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Husky Energy Inc. – Target (TSX:HSE)

Cenovus Energy Inc. – Acquirer (TSX:CVE)

Natural Resources - Energy

Cenovus Creates an Energy Powerhouse

January 5, 2022

Cenovus Energy Inc (Cenovus) announced on 10/15/2020 their intent to acquire competitor Husky Energy Inc (Husky) for $13.2B. The deal creates a resilient vertically integrated energy leader that provides superior returns for investors while placing a strong focus on ESG performance. The transaction closed on January 4th, 2021 and the companies were fully amalgamated on March 31st, 2021.

Acquirer Company Strategic Objectives

Cenovus's acquisition of Husky was beneficial for two main reasons. Firstly, the company now has a fully integrated value chain with refining activities in the US that are capable of supporting almost all Canadian heavy crude production. This means less exposure to WCS prices and more opportunities for selling oil in stronger markets. Secondly, the deal provides Cenovus with diversified stable cash flows to continue with their goal of reaching $10B of net debt over the next couple of years.

Synergies

The deal could realize an estimated $1.2B of synergies from the cost and capital efficiencies in the combined company. Through workforce optimization and IT system consolidation, Cenovus has the potential to realize $600B of cost synergies. The combined company could also benefit from an estimated $600B in sustaining capital efficiencies.

Industry Analysis

Oil and Gas companies have just been through one of the most active M&A years in history. In 2020 and 2021, the industry saw major consolidations with small, medium, and large players. Although initially hit hard by the pandemic, oil companies have mostly recovered from the pandemic as oil and gas prices have hit recent highs. The industry is expected to continue recovering from the pandemic and turn its focus to energy transition as more and more governments enact mandates surrounding climate change.

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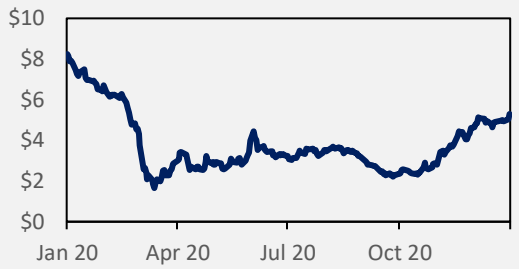
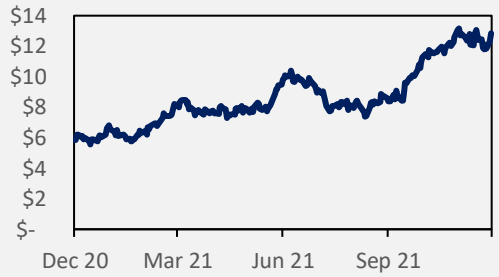
Key Statistics - Target	
52 Week H/L	$10.7/$2.4
Market Capitalization	6.795M
Average Daily Trading Volume	3.07M
Net Debt	$5,395.1M
Enterprise Value	$11,471.6M
Net Debt/EBITDA	N/A
Diluted Shares Outstanding	1,005M
Dividend Yield	0.074%

1-Year Price Performance



Key Statistics - Acquirer	
52 Week H/L	$13.5/$5.5
Market Capitalization	$25,897.5M
Average Daily Trading Volume	9.903M
Net Debt	$11,074.1M
Enterprise Value	$260M
Net Debt/EBITDA	38.5x
Diluted Shares Outstanding	2,017.7M
Dividend Yield	10%

