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INDUSTRY EXPLORATIONS

CANADA OIL & GAS

2014

Economy | Oilsands | Finance | Environment | Services

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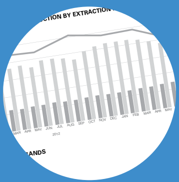

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An Introduction to Canada

A brief overview of the country and economy

Canada's economy is diverse and paradoxical. On the one hand, the world's 14th largest economy claimed modest yet stable growth rates in a period when other developed nations remained stagnant or words: 3.2% GDP growth in 2010 and 2.4% in 2011. Its banks, which proved so resilient during the global financial crisis, have recently shown gains in the Toronto Stock Exchange. A recent Bloomberg ranking moved it up four places this year in ease of doing business, placing it behind only Hong Kong. The fourth quarter of 2013 showed growth of 2.9%, better than forecasts and above that of neighboring USA.

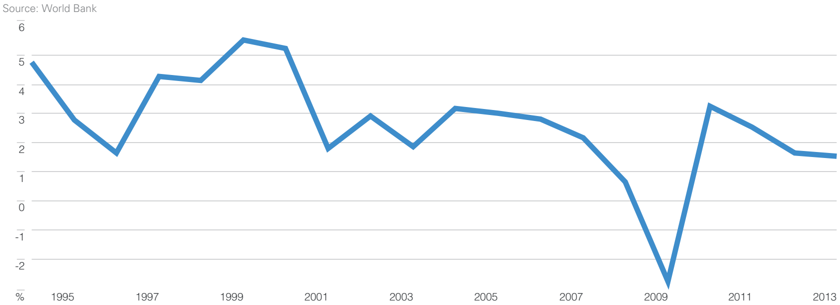
Yet the stories carried by the media present a picture of economic woe. The country's second-largest national newspaper, The Globe and Mail, carries the headline "The growth puzzle: Why Canada's economy is lagging the US". The Financial Post reads "Canada's economy sheds 7,000 jobs in second decline in 3 months". Media, as it is so often accused, loves bad news. The unusually cold winter, which has seen snowstorms blanket large swathes of Ontario, Quebec and the Atlantic provinces, has slowed the economy and is having a similar effect on the USA. Even taking these excuses into account, however, there is no doubt that Canada, for all its strengths, is struggling and has been for a while.

GDP growth in 2012 was a disappointing 1.7%. In 2013 it was 1.6% (although some estimates put it up to a more respectable but still slow 2%). Forecasts for 2014 are around 2.3%: an increase, but below the 3.1% forecast for the USA and nowhere near Canada's potential. Similar growth is expected for 2015.

The job losses early this year are real, and unemployment stubbornly refuses to fall below the 7% mark. This March Statistics Canada noted "there has been little overall employment growth in Canada since August 2013". Despite the expanding economy of Canada's largest trade partner, the USA, Canadian exports also appear to be stuck: something that the chief economist of the Canadian Imperial Bank of Commerce blames on former Bank of Canada governor (and current Bank of England governor) Mark

GDP GROWTH RATE

Source: World Bank



Carney. Because of his failure to check the Canadian dollar appreciation rate, says Avery Shenfeld, export-orientated companies did not invest in Canada. As a result, there are now 9,000 fewer Canadian exporting companies than there were in 2008.

While this may be the case (GBR will reserve its judgment on central bank policies for the time being), even 9,000 fewer companies do not significantly diminish the impressive diversity of Canada's economy. Its financial sector is among the world's most stable and respected. Its manufacturing sector boasts large and mature automobile and aerospace industries, supported by strong research and development funding. In the extractive industries, Canada boasts both the world's most important financing markets and substantial natural resources of its own.

Indeed, the negative news coming from the Canadian economy can be at least partially (but, unfortunately, by no means fully) explained by Canada's strong foundations. The government plans to balance the budget by 2015 and is therefore not spending in the same way as other countries, which still continue aspects of fiscal stimulus introduced during the global financial crisis. This means less government money and jobs contributing to economic growth, but it also means Canada is in a stronger position to counter unexpected shocks: as it did in 2009, after which it rebounded strongly. This rebound also contributes to its poor comparative performance now: other countries are still recovering from recession and rebound growth rates are often higher as countries return to normal; Canada has had its rebound.

