China’s oil company

CNOOC’s $15.1 billion takeover of Canada’s Nexen was China’s largest foreign acquisition. A year after it was unveiled, the deal is not looking so hot.

The education of China’s oil company

BY CHARLIE ZHU AND BILL POWELL
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Yang Hua was a rising star at Chinese oil giant CNOOC Ltd back in 2005. Then, the 44-year-old chief financial officer participated in one of corporate China’s biggest belly flops ever.

Yang helped CNOOC, the publicly listed arm of state-owned China National Offshore Oil Corp, craft an $18.5 billion bid for Unocal Corp of Los Angeles. It turned into a debacle. Political opposition exploded in Washington, where the company had done little preparation. At home in Beijing, some board members revolted after being blindsided by the bid, and some of China’s leaders were said to be queasy. CNOOC stood down and Unocal was sold to a rival, Chevron Corp.

Seven years later, Yang appeared to triumph. On February 26, CNOOC closed China’s largest foreign acquisition in modern Chinese history: the $15.1 billion all-cash takeover of Calgary-based Nexen Inc. The deal caused far less rancor than the aborted Unocal effort, and it was a landmark, touted in China as foreshadowing a bigger global role for the state-owned giants that dominate the world’s second-largest economy.

At a small briefing for reporters from the official Chinese media the next day, CNOOC Vice Chairman Yang Hua smiled broadly and said: “I slept like a log last night.”

CNOOC had demonstrated that China’s state-owned enterprises can play on the world stage, said one banker involved in the deal. “They learn from their mistakes and don’t repeat them,” the banker said. “In terms of the process, the Nexen deal was very smooth, and Yang was the key to that.”

But as deftly as it was done, it is now anything but clear that the Nexen acquisition was wise for CNOOC’s constituents – the Chinese government and shareholders in the publicly traded company.

As one company insider told Reuters: “For CNOOC, the closing of the deal marked the end of euphoria, and the beginning of pain.”

There are good reasons to believe he is right.

The deal may be emblematic in a different way than its boosters think. Critics of China’s decade-long overseas resource-buying binge believe state-owned companies have wasted huge chunks of the money because deals were done for political, not commercial, reasons.

“The central problem, analysts say, is that in a global energy industry transformed by the shale gas revolution in North America and elsewhere, CNOOC overpaid. And it underestimated the risks of monetizing the landlocked oil-sands and shale-gas assets in Canada that account for 75 percent of Nexen’s proven and probable reserves.”

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Since 2005, CNOOC and other Chinese state-owned enterprises such as PetroChina and Sinopec Group, parent of Asia’s largest oil refiner Sinopec Corp, have poured more than $30 billion into the acquisitions of Canadian hydrocarbon reserves, mostly oil sands, making them a top energy investor in the country.

“Going global,” said a Chinese official involved in overseas oil projects, had become a “political task for state oil companies and a key metric to gauge the performance of top bosses.”

The question is whether “going global” profitably also counts. Resource projects accounted for most of the $380 billion of total Chinese outbound investment as of the end of 2011, according to China’s Ministry of Commerce. Losses on China’s overseas investments had reached almost $27 billion, official media reported last year, citing an estimate by analysts at an industry conference in Beijing.

Yang has repeatedly said in the past that the deal was “commercially driven.” A spokesperson told Reuters the company remains confident it paid a competitive price.
for Nexen and its value would be realized in time, a view shared by some energy stock analysts in Hong Kong.

THE LONG GAME

Nexen had been on Yang Hua’s radar for seven years, almost from the day the Unocal deal fell apart, Yang Hua had said. CNOOC had identified Canada’s enormous oil sands – thick, bituminous oil that traded at a steep discount to lighter crudes – as a strategic opportunity to boost its international reserve base.

The company could also reap a big technology dividend for CNOOC and China. The experience of operating a major oil-sands project for the first time will give Beijing the expertise to tap its own potentially huge reserves of heavy oil, industry analysts say.

By 2011, Yang made the company’s first move in Nexen’s direction. By then the CEO of CNOOC, Yang paid $2.1 billion for a bankrupt Canadian oil producer – Opti Canada Inc – whose main asset was an Alberta oil-sands development called Long Lake. Its partner in the project: Nexen.

Over the next year, CNOOC developed an operational relationship with Nexen. The companies worked to overcome the technical challenges of developing the Long Lake reserves, which caused cost overruns and production delays.