1-Year Price Performance

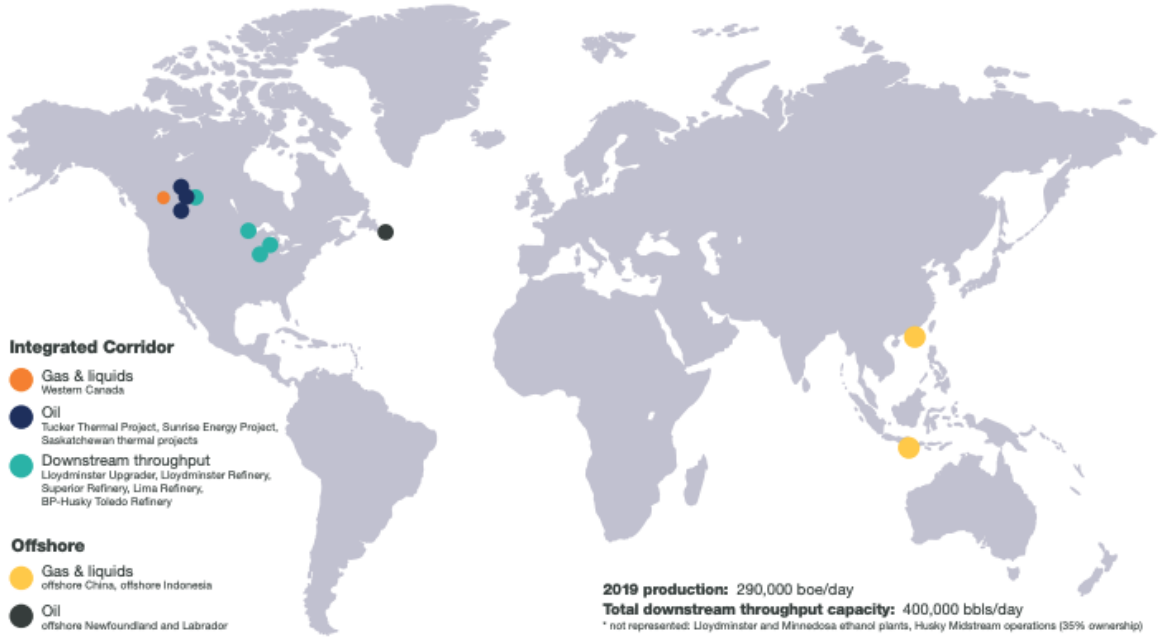


Business Overview – Husky Energy Inc *(pre-acquisition)*

Company Overview

Husky Energy Inc. was involved in the explorations, development, and production of Oil and Natural Gas. The company also has business lines in pipeline operations, downstream refining and retailing, and commodity trading. Before the merger, they were one of Canada's largest oil and gas companies focused primarily within Alberta and Saskatchewan. The company operated 2 main segments: (1) Integrated Corridor Operations and (2) Offshore Operations

Exhibit 9: Husky Energy Asset Map



Integrated Corridor Operations

The integrated corridor operations consisted of 5 main business segments: (1) Lloydminster Heavy Oil Value Chain, (2) Oil Sands, (3) Western Canada Production, (4) U.S Refining, and (5) Canadian Refined Products. The Lloydminster segment included the explorations for and the development and production of heavy crude oil and bitumen, as well as the production of ethanol. The segment also includes a key upgrading facility to turn heavy crude into more valuable synthetic crudes. The operation was complemented by the midstream infrastructure and marketing divisions that transport and market both the Company's and third-party commodities. The segment produces 124 mboe/d.

The Oil Sands business segment included the exploration for, and development and production of, bitumen within the Sunrise Energy Project. The midstream operations within the Oil Sands were through access to capacity on third-party pipelines and storage facilities in Canada and the US. The segment produced 22.4 mboe/d.

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The Western Canada Production business segment included the exploration, development, and production of light crude oil, conventional natural gas and natural gas liquids (NGL) in Western Canada. The NGLs and conventional gas were transported through access to third-party pipelines to export terminals and storage facilities which provided the company access to other markets allowing Husky to get better value out of their production. The segment produced 57.6 mboe/d.

The U.S Refining business segment included the refining of crude oil at the Lima Refinery, jointly owned BP-Husky Toledo Refinery, and the Superior Refinery. The major outputs were diesel fuel, gasoline, jet fuel, asphalt, and other carbon-based products. Lastly, the Canadian Refined Products business segment included the marketing of Husky's own and third-party volumes of refined petroleum products like gasoline and diesel through the operation of 549 retail gas stations and other petroleum outlets.

Offshore Operations

Offshore Operations for Husky made up 25% of total production (68 mboe/day) in 2020. The operation consisted of production from the Asia Pacific region and Atlantic region. The Asia Pacific segment operated offshore production in China and Indonesia (50.4 mboe/day). The Atlantic segment was primarily focused in Newfoundland and Labrador, Canada (17.6 mboe/day).

Company Strategy

Prior to the acquisition, Husky Energy Inc's corporate strategy focused on three key pillars: (1) Improving Safety, Reliability, & ESG Performance, (2) Business Resilience, and (3) being positioned for value capture.

