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Reverse Road Show

A "road show" in the investment business is when a company travels the country or continent to promote its business to investors. This may be to promote an initial public offering (IPO) or just a business update for investors. A "reverse road show" is when the investor travels around and meets a variety of different companies usually in a particular sector. This week we went on a reverse road show in Calgary to visit six midstream energy companies, which are businesses involved in the transportation, storage and marketing of oil and its derivative products. It can also involve natural gas transportation and processing. The tour visited a combination of companies we own and don't own. In light of the changes in the Energy sector over the last year, we thought it would be useful to share some of our learnings.

During the boom years in the oil sands, one of the industry concerns was the escalation of construction and engineering costs in Western Canada. To preserve profit margins, engineering companies started refusing to do business on a fixed rate contract. The result was cost plus contracts, which pushed the risk onto the customer. Many of the companies we met this week described a new paradigm with the return of fixed rate contracts. The reduction in available work has created a more customer friendly environment. This will benefit many of the companies that we own who continue to invest in this low oil price environment. Companies indicated engineering and construction costs were down between 5-10%. We should also note this may help other businesses in our portfolio that are building assets in Western Canada.

Being able to build new assets at this time allows companies to benefit from more experienced and productive employees. If we again go back to the boom years in oil sands, the Horizon oil sands project constructed by Canadian Natural Resources (CNRL) employed 10,000 contract and CNRL employees on the site. The result, as described by CNRL, was a lack of productivity due to a variety of reasons such as idle time and a lack of materials. Moreover, the 10,001 person probably wasn't as skilled as the 200th person hired, so with the number of projects going on at the time the skill level of the marginal employee was low. CNRL is one of many companies that have vowed to do everything possible to avoid this type of environment again. The companies we met with described that the productivity and skill level of the people they are using now is much better, allowing for less expensive construction and a reduced number of costly errors.

Capital is very flexible. All of the companies reflected on the new NDP government in Alberta and how changes to corporate tax rates and/or royalty rates could affect their investment decisions. No company had adjusted spending at this point, but made it clear that if the returns were higher in a different jurisdiction, or uncertainty remained in Alberta, then capital would be allocated elsewhere. These midstream companies did say many of their customers, who are the big oil and gas producers mostly in the oil sands, have already deferred projects due to low commodity prices so their future growth may slow. However, the slowing will take place in a few years as existing companies will need to move the oil from projects currently under construction.

Many companies are interested in acquiring natural gas processing assets. Usually in this type of transaction, an exploration and producing (E&P) company may be looking to reduce its debt level, so it may be interested in selling its processing plant. The deal will be structured so that the E&P pays a toll to the midstreamer to process the gas. The difficulty is the midstream company wants to enter a tolling contract with a strong counterparty. A strong counterparty is one with low debt. The problem lies in that the only businesses which need to sell their processing plants are the ones that are not strong counterparties given their high debt levels. This reinforces our discipline of investing in enterprises with strong balance sheets because when a market downturn arrives, it is very difficult to adjust in the downturn.

These reverse road shows may not result in a new investment, but it highlights some of the benefits that may be realized by those companies and others affected in the portfolio. The investment business is full of information, but hearing the perspectives of those in the trenches is an excellent source.