At the same time, CNOOC mounted a “soft power” operation. Its executives made it a point to get to know important officials and politicians in Canada – a step that had been notably absent in the failed Unocal deal.

In February of last year, Yang was encouraged by a visit to Beijing by Canadian Prime Minister Stephen Harper. Harper made it clear Canada wanted to sell more oil and gas to China.

With surging crude imports accounting for nearly 60 percent of oil consumption, China was keen to court Canada, which sits on the world’s third-largest oil reserves after Venezuela, as a key supply source. Half of China’s oil imports come from the volatile Middle East via the Malacca Strait.

On the morning of Feb. 8, 2012, CNOOC chairman Wang Yilin met with Canadian Natural Resources Minister Joe Oliver, who was in Harper’s delegation, at CNOOC’s oil barrel-shaped headquarters. Wang expressed interest in expanding CNOOC’s footprint in Canada’s oil and gas industry, and Oliver welcomed the idea, according to CNOOC officials.

Yang sensed the political atmosphere was increasingly favorable for CNOOC, the officials said. He was ready to go.

Yang had developed a relationship with Nexen’s chairman, Barry Jackson. According to Nexen, Jackson became aware that February that a Chinese state-controlled oil company was interested in making an acquisition offer for his company. Yang first floated the possibility of a deal in a meeting with him in Vancouver on May 17 of last year. Nexen’s board rejected the offer as too low, but made it clear the door was still open for a higher bid.

Yang was still interested.

By the early summer of 2012, Yang had developed a new morning routine, according to a CNOOC official with knowledge of the matter. The first thing he did before climbing out of bed every morning was check on Nexen’s stock price.

On July 3, CNOOC made a second offer for Nexen that was again rejected by Nexen’s board. On July 10, Yang, with the CNOOC board’s approval, flew to London to meet Jackson again, this time to make an offer representing a 61 percent premium to

BIG DEAL: The acquisition of Nexen proceeded flawlessly, but it is far from clear how wise it was.
China goes abroad
China’s foreign acquisitions by industry since 1962

<table>
<thead>
<tr>
<th>Industry</th>
<th>Deal value in $ billions*</th>
<th>Number of deals</th>
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</thead>
<tbody>
<tr>
<td>Energy and power</td>
<td></td>
<td>333</td>
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<tr>
<td>Materials</td>
<td>79.0</td>
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<tr>
<td>Financials</td>
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<tr>
<td>High technology</td>
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<tr>
<td>Real estate</td>
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<tr>
<td>Media and entertainment</td>
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<td>Healthcare</td>
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<tr>
<td>Retail</td>
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<tr>
<td>Government and agencies</td>
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**TOP TEN CHINESE FOREIGN ACQUISITIONS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Acquirer</th>
<th>Target</th>
<th>Deal value in $ billions*</th>
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</thead>
<tbody>
<tr>
<td>2013</td>
<td>CNOOC Canada (Canada)</td>
<td>Nexen (Canada)</td>
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</tr>
<tr>
<td>2008</td>
<td>Shining Prospect (Singapore)</td>
<td>Rio Tinto (U.K.)</td>
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<td>2009</td>
<td>Mirror Lake Oil &amp; Gas (Canada)</td>
<td>Addax Petroleum (Switz.)</td>
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<td>2010</td>
<td>Sinopec Group (China)</td>
<td>Repsol YPF Brasil (Brazil)</td>
<td>7.1</td>
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<tr>
<td>2013</td>
<td>Shuanghui Intl Hldg (China)</td>
<td>Smithfield Foods (U.S.)</td>
<td>7.0</td>
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<tr>
<td>2008</td>
<td>ICBC (China)</td>
<td>Standard Bank (S. Africa)</td>
<td>5.6</td>
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<tr>
<td>2007</td>
<td>CIC (China)</td>
<td>Morgan Stanley (U.S.)</td>
<td>5.0</td>
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<tr>
<td>2013</td>
<td>CNPC (China)</td>
<td>Kashagan Oilfield (Kazakh.)</td>
<td>5.0</td>
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<tr>
<td>2012</td>
<td>SIPC (China)</td>
<td>Petrogal Brasil (Brazil)</td>
<td>4.8</td>
</tr>
<tr>
<td>2010</td>
<td>SIPC (China)</td>
<td>Syncrude Canada (Canada)</td>
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Source: Thomson Reuters

* Including net debt.
Nexen’s share price. Jackson said he thought his board would approve and took the offer back to them, according to people familiar with the negotiations.