Improving Safety, Reliability, & ESG Performance

The company placed a lot of value on the safety and reliability of its operations. In 2019, the company had no major incidents and improved their lost-time incidence rate by 55%. The Company's success continued into 2020 with again, no major incidents and another 20% reduction in the lost time incident rate. The Company had set a target to be a global top quartile safety performer by the end of 2022 through promoting a safety culture and extensive systems, processes and continued learning to prevent employee and contractor injuries. With strong performance in safety and reliability over the past year, Husky had turned its focus to ESG performance. This would be done through (1) Defined carbon intensity targets and (2) Diversity targets. The Company has set a target to reduce scope 1 greenhouse gas emissions by 25% through 2025 with 2015 as the base year and Husky aspired to be net-zero by 2050. The plan to become net-zero and to achieve the 25% GHG emission reduction goal will be achieved through the generation of carbon offsets through beyond compliance emission reductions as well as continued contributions to joint industry air emissions management initiatives.

Business Resilience

Since 2019, the funding priorities of the company had remained unchanged. With no debt maturing until 2022 the company has a strong balance sheet and plans to prioritize early debt reduction and balance sheet resilience. This would be performed through capital spending cuts to ensure ample liquidity through the pandemic (management deferred 2 capital projects and planed to put other CAPEX projects on hold), reducing the dividend through the pandemic to retain cash, optimizing production to reduce cash-negative margin production, and continued construction of current oil field projects

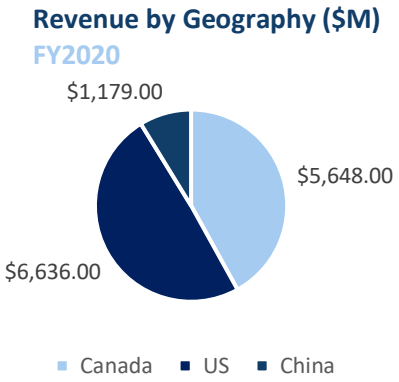
to increase production. This combined with the existing stable cash flow through integrated upstream, midstream, and downstream channels positioned the company well to weather the pandemic.

Positioned For Value Capture

The Company's third pillar of its strategy was to continually position itself for full value chain capture. On the upstream side, the Company was supported by long-life SAGD (Steam Assisted Gravity Drainage) assets with a large resource base. The size of the operation allowed the company to have low operating and sustaining capital costs. The strategy of shutting or reducing uneconomic production also ref into the Company's long-term value capture plan of prioritizing value over volume. In the midstream segment, the company had 5.6M barrels of storage assets and a 75,000 bbls/day capacity on existing pipelines allowing Husky to capture value based on both time and location arbitrage. On the downstream side, the Company had competitive margins and cost structure allowing for efficient and competitive operations. Their 355,000 bbls/day Downstream processing capacity also complemented their upstream production to allow for an almost fully integrated operation from well to consumer.

Revenue Breakdown

Husky Energy Inc much like other oil and gas companies has 2 main ways to segment revenue. For the year ending 2020, 41.95% of revenue came from Canadian operations, 49.29% came from US operations, and the remaining 8.76% came from Chinese operations. Looking at the value chain revenue segmentation, 32.88% of revenue came from upstream E&P operations primarily focused in Canada, 60.34% came from downstream refining or upgrading operations, and the final 6.78% came from other operations such as offshore drilling and eliminations.