There is no denying that the Canadian economy has entered a period of lethargy, even if slightly short of stagnation. There is no end to this period in the near future (although the end of the bear market in commodity prices that many predict would be positive news for the country). Nonetheless, it has avoided the dismal situation in many parts of Europe and is highly unlikely to fall into recession any time soon. Canada's fundamentals are strong, making the current period unlikely to turn into a long-term malaise. •

CANADA AT A GLANCE

Source: CIA World Factbook

Population: 34,834,841 (July 2014 est.)
Capital: Ottawa
Head of Government: Prime Minister Stephen Joseph Harper
Currency: Canadian Dollar (CAD)
GDP: $1.825 trillion (2013 estimate)
Growth Rate: 1.6% (2013 estimate)
GDP per Capita: $43,100 (2013 estimate)
Economic sector breakdown: agriculture: 1.7%, manufacturing: 28.4%, services: 69.9% (2013 estimate)
Exports: $458.7 billion (2013): motor vehicles and parts, industrial machinery, aircraft, telecommunications equipment; chemicals, plastics, fertilizers; wood pulp, timber, crude petroleum, natural gas, electricity, aluminum
Imports: $471.0 billion (2013): machinery and equipment, motor vehicles and parts, crude oil, chemicals, electricity, durable consumer goods
Major Trade Partners: US, China, Mexico, UK

$1.825
trillion

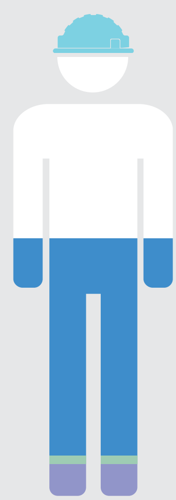
GDP
(current US dollars) 2013

Source: CIA World Factbook

POPULATION AND WORKFORCE INFORMATION

Source: CIA World Factbook, CAPP

Population 2014
34,834,841



- Labor Force 2013: **19,080,000**
- Unemployment Rate 2013: **7.1%**
- Poverty Line 2010: **9.4%**
- Jobs Supported by the Oil and Gas Industry 2012: **550,000 (1.6% of total population)**

The Honorable Ken Hughes

Minister of Energy
LEGISLATIVE ASSEMBLY OF ALBERTA

To what extent is the Albertan Government looking into contingency plans to deal with the price differential on Western Canadian Select should Keystone and Northern Gateway continue to be stalled?
We have developed an oil market diversification strategy over the past year that we are pursuing. The strategy involves getting transportation infrastructure in place in whichever direction makes sense. We are looking at every possible alternative that people bring to us, including pipelines in all directions and rail transportation. The other element is to add value to bitumen and natural gas here in Alberta, which would allow us to capture close to world price in the domestic market. None of these plans are 'contingency', based upon something else not happening—they are options we are pursuing to ensure that we have access to tide water in any way we can.

In the run up to the BC elections, Christy Clarke was quoted by the Globe and Mail saying 'we don't need Alberta' in relation to Northern Gateway. Can the Alberta government work with BC on inter-provincial oil pipeline development to reach a mutually beneficial solution?
Alberta, British Colombia, and Saskatchewan are part of the New Western Partnership, which has become an enduring relationship amongst the three Western provinces, and a way in which we can collaborate together on a number of issues. Lets look at what our respective interests are: gaining access to markets for LNG is an important interest that all three provinces have in common, so I believe that there is a lot of common ground to be built upon there. Secondly, there continues to be growing demand for electricity in both BC and Alberta; we can potentially work together to ensure that we have adequate electricity in the northern parts of our two respective provinces.

Is the government working directly with rail providers or are these relationships the preserve of negotiations between private sector entities?
The Alberta Government is working with companies that are [shipping]. We are in the commodity business ourselves, because we can take bitumen royalty in kind, so we can deliver our own product oil to refiners to help them determine what they need to do to be able to accept larger volumes. Through the Alberta Petroleum Marketing Corporation, we are active players in the market place exploring alternatives, and working with private sector players to develop alternatives.

