

AN INTERVIEW WITH ADAM WATEROUS, GLOBAL HEAD
OF INVESTMENT BANKING, SCOTIA CAPITAL

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A portrait of Adam Waterous, a middle-aged man with short brown hair and blue eyes, wearing a dark pinstriped suit jacket, a light-colored checkered shirt, and a red patterned tie. He is smiling slightly and looking towards the camera. The background is a blurred office setting with large windows showing a cityscape.

M&A leader says
low valuations
are driving activity

Don Stowers, *Editor, OGFJ*

EDITOR'S NOTE: Adam Waterous is vice-chairman and head of global investment banking for Scotia Capital. In this capacity, he is responsible for all of Scotia Capital's global investment banking activities. In his role as president and head of Scotia Waterous, he is also responsible for the operations of the oil and gas M&A arm of Scotia Capital. During a recent visit to Houston, Waterous talked to OGFJ's Don Stowers about his company and the state of the oil and gas industry.

OIL & GAS FINANCIAL JOURNAL: First, let's review a little history to give our readers some perspective. The firm that you founded in 1991, Waterous & Co., was acquired by Scotia Capital in 2005. Can you explain to our readers the relationship between Scotiabank, Scotia Capital, and Scotia Waterous?

ADAM WATEROUS: Let's start at the top then. Scotiabank is one of the largest banks in Canada and one of the 10 largest banks in North America by capitalization. The bank has three divisions. It has a retail business. It has an international business. And it has its wholesale business, or corporate business, and the wholesale/corporate business is done through Scotia Capital. Within Scotia Capital, which essentially does investment banking and corporate lending, Scotia Waterous is the oil and gas investment banking division of Scotia Capital.

Prior to the 2005 acquisition by Scotiabank, we were able to build Waterous & Co. into one of the largest independent oil and gas M&A firms in the world. By the time we sold it, we had about 17 employees and offices in Houston, Denver, Calgary, and Buenos Aires. So we were already a global firm at that time.

OGFJ: Were you just focused on the oil and gas business?

WATEROUS: That's right – the oil and gas advisory business. Since joining up with Scotia Capital, we have become involved in the oil and gas investment banking business. But in addition to this, last fall I took on additional responsibilities as head of all investment banking activity – not just oil and gas. So that's just a very quick Readers Digest version of our business.

OGFJ: Is Scotia's research analysis mostly on US or Canadian companies?

WATEROUS: Most of our research coverage, but not all, is on Canadian companies. But our merger and acquisition business is very global. About one-third of our business is in the United States, about one-third is in Canada, and the remaining third is outside North America. It's very well balanced. If you look at where our deal-flow was in 2008, in more than half of our

transactions, the buyer and the seller were not headquartered in the same country. So a large percentage of our business is cross-border transactions. We have built this by developing our global network, our global platform. We have emphasized this because today's oil and gas industry has become one of the most global, integrated businesses in the world. It's very difficult to be able to provide effective advice to your clients if you don't have this global perspective and a global reach. Regional banks simply don't have the same perspective and capabilities.

OGFJ: Low commodity prices and the global economic recession have hit a lot of businesses hard. What kind of year do you expect to have in 2009? Will business be off considerably from your record-breaking year in 2008?

WATEROUS: No, actually I expect 2009 to be an extremely active year. We are coming off two consecutive record-setting years in 2007 and 2008. Our financial performance has been strong, and we have been growing our business. We expect that growth to continue in 2009. The two main drivers for M&As are valuations. The transaction market has fallen relative to the cost of organic growth. In the oil and gas business, the chief executive officer is always faced with the decision – do I make or do I buy? "To make" is basically organic growth, which is by drilling wells. Or am I going to buy – am I going to buy a company or am I going to buy assets? Today, M&A valuations have fallen far faster than have service costs. As a consequence, it's generally much cheaper to be able to acquire companies and assets than to organically grow the portfolio. So that's going to increase M&A in the marketplace.

OGFJ: Have you seen any of this so far in 2009?

WATEROUS: Tons. Tons. The transaction metrics have really fallen in 2009 relative to 2008, as share prices have fallen. There's a reasonably good correlation between share price performance and M&A transaction metrics.

OGFJ: Would you categorize some of the asset transactions as "distressed sales?"

WATEROUS: It isn't necessarily that they are distressed. A distressed sale, in my view, is somebody being forced to sell because of leverage. I'll circle back with that, but the main reasons for the sales are what I just stated. One, it's cheaper to buy than to make. Two, access to capital is very challenged. So, as a consequence, to be able to invest in core properties, many companies are being forced to sell non-core assets, as a source of finance.