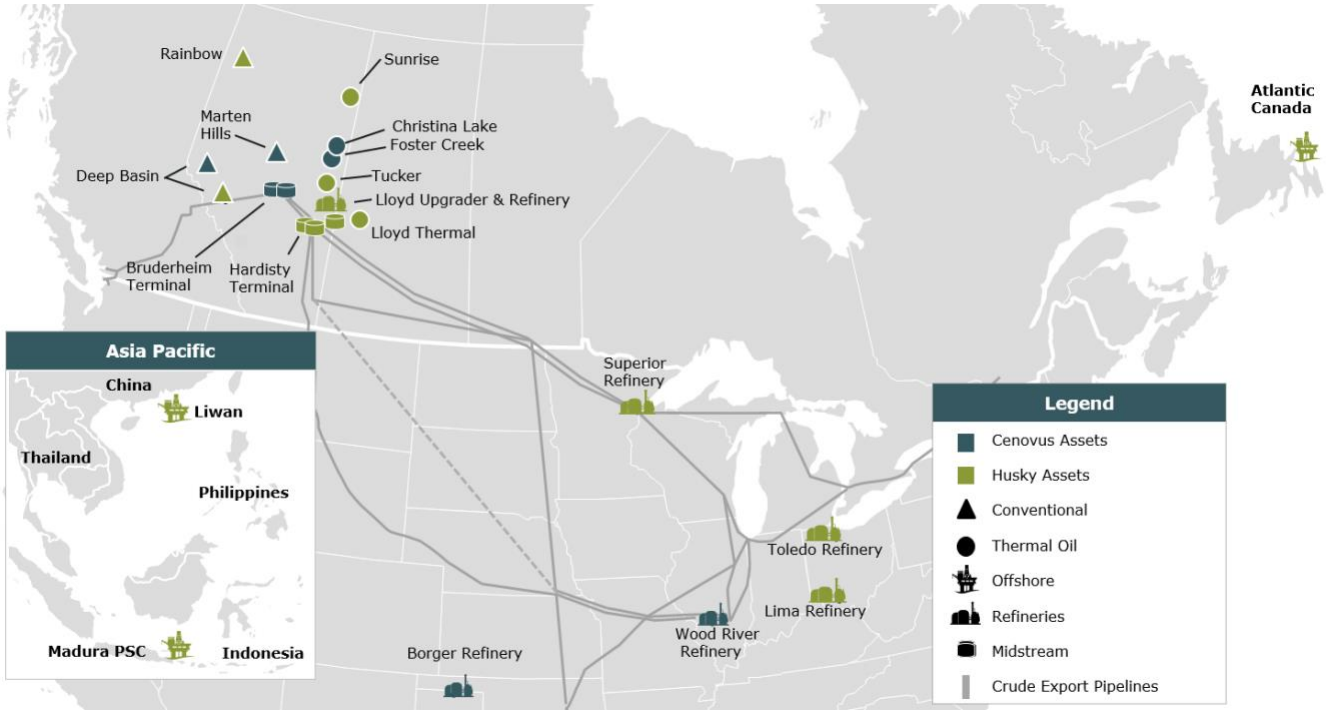


Business Overview – Cenovus Energy Inc.

Company Overview

Cenovus Energy Inc is an integrated Canadian oil company. Similar to Husky, the company produces, transports, and refines oil and natural gas through their upstream, midstream, and downstream segments. The production portion of the company is focused in Alberta and Saskatchewan and the refining portion of the business is primarily located in Illinois and Texas (acquired from Husky). Operations for Cenovus Energy Inc. are divided into two segments: (1) Upstream Operations and (2) Downstream Operations.

Exhibit 10: Cenovus Energy Asset Map



Upstream Operations

The upstream segment of Cenovus consists of 3 subsegments: (1) Oil Sands, (2) Conventional, (3) Offshore. The Oil Sands business includes the development and production of bitumen and heavy oil in Saskatchewan and Alberta. The primary assets include Foster Creek, Christina Lake, Sunrise, and Tucker Oil Sands projects along with the Lloydminster thermal and enhanced oil recovery assets acquired from Husky Energy Inc. The Oil Sands business also includes company-owned pipeline infrastructure and terminals (some pipelines are partly owned by Husky Midstream Limited Partnership). Excess production is transported through access to third-party pipeline capacity.

The Conventional business segment includes assets rich in NGLs and natural gas. The primary locations are within the Elmworth-Wapiti, Kaybob-Edson, Clearwater, and Rainbow Lake operating areas in Alberta and British Columbia. NGLs and natural gas are transported with third-party products through access to third-party pipelines, export terminals, and storage facilities. Finally, the Offshore business was acquired in the Cenovus/Husky merger and as described above includes operations off the coast of China, Indonesia, and Atlantic Canada. In total, upstream operations had production volumes of 804.8 mboe/day YTD.