Do you think there the need to further a unified Canada Energy Plan?
Certainly. The Canadian Energy Strategy in an initiative ably led by Premier Alison Redford and her colleagues. The strategy is still in its early stages but we have already seen great results. An example is our work with the government of New Brunswick on the proposed conversion of the TransCanada Pipeline, and then the extension of that pipeline down to Saint John New Brunswick. This happened as a result of a private company and the respective governments working together very effectively so that all of the stakeholders are well informed on any challenges they might face or concerns that might be raised along the transit route. The New Brunswick Government are strong champions of adding value to Alberta Bitumen in New Brunswick and that eastern pipeline has the potential to deliver bitumen to facilities in Montreal, Quebec City, and potentially also the Come By Chance refinery in Labrador and the Dartmouth refinery in Nova Scotia. This creates immense value-add to Alberta products in parts of the country that have higher unemployment rates and welcome the economic activity; this helps build good will for the Alberta energy sector and is win-win-win all around.

Can you provide us with an introduction to the Responsible Energy Development Act and how the creation of a super regulator will improve the permitting process in Alberta?
This initiative has come about as a result of work that was done around four years ago when it was determined that Alberta's regulatory processes were not as efficient or competitive as some other jurisdictions. The goal is to create an effective and efficient regulatory regime that works not just for applicants but also for landowners and those who have concerns about environmental issues. We are combining the regulatory roles that currently reside in the Energy Resources Conservation Board (ERCB) on one hand, and the Department of Environment and Sustainable Resource Development on the other hand.
The new regulator will function under the six existing pieces of energy legislation, and the four existing environment related pieces of legislation. I would characterize this as the next generation of regulatory structure. In Alberta we have had 75 years of very strong regulatory performance and oversight of the energy industry, and we have built on that at every generation to improve how the process works. For example, if you are doing a SAGD project in the oil sands, it could require as many as 200 separate licenses; we are turning that into a one window approach and if we can take a few months off the process it provides huge value to the applicants. •

TSX TRADING STATISTICS - JANUARY/FEBRUARY

Source: TMX

	2013	2014	% CHANGE
2013-2014:			
Volume	13,142,392,010	14,270,685,613	+8.6
Value	$188,988,895,272	$203,322,973,319	+7.6
Transactions	25,572,470	31,698,441	+24.0
Daily Averages:			
Volume	320.5 million	348.1 million	+8.6
Value	$4,609.7 million	$4,959.1 million	+7.6
Transactions	623,694	773,133	+24.0

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ti-stage fraced horizontal wells are highly capital intensive and, while they are very attractive economically, the rate of return profile is longer," says Shane Fildes, executive managing director for capital markets at the Bank of Montreal (BMO).

Faced with a lack of exit opportunities, some Canadian companies are considering turning their backs on the public markets and exploring private capital to finance their activities. Laricina Energy is a particular success story, having raised over $1.3 billion through private equity to fund its Saleski and Germain projects in Canada's oil sands. "Private equity is becoming more common as an option for good management teams," said David Vankka, managing director, investment banking at Canaccord Genuity.

Not every investor believes that private equity is the miracle that cash-strapped oil and gas companies are looking for. "The problem with private equity here is that the funds go out to raise money, become increasingly successful, and then face more challenging investment criteria," said David McGorman, CEO of Jennings Capital.

"Many projects do not need C$100 million to get started; they want C$25 million toC$40 million. Trying to find that amount is very difficult. The conventional hedge fund is not interested, and private-equity firms think this amount is too small for their portfolios. Currently the private-equity market raises more money than it knows how to deploy and this goes to companies that have more than they need already."

Another option for high-performing, producing companies is to start paying a dividend to investors. Whitecap Resources recently established a $0.05 dividend. According to Grant Fagerheim, Whitecap's CEO: "We had to look at it in terms of what we believed our assets could deliver, and how effective we could be with our capital. Now we are setting aside 34% of our cash flow to pay dividends to our shareholders, and the rest is used to fund our growth strategy."

A dividend model may be attractive to investors, but can consume a company's existing cash flow: the balance between spending money to stimulate investment and saving the investment received is a fine one. Nevertheless, Paul Colborne, CEO of Surge Energy, a light-oil producer in Alberta, believes it is a low-risk way to play their basin. "Surge will grow about 3% to 5% per year and pay a 7% dividend to our shareholders, giving us a return of 11% per year. This model allows us to return a monthly payment to our shareholders who can benefit from strong oil prices," he said. •

Rick Rule

Founder Global Companies
SPROTT GLOBAL RESOURCE INVESTMENTS LTD.

