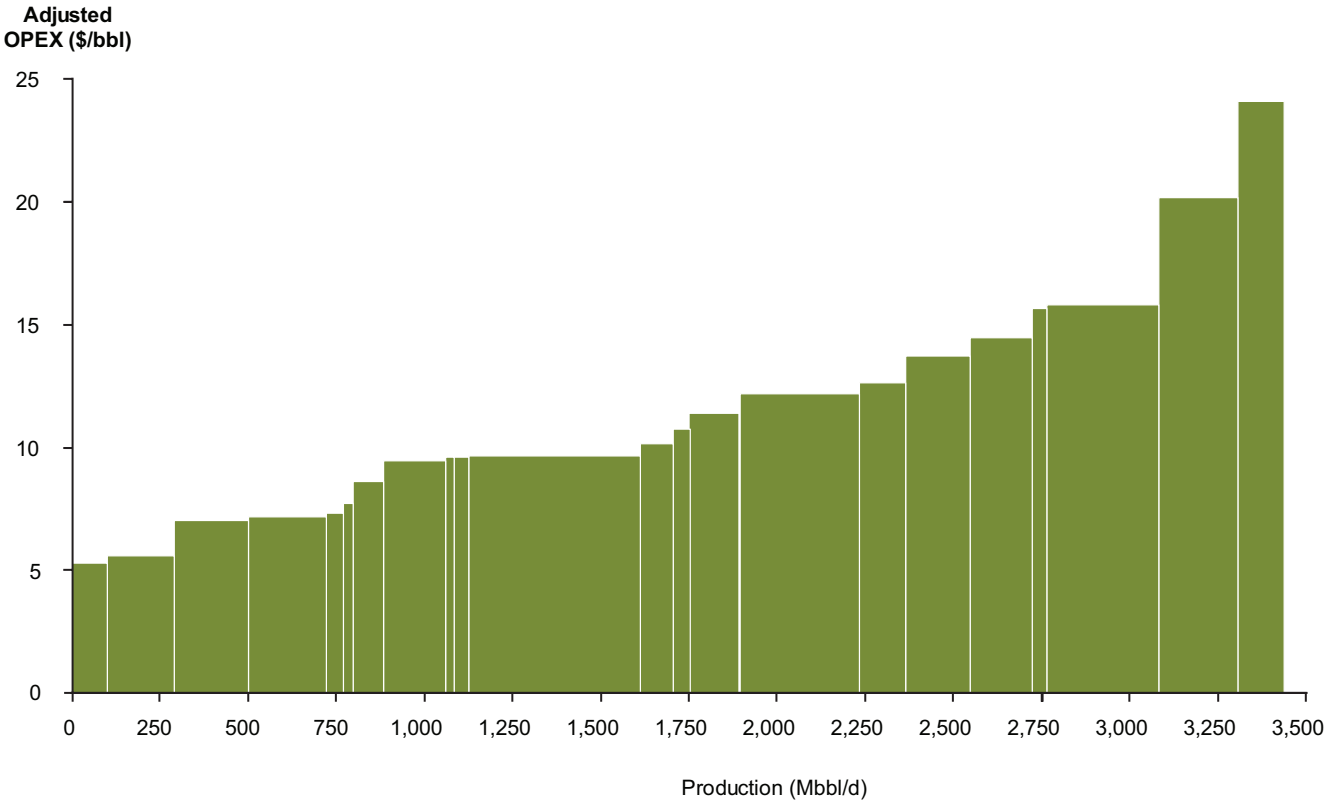
[1] John Paul Tasker, "May and Blanchet declare the oilpatch 'dead,' warn Ottawa against financial supports," *CBC,* May 6, 2020, at https://www.cbc.ca/news/politics/oil-is-dead-green-bloc-parties-1.5557725.

[2] Statistics Canada, Natural Resources Canada

Overall, Canadian oil and gas production is not competitive at the global level and requires higher prices than most countries to generate returns above the cost of capital. Capital costs are only getting higher as investors turn away from oil sands companies due to environmental, social, and governance (ESG) concerns. Non-competitiveness is driven by the sector's position on the global cost curve and well-known challenges of getting product to market. However, there is a significant discrepancy in asset quality across the industry, meaning the oil price at which assets generate a positive return varies substantially.

The allocation of increasingly scarce resources will need to be optimized for the industry to be more competitive, profitable, and viable long-term against the backdrop of slowing demand growth and pressure to reduce carbon emissions. The only way to achieve that is through consolidation. Be it M&A or strategic partnerships, companies need to work together. Mergers and new asset configurations have the potential to create substantial value by reducing overhead costs, unlocking operating synergies, driving uptake of new technology, and rationalizing uncompetitive assets to free up capital for the best opportunities. Doing so will not be easy or straightforward, but the result will be a more stable and profitable industry, that can continue to be a driving force for the Canadian economy for years to come.

Exhibit 3: Adjusted OPEX by Oil Sands Asset (proxy for asset quality)



Source: Marakon analysis and company reports

Written by:
Charlie Johnson
Associate Principal, London
cjohnson@marakon.com
+44-20-7664-3643

Neal Kissel
Managing Director, London
nkissel@marakon.com
+44-20-7664-3727

ABOUT MARAKON

Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

We help clients achieve their ambitions for sustainable profitable growth through:

- Stronger strategies and advantaged execution based on:
  a. A better understanding of what drives client economics and value
  b. Insight into changing industry dynamics and the context in which clients need to succeed
- A stronger management framework to generate better ideas and link decisions and actions to value
- A stronger organization with a more focused top management agenda and well-aligned resources
- A more confident and effective leadership team that's focused, decisive, and strategic

We have a joint team delivery approach where client ownership and engagement is paramount. Partners are highly engaged in the work product and supported by strong analytical and industry relevant capability. We work as advisers and catalysts in close, trust-based relationships with top management teams.