Yang didn’t want to take any chances, these people said. He told the Nexen chief that CNOOC would commit to retaining the entire Nexen staff, while basing CNOOC’s North American and Central American operations in Calgary, among other promises.

On July 23, he had a deal. Nexen’s shareholders unanimously agreed to the $27.50 per share offer on September 20, and the transaction formally closed five months later.

Since then, problems with the economics of the acquisition, which had been intensifying as closing day drew near, have grown apparent.

RESERVES TO NOWHERE

The process of turning Nexen’s oil sands into crude oil in western Canada is technically challenging, using horizontal wells and steam to extract the bitumen, oil industry executives say.

For now, production at Long Lake accounts for just over one tenth of Nexen’s overall production. CNOOC says it is seeking “new technology” to overcome the complex geology. It is not yet clear, industry analysts say, where that technology will come from.

“If Long Lake does not improve, the Nexen deal will be very challenged.”

Further complicating Yang’s life since the acquisition: The economics for Nexen’s already-developed tar sands reserves have deteriorated.

Benchmark prices for Canadian heavy oil – known as Western Canada Select – always trade at a discount to West Texas Intermediate (WTI), the benchmark crude in North America. But since the deal, the price of Canadian heavy has been extraordinarily volatile.

At its low, it plunged to more than $40 below WTI, caused in part by soaring oil-sands production and shale-oil output from the U.S. Bakken field, which straddles the U.S.-Canadian border. WTI has steadily held above $100 throughout the year, thanks in part to tensions in the Middle East.

Pessimism now hangs over the oil-sands sector. Hugh Hopewell, senior analyst at energy consultancy Wood Mackenzie, says the volatility of Canadian oil prices should remain for the rest of the decade. He saw a 40 percent discount to WTI as the long-term price assumption to evaluate bitumen projects.

Getting the product to market presents a further challenge. One option is to use the Keystone pipeline south to the United States. But to the irritation of both Canadian and Chinese oil executives, U.S. President Barack Obama’s administration has still not given the go-ahead to build the U.S. leg of the pipeline.

Another option is a pipeline to Canada’s west coast, where both Nexen’s oil and liquefied natural gas could be exported to China and other growth markets in Asia.

But the difficulties there are enormous and increasing. Environmental groups and native communities in Canada are opposed. It would be hugely expensive: One study shows a pipeline from Nexen’s fields in Alberta province to the Pacific Coast would cost $6 billion. The United States has already jump-started a plan to export LNG to Asia. And it won’t be long before China produces its own shale gas – it has the world’s largest reserves.

For all of these reasons, oil industry executives told Reuters, several companies operating in western Canada have tried to shed assets in the region, only to find little to no demand for them. Several major auctions this year, including a sale of a multi-billion dollar oil-sands stake by ConocoPhillips, have been called off, investment bankers said.

“As Long Lake does not improve, the Nexen deal will be very challenged.”

Lysle Brinker
Director of Energy Equity Research for IHS
RESERVE VALUE

These challenges cast doubt over exactly what value China is getting from deals such as CNOOC-Nexen.

Top executives of CNOOC have repeatedly said the acquisition of Nexen, which has proven reserves of 900 million barrels of oil equivalents stretching from Canada to North Sea and Africa to the U.S. Gulf of Mexico diversified CNOOC’s reserve mix. It is also, Chairman Wang Yilin has said, aiding the long-term development of the company. CNOOC aims to more than double its annual output to 2.6 million barrels per day by 2020 under a strategy Wang dubs “New Leap Forward”. The Nexen deal boosted CNOOC’s net proved reserves by around 30 percent and its net production by 20 percent.

“We bought Nexen for its reserves ... which can help underpin the long term development of our company. We don’t care how much production it can bring us in the second half,” CEO Li Fanrong told reporters at CNOOC’s first half results briefing in Hong Kong in August.

At current oil prices, according to a senior banker with ties to both CNOOC and Nexen told Reuters, it is becoming clear that CNOOC overpaid.

“The only question now is by how much. The banker “conservatively” estimates that Nexen was more fairly valued at $11 to 12 billion – three to four billion dollars less than CNOOC paid.

Since the start of the year, CNOOC’s shares listed in Hong Kong and on the New York Stock Exchange have declined around five per cent, making it one of the worst performers among the major global oil explorers.

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