Can you introduce us to Sprott Global Resource Investments Ltd. and its involvement in oil and gas?

Sprott Global Resource Investments Ltd. is mostly involved in the sub-$500 million market valuation space in both Canada and the United States. We are known as an alpha shop, which essentially generates alpha by answering unanswered questions; we have found that the flow of information is less efficient in smaller companies, and our ability to compete has been more efficient in smaller companies. In the US, Sprott has consistently recommended that US investors take a cornerstone position in oil sands: we think it is the largest source of secure hydrocarbons in North America, and is scalable in that it responds well to applications of capital during high oil prices. This does represent an exception to Sprott's smaller cap focus, because they play a unique role in high-end retail portfolios for US investors.

How has Sprott adapted its investment strategies to the tight fiscal environment?

Most of Sprott's competitors in the Canadian energy space are focused on companies producing 15,000 boe/d, but we focus on a lower level with the understanding that our exit strategy is uncertain. However, the valuation metrics are more attractive based on things like enterprise value and cash flow multiples. Over the coming months our suspicion is that companies producing less than 10,000 boe/d will either be taken private or opt out of an IPO. This will lead to more consolidation; for investors, there is money to be made by owning both the buyers and sellers. Sprott has been focused on light oil for the last few years, but recently is looking at assets with a dry gas "kicker". We look for companies with enough production acreage whereby that when gas prices do begin to recover, there is a warrant built in to the existing production base. We do not believe that prices will recover in the near term, but our attitude towards gas packages is higher than it used to be.

A number of companies have transitioned to a dividend model. How attractive is this to investors?

The market lift that companies have previously enjoyed by switching to a dividend model has been overdone. Sprott would prefer to see companies who utilize their free cash flow to develop attractive recycle ratios and deploy their capital effectively, rather than pass it along to shareholders. Companies that rely on a high dividend rather than capital efficiency will be taken private. There was a time two years ago where the way to lower your cost of capital was to increase your dividend, but this time has passed. Now, companies that have a large and repeatable resource base that can effectively redeploy their cash to grow production and reserves will enjoy premium values.

The retail market has proven an inadequate source of capital for oil and gas plays. What opportunities are currently available for financially constrained companies?

The institutional investors have exited the junior market, but there should still be adequate access to capital for juniors to access. The extractive industry entrepreneurs enjoyed remarkable access to capital from 2003-2010, and the issuers confused optimal pricing conditions with normalized pricing. If the issuers adjusted their expectations with regards to what ought to be normalized cost of capital, they would find that capital is reasonably available, although they would prefer that capital was cheap. We will see an increasing reliance on four sources of capital. First, conventional bank financing is still available in Calgary. Second, private equity will come into Canada with a vengeance; Canadian private equity valuations are cheap in comparison to their US counterparts. We also believe that consolidation will begin to take place, albeit slowly. Finally, juniors who are location-rich with large inventories will look to joint venture opportunities.

Can you give us some insight into whether we can expect higher natural gas prices and a closing of the gap between WTI and Brent prices?

There is a difference between the words "inevitable" and "imminent." On both sides of the border, primary gas producers are not earning anything close to their cost of capital and the industry is in liquidation. In these situations when you have an industry that is in liquidation and the utility of the commodity to users is so high, the price has to go up. Unfortunately, it does not have to do so in a timeframe that makes sense. With regards to crude price differentials, the disparity between WTI and Brent is particularly interesting in that the national oil company model is problematic to importers. NOCs have not made the sustaining capital investments necessary to maintain their production, and instead have diverted cash flow to domestic spending projects. The consequence on prices is that there is much less supply than people had been inclined to believe. The fact that political disruptions in Egypt and Syria – both non oil-producing countries – had such a dramatic impact on oil prices says a lot about the fact that many traditional oil-producing countries have less to export. It is difficult for me to see in five years with production volumes declining how some countries can generate enough cash to maintain domestic spending and arrest a decline in production. If that does not happen, it has positive implications for valuations put on high-quality production in jurisdictions like Canada, and goes to the disparity between WTI and Brent quotes. •

Alberta's Landlocked Oil

From the oilsands to elsewhere

Alberta's oilsands are famous largely for the controversy they elicit. They are Canada's dominant source of oil, and as such a key contributor to the country's economy and employment, and the process of extracting them serves as a driver of new technologies that have applications across the world. Yet they are continually under the spotlight not for the benefits they provide, but for their environmental impact of both their extraction and of the proposals being put forward to solve the transportation issues inherent in their location.