Downstream Operations

The downstream segment of Cenovus consists of 3 subsegments: (1) Canadian Manufacturing, (2) U.S manufacturing, (3) Retail. The Canadian Manufacturing business includes the Lloydminster upgrading and asphalt refining complex acquired in the Husky acquisition. Other parts of the segment include the Bruderheim crude-by-rail terminal and two ethanol plants. The segment also performs marketing activities for synthetic crude oil, asphalt, and ancillary products. The U.S. Manufacturing business includes the refining of crude oil to produce diesel fuel, gasoline, jet fuel, asphalt, and other carbon-based products. The business includes the Lima Refinery, the Superior Refinery, the Wood River and Border Refineries

(partly owned by Phillips 66), and the Toledo Refinery (partly owned by BP Products North America Inc). Finally, the retail subsegment includes the marketing of Cenovus's own and third-party carbon products through retail, commercial, and bulk petroleum outlets. This includes wholesale channels in Canada. The downstream operations of Cenovus have a total throughput of 561.4 mbbls/d YTD.

Company Strategy

Cenovus Energy Inc's strategy is to maximize shareholder value through cost leadership and realizing the best margins for their products. The statement can be further broken down into 3 main pillars: (1) Market Diversification & Integration, (2) Resilient Balance sheet and a focus on Free Funds flow, (3) A commitment to ESG leadership.

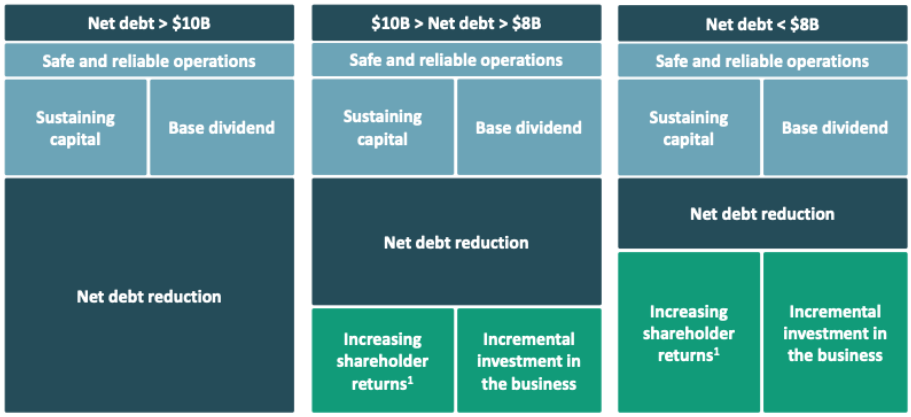
Market Diversification & Integration

The first pillar of Cenovus's strategy revolves around having an integrated portfolio of high-quality assets to ensure strong operations. This pillar of the strategy is driven by 4 main portfolios. First, top-tier heavy oil assets will allow the Company to sustain current production at low costs for 30 or more years. They also have oil sand assets with large long-life reserves. Secondly, the company is integrated vertically with extensive midstream and downstream assets to complement its upstream production. The strategic location of different midstream and downstream assets also provides Cenovus with enhanced access to different markets to capture margins. The Company also has a strategic interest in natural gas development opportunities in the liquids-rich Montney and Deep Basin regions.

Balance Sheet Strength

Cenovus is committed to continued balance sheet strength. The Company plans on strategically reducing debt over the next couple of years while maintaining its investment-grade credit profile. This is supported by growing cash balances at current commodity prices and undrawn credit facilities. The company also has time to strategically plan debt repayment with the average bond maturity being 12.5 years and bonds maturing the soonest being due in 2023. Overall, the company strategy to have disciplined capital allocation and a strong balance sheet will allow increased shareholder returns and re-investment into the business.

Exhibit 11: Cenovus Energy Balance Sheet Plan



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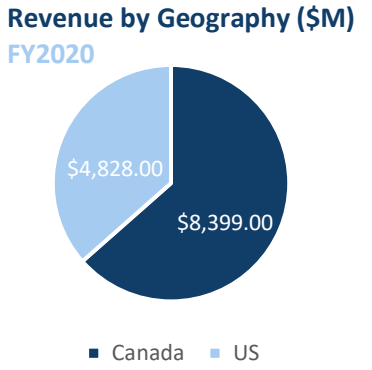
ESG Commitments

Cenovus has started to incorporate ESG strategy into all its business lines. Some key areas of focus for the company are GHG emissions, water stewardship, biodiversity, indigenous reconciliation, and inclusivity & diversity. The Company's strategy for ESG includes being an initial member of the Oil Sands Pathways to Net Zero Initiative. This is an alliance between Canada's six largest producers to reduce total oil sands greenhouse gas emissions to net-zero by 2050. A large part of this ESG strategy involves Cenovus investing in technology and innovations to make oil & gas production carbon neutral. Cenovus's ESG commitment strategy is to use Canada's well-known high ESG-ranked barrels to displace lower ESG-ranked barrels while maintaining steady cash flows to bring value to investors