OGFJ: It's one of the few options companies have.

WATEROUS: Yes. Historically, if you go back through much of the 1990s, the global oil and gas business really picked up steam during this period. It was driven in large part by lack of access to financing. The majors began to shed a lot of their assets, and it was because they had poor access to capital. To put it another way, they didn't want to issue equity at low levels. Their shareholders would rather sell assets. Of course, as you mentioned earlier, another driver is the so-called "forced sale" of assets. Companies have run into leverage issues with their lenders and are being forced to sell to retire bank debt.

That's quite different though than not having access to capital. That's why I say that a down market leads to increased M&A activity. From the sale of large companies down to the sale of assets, all these transactions will have one of these elements in common.

OGFJ: I was reading an interview you did with Bloomberg back in January. You mentioned that in 2008 Scotia Waterous had advised on 29 global upstream M&A deals, more than any other M&A firm, and that the completed deal value of \$20.1 billion was second only to Goldman Sachs. With what you have just said about a down market leading to increased M&A activity, do you expect your results in 2009 to exceed those in 2008?

WATEROUS: It's really too early in the season to give you a definitive answer on that. It's like asking a baseball player in spring training if he's going to exceed his home run total from last year. Having said that, however, the market fundamentals for M&A activity remain very, very attractive. There are drivers for M&A in oil and gas that are cyclical, and there are drivers for M&A in oil and gas that are structural. One is the challenge companies have with organic growth today. And that organic growth is driven by the maturation of the business and of the oil fields themselves. Another challenge is that many host governments have made it much more difficult to be able to have attractive transactions – to make attractive investments with those host governments. So, when you have challenges with organic growth and you still have shareholders who want to see the divisions expand over time, that's going to lead the oil and gas business to be able to make acquisitions.



Left to right: Joe Amador, Ron Gajdica, Ken Becker, and Tim Pish check a company's holdings on a map.

OGFJ: To what extent does an advisory firm like Scotia Waterous get involved in non-M&A transactions such as joint ventures and partnerships? I'm thinking specifically of the Chesapeake Energy-StatOilHydro deal in the Marcellus shale, in which I believe Scotia was an advisor.

WATEROUS: Last year we advised Husky on their joint venture with BP where there was a 50/50 arrangement struck whereby Husky sold BP a 50% interest in their Sunrise oil sands project in Canada. In return Husky got a 50% interest in BP's Toledo refinery. While this was a joint venture and there was no cash exchanged, therefore there was never a valuation placed on the transaction, that was a several billion-dollar transaction, if you look up comparables to what the oil sands business was worth and what the refinery was worth. So that's a very large, complicated, ongoing business relationship that was struck between the two companies. As I said, we advised Husky on this transaction, and someone else advised BP. Advisory firms are still needed because of the value of the transactions even if money does not change hands.

OGFJ: You mentioned the oil sands. I assume you have quite a bit of expertise in this area. How will lower commodity prices impact oil sands development in your view?

WATEROUS: It's my view that, over time, all or almost all of the independent oil sands companies will be bought by larger entities. The reason is that their access to capital is very limited. In the past, their access to capital for acquiring leases, doing delineation drilling, doing some

piloting, and so on has been available. But, when you move from having to raise hundreds of millions of dollars to having to raise billions of dollars to be able to develop, the capital markets, generally speaking, are not supportive enough for independents to raise that much capital. Ultimately, they will be driven into the arms of what many describe as the “rightful holders” of the assets, very large companies that can afford the enormous development costs associated with the oil sands. So that’s a great space to watch for industry consolidation.

OGFJ: With lower natural gas prices, some of the cost associated with oil sands development has gone down. Are you saying this is not enough, that lack of access to capital trumps lower development costs?

WATEROUS: Absolutely.

OGFJ: Speaking of commodity prices, will gas-heavy producers suffer worse in the downturn than companies that have more balanced production, more oil in the mix? Oil prices seem to be making a bit of a comeback, while gas prices remain depressed.