The European Union's 2011 assessment that oilsands extraction emitted 23% greater greenhouse gases than that of conventional oil extraction put Canada's industry under increased scrutiny. With deliverability issues constraining investment in the oilsands and putting a cap on profitability, companies are looking to transport bitumen via pipelines in almost every direction possible.

Enbridge's proposed Northern Gateway pipeline has elicited domestic backlash. The constituency of British Columbia is currently undergoing a provincial election that is set to bring the pro-environmental National Democratic Party (NDP) to power, which, at minimum, may stall the project. In the international realm, the administration of Barrack Obama delayed a decision on the Keystone XL pipeline in November 2011 under environmental pressure.

Given the controversy surrounding the oilsands, innovation is not the first thing that comes to mind. Rather, many think about large producers or new and emerging transportation possibilities, from the Keystone XL pipeline to the ever-growing practice of transportation by rail. Recent innovations in the oilsands

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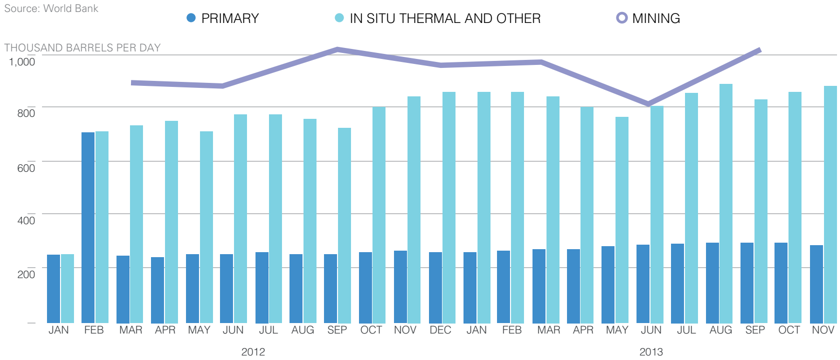
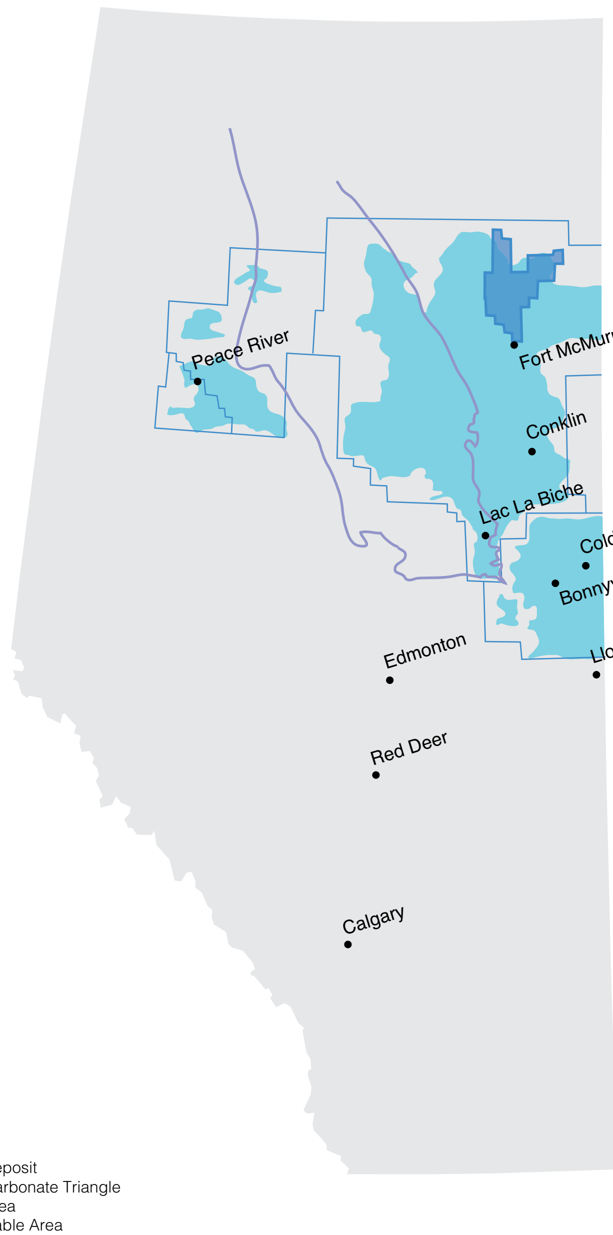
ALBERTA OILSANDS PRODUCTION BY EXTRACTION METHOD