Revenue Breakdown (pre-acquisition)

Looking at the same breakdown for Cenovus Energy Inc. as with Husky Energy Inc. For the year ending 2020, 63.50% of revenue came from Canadian operations and the remaining 36.50% of revenue came from US operations. For the value chain revenue segmentation, 58.86% of revenue came from upstream E&P operations primarily focused in Canada, 35.79% came from downstream refining or upgrading operations, and the final 5.35% came from other operation eliminations.



Industry Analysis

Industry Value Chain

The Canadian & US Energy Industry value chain is broadly classified into three key segments: (1) Upstream, (2) Midstream, (3) Downstream.

The **upstream** segment consists primarily of the exploration and production of oil and natural gas. This is normally conducted by companies who identify where reserves are located (exploration) and then extract (production) the resource to be refined further down the supply chain. This segment also includes related services such as oil rig operations companies, machinery rental companies, and chemical supply companies (Oil Field Services).

The **midstream** segment is the intermediary between upstream and downstream companies. Companies in the midstream segment transport natural gas, NGLs, and crude oil from extraction sites to refineries "downstream". This is primarily done through extensive pipeline infrastructure networks but can also be done with trucks, rails, or tankers. Other services considered to be midstream include processing, storing, and marketing carbon-based products.

The **downstream** segment includes all activities after production up until the consumer buys the product. Downstream services include refining crude oil into more commonly used products like gasoline which is then sold through retail, commercial, or wholesale channels.

Industry key metrics

EV/DACF

adjusts for the Enterprise value to debt-adjusted cash flow is one of the most common multiples to use in Oil and Gas valuation. Debt-adjusted cash flow is a metric that represents pre-tax operating cash flow adjusted for financing expenses after taxes. Other adjustments for exploration expenses may also be used. This multiple is common because it effects of a company's capital structure since other multiples can indicate a company is cheap if it uses a lot of debt.

P/CFPS

Price to cash flow per share is another common multiple used in oil and gas company valuation. The multiple compares the price of the company's stock to the operating cash flow generated per share. Since it uses operating cash flow, the multiple does not reflect exploration expenses but it does include non-cash expenses, depreciation, amortization, deferred taxes, and depletion. A benefit of P/CFPS is that it can allow for better comparison across the sector but be careful because it can be misleading because of a company's financial leverage compares to peers.

EV/EBITDAX

EV/EBITDAX is a variation on the EV/EBITDA multiple. The X stands for exploration costs and this multiple is often used by upstream companies where a major expense is the exploration, where they find reserves before developing them. Given that exploration costs are capitalized over many years since exploration results in multi-year assets on the balance sheet, EBITDAX gives a more accurate EBITDA for oil E&P companies. EBITDAX also helps compare companies of different sizes by adjusting for any depreciation or amortization accounting differences.

M&A Rationale

Strategic Objective

Balanced Portfolio of Assets across the Value Chain

Prior to the acquisition of Husky, Cenovus was seen to be heavily exposed to Canadian oil prices which are known to be cheaper and more volatile than U.S. prices due to egress capacity and commodity quality. The Husky acquisition creates a much more balanced company across upstream, midstream, and downstream segments.

Exhibit 12: Acquisition Production Summary

	Standalone Cenovus[1]	Standalone Husky[1]	**Pro forma company[1]**
Production (BOE/d)	~475,000	~275,000	~750,000
Upgrading & refining capacity (BOE/d)	~250,000	410,000	~660,000
2P reserves (mmBOE)	~7,000	~2,000	~9,000
Takeaway capacity from Alberta (bbls/d)			
Current pipelines	~135,000	~130,000	~265,000
Planned pipelines/expansions	~275,000	~30,000	~305,000
Crude oil storage (mmbbls)	~10	~6	~16
Sustaining capital ($billion per year)	1.2	1.8	2.4

The combined company will have almost equivalent upstream production and downstream refining capacity. Also, the combined companies' pipeline infrastructure allows for more consistent egress to the U.S. Through the extensive downstream infrastructure in the United States acquired through Husky, Cenovus also has reduced exposure to lower Alberta WCS prices. Additionally, the combined company will have the opportunity to use heavy crude (which is cheaper) in their refineries to boost margins there while selling Husky's lighter crude (more expensive) to the market. This all leads to ultimately higher and more stable cash flows and more value for shareholders.