WATEROUS:

Both oil and natural gas prices have fallen in North America because the economy is contracting. Having said that, with respect to oil, constraint to supply on a global basis remains very compelling. The ability to bring on a new supply of oil from anywhere around the world remains very difficult. Conversely, you don’t have these same constraints to natural gas supply in North America. The shale plays have changed the picture dramatically. We now have a situation with increased supply and reduced demand. When oil moves from \$50 to \$100, it’s still quite difficult to bring on a lot more oil production. We saw that first hand when oil moved to as high as \$147/bbl. It’s difficult to bring on new production quickly and at low cost. In the oil sands, for instance, the break-even price of oil would be as much as \$70/bbl to \$80/bbl to justify new projects. It takes a lot of time to ramp up production even in the right price environment. Conversely, if gas moves from \$4/Mcf to \$8/Mcf, because of the development of these new gas shale plays, a lot of gas could come on the market. Over the long term, that is going to act as a governor for the ceiling for gas prices in North America.

OGFJ: So it’s a lot easier to bring additional gas supply on stream today than it is to bring new oil supply.

WATEROUS: Absolutely, because of the shale plays. Historically, it was just the opposite. Gas had such a great future because gas production was falling in the Gulf of Mexico and demand was growing quickly because it is a clean-burning fuel. People were more bullish on gas than on oil. Today in North America, it’s the reverse.

OGFJ: What are the major obstacles to development of oil and gas resources in North America and globally?

WATEROUS: There are three or four major challenges. One is the maturation of fields in North America; the low-hanging fruit has been plucked. As a consequence, we’ve had to go to higher-cost reserves – oil sands, deepwater Gulf of Mexico, etc., where the development costs are much, much higher. The second challenge is

regulatory/government intervention, and that applies both in the United States and overseas. In the United States, access to offshore drilling remains restricted, and access to drilling on federal lands remains a difficult, cumbersome process, and instead of becoming easier, it seems to be moving

in the opposite direction. Overseas, the takes that host governments are making are, generally speaking, making it difficult to operate there. The third challenge the industry faces is perception of it as a carbon-producing industry and the consequential additional cost burden in the form of direct and indirect taxation on developers. All these are very tough challenges.

The fourth major challenge is the rise of Asian buyers – the Chinese, Koreans, Japanese, and Indians in particular. This has dramatically altered the landscape as to who will be most competitive in acquiring new reserves. US companies, for instance, used to take cash flow from their domestic operations and invest it in Africa, Latin America, or Asia, and they would be able to acquire those resources at a discount to what valuations were. That was an arbitrage that was played for many decades, and the guys who benefited the most were the super majors. That business model is now broken. The people in the non-OECD world are focused on their world, and that has pushed valuations higher. Today, valuations in the non-OECD world are as high or higher than in the

“US companies...used to take cash flow from their domestic operations and invest it in Africa, Latin America, or Asia, and they would be able to acquire those resources at a discount to what valuations were. That was an arbitrage that was played for many decades, and the guys who benefited the most were the super majors. That business model is now broken.”

OECD world. Now, it has become too expensive for OECD countries to invest in emerging markets, and they are being forced to develop in their home markets. This is a very recent trend, but one that will slow development of these resources.

OGFJ: In your view, what kind of company will come out of the current economic climate in the best shape?

WATEROUS: The companies that will be in the best shape are those that have strong access to capital and, on a comparative basis, clean balance sheets. Also companies that are not dependent on emerging market acquisitions. Companies that are capable of growing through acquisitions in the United States and Canada, primarily in the OECD world, and not surprisingly will have some of the longer reserve life assets. If you have a company with short-life assets and you run into a prolonged downturn, then they don't have the running room to be able to outlive a long slump.

OGFJ: Final question. Are you bullish on the future of the petroleum industry?

WATEROUS: Absolutely. What makes me bullish on the sector is what is driving the development of the oil business more than any single factor is globalization of trade. Trade barriers have come down, and this increases the economies of these emerging markets, and China and India are the two biggest of those. As those economies improve and people move out of poverty into the middle class, their consumption of commodities like oil and gas dramatically increases. That policy of globalization – low trade barriers – has been one of the most successful social policies ever implemented by governments around the world. There have been approximately 300 million people lifted out of poverty around the world in the last 20 years as a result of those policies. The benefit is so powerful that I believe globalization is here to stay. And if you believe this, you have to believe that oil and gas have got a very bright future. **OGFJ**



The management team at Scotia Waterous are shown in the firm's Houston office. Front row (from left): David Cecil, Adam Waterous, and Adrian Goodisman. Back row (left to right): Ron Gajdica, Ed Katterhagen, Tim Pish, Shaun Finnie, Jeff Hamilton, Ken Becker, Lance Dardis, Randy Crath, Joe Amador, and Doug De Filippi.