Source: World Bank



ALBERTA'S OILSANDS

Source: Alberta Government



Succeeding in a Tight Market

Battening down the hatches

As the constricted market causes companies to become leaner and more efficient, and with industry-wide emphasis on growth through the drill bit and the reallocation of stranded assets, analysts predict that the Canadian companies able to ride out the current conditions will be in a much stronger position when the markets recover.

But even in today's bearish market, some Canadian companies have thrived through a combination of astute portfolio management, shrewd divestments and timely acquisitions. Arguably more than ever before, a strong, experienced management team is vital for inspiring investor confidence.

Manitok Energy, which was one of the TSX-V's top-10 performing oil and gas companies in 2012, focuses on conventional oil and gas reservoirs in the Canadian foothills along with heavy crude oil in east-central Alberta. Following successful capital raising programs in 2010 and 2011, Manitok Energy again went to market in late 2012 and raised around $18 million.

"Drilling in the foothills was 30 years behind the Deep Basin and the Peace River Arch, so there was an opportunity for big results. The problem was that there had been at least 10 juniors in the last 20 years trying to do the same thing, and all of them had failed, so there was a lot of skepticism in Calgary," Manitok's president and CEO Massimo Geremia, said.

One of Manitok's key differentiators was the experience of the management team and the match between the asset and the skill set of the technical team. Led by chief operations officer Tim de Freitas, Manitok employed a series of experts that had previously worked in the foothills with Talisman Energy.

"All of the other companies had been started by deep basin guys, or junior guys who had never drilled in the foothills and had to learn the pitfalls the hard way. Tim and the team from Talisman had already spent C$3 billion or C$4 billion dollars and more than 10 years in the area getting to grips with the pitfalls," said Geremia. "If you look at the junior companies that have prospered in Calgary over the last 30 years, a lot of them start with guys leaving the major firms and knowing the assets very well."

For companies with strong balance sheets, or those prepared to take on debt, asset divestiture presents a rare opportunity to pick up underdeveloped assets. Sub-C$15 million market capitalization Edge Resources was able to raise just over $6 million in early 2013. According to CEO Brad Nichol, a close and open relationship with investors was integral to achieving this.

"Debt is by far the least expensive and most readily available form of capital available today," said Nichol. "I think our greatest asset outside of the physical properties is that we have some great partnerships with our investors. Many juniors are struggling and lots of assets are underdeveloped, so there are many acquisition opportunities that we are working with our partners to take advantage of," said Nichol.

Other companies have had to refocus and reposition themselves to adjust to the challenging equity markets by selling assets. Connacher Oil and Gas, a junior oilsands player in Alberta, overhauled its management team and sold their downstream assets to focus on production at the Great Divide oilsands project in Alberta.

Prior to the reorganization, the concept of Connacher was in-situ oilsands hedged against gas with conventional assets, and then the downstream aspect. The market turned and performance was trailing, and the company had a balance sheet issue, according to Christopher Bloomer, Connacher's recently appointed CEO. The board and the previous management were able to sell the refinery to put capital on the balance sheet and start to re-focus the company.

"Connacher's business was good – with reservoir geology in the top 10% of our peer-group – but the balance sheet needed to be right-sized," Bloomer said. "The priority at the moment is positioning Connacher to show that it can invest capital and grow, to warrant people to say that the business deserves more capital because it has value." •