Boosted Cash Flow to Pay Down Debt

One of the key corporate strategies for Cenovus Energy Inc is to create a resilient balance sheet by paying down debts. Through the all-stock merger with Husky, Cenovus has the opportunity to use the cash flow from refining activities and the higher profit margins achieved from access to better market hubs to pay off debt at an accelerated rate. This could ultimately lead to the company achieving its $10B net debt target much sooner than expected. Achieving this debt target earlier will free up cash flow later on, allowing for the Company to perform more accretive acquisitions or have some buffer room for any downturns arising from the energy transition.

Synergies

The Cenovus Husky deal was most likely completed for the strong integrated company it creates as well as the 2 large synergy opportunities it could realize. The Cost Synergy from operational efficiency and the Capital Synergy from capital investment efficiency will allow for approximately $1.2B in annual cost savings.

Cost Synergy - Operational Efficiency

$600M in synergies is expected to come in the form of annual corporate and operating cost synergies. The costs are going to be cut through workforce reductions within redundant divisions of Husky as well as overhead cost savings from a streamlined IT system. Other less quantifiable synergies are also expected once the best practices of both companies can be analyzed and implemented. The most notable best practice could be the application of Cenovus's operating expertise to Husky's oil sands assets (Cenovus currently has a lower cost per barrel than Husky).

Capital Synergy - Capital Investment Efficiency

The combined company will also benefit from a capital synergy in upstream assets. In the earnings call, Cenovus representatives pointed out $600M in synergies from the upstream assets of both companies. This will be realized through pivoting capital from lower-margin production to high-margin production and development opportunities. Corporate sustaining capital for both companies will also be allocated between the upstream and downstream segments of the larger combined company. Standalone, Cenovus and Husky had sustaining capital allocation costs of $1,200M and $1,800M, respectively. After the merger, sustaining capital costs should be $2,400M which is approximately $600M in savings.

Valuation

Precedent Transactions

Cenovus Energy Inc.'s acquisition of Husky Energy Inc. was priced at a 6.8x EV/EBITDA (NTM) forward multiple based on a final purchase price of $11,179M CAD and Husky's NTM consensus mean EBITDA of $1647M CAD. Compared to other recent deals, we see that Cenovus completed this acquisition at a similar multiple to its peers which had an average of 6.9x EV/EBITDA (NTM). One note for this precedent set is that these are all similar sized deals but the 4 deals are all acquisitions of primarily upstream companies. Given the similar geographic location, size, and industry, they should reasonably compare with the Cenovus deal.

Exhibit 13: Precedent Transaction Comparables

Date	Target	Buyer	Transaction Value ($M)	EV/EBITDA (NTM)
15-Jan-21	Concho Resources Inc.	ConocoPhillips	$ 17,173.81	6.9x
01-Oct-21	Cimarex Energy Co.	Coterra Energy Inc.	$ 10,408.45	6.2x
05-Oct-20	Noble Energy Inc	Chevron Corp	$ 12,823.90	8.4x
07-Jan-21	WPX Energy Inc.	Devon Energy Corp	$ 8,451.24	6.0x
Average				**6.9x**
Median				**6.5x**

Risks

Commodity Pricing

Valuation in the Oil and Gas industry is based on cash flows that are derived from predictions on commodity prices and the predicted production from oil and gas producing assets. If future commodity prices take a steep downturn, the stock price will be affected, and the company's valuation could drop. With oil and natural gas prices at 10-year highs, any major price drop could bring lower cash flows for the combined company making it harder to break even.

Failure to Realize Synergies

The acquisition was primarily driven by the integration of Husky into Cenovus's value chain to create a truly integrated oil and gas company. If the company fails to integrate easily, cost synergies related to corporate efficiencies might not be realized and an assumed $600M in synergies could be lost. Additionally, if sustaining capital allocation cost synergies are not as realistic as management thinks, the $600M a year savings from efficient capital allocation could also be lost