Canacol Energy, Limited

Second Quarter 2021 Financial Results

Friday, August 6, 2021 10:00 AM Eastern

CORPORATE PARTICIPANTS

Carolina Orozco - *Vice President of Investor Relations*

Charle Gamba - *President, CEO*

Jason Bednar - *CFO*

PRESENTATION

Operator
Good morning, and welcome to the Canacol Energy second quarter 2021 financial results call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded. I'd now like to turn the conference over to Carolina Orozco, vice president of investor relations. Please go ahead.

Carolina Orozco
Good morning, and welcome to Canacol's second quarter 2021 financial results conference call. This is Carolina Orozco, vice president of investor relations. I'm with Mr. Charle Gamba, president and CEO, and Mr. Jason Bednar, chief financial officer.

Before we begin, it's important to mention that the comments on this call that Canacol senior management can include projections of the corporation's future performance. These projections neither constitute any commitment of the future results, nor take into account risk or uncertainties that could materialize. As a result, Canacol assumes no responsibility in the event that future results are different from the projections shared on this conference call. Please note that all finance figures on this call are denominated in USD.

We will begin the presentation with our president and CEO, Mr. Charle Gamba, who will cover the operational highlights for the second quarter. Mr. Jason Bednar, our CFO, will then cover financial highlights. We will close with a discussion of the corporation's outlook for the remainder of 2021. A Q&A session will follow. Today, Mr. Charle Gamba is joining us on the line from Bogotá and Mr. Bednar is joining us on the line from Calgary. I will now turn the call over to Mr. Charle Gamba, president and CEO of Canacol Energy.

Charle Gamba
Thanks, Carolina. Good morning or good afternoon to everyone, and welcome to Canacol's second quarter 2021 conference call.

In the second quarter of 2021, we realized natural gas bills of 171 million standard cubic feet per day, slightly lower than in the first quarter of this year but substantially higher than the low of 152 million standard cubic feet per day reported for the same period in 2020. That was of course when the then very novel coronavirus was at its worst. Q2 '21 volumes were almost exactly in line with our midpoint or guidance for the full year of 2021 of 153 to 190 million standard cubic feet per day. We also reported another quarter with a strong and stable operating margin of 77% as well as a very respectable return on capital employed of 10%.

We remain committed to our return of capital to shareholders with the payment of the seventh consecutive quarterly dividend of 5.2 Canadian cents per share, $7.4 million in total. The current share price represents an annual dividend yield of approximately 6.6%. We also repurchased $2.8 million large worth of shares under our normal course issuer bid, taking advantage of what we perceive as unfounded weakness in our share price.

During the second quarter, we completed the drilling of four wells. The most significant drilling results during the quarter came with the Aguas Vivas 1 exploration well. We've encountered 412 feet of net gas pay within the Cienaga de Oro formation. This is the thickest net pay we have ever encountered in any of our wells. The well tested at a final rate of 35.5 million standard cubic feet per day, and the well have been tied in and is on permanent production. Due to the very encouraging results achieved at Aguas Vivas 1, we elected to immediately shift our exploration drilling program to focus on delineation of this significant new gas discovery. We're planning to drill two appraisal wells back-to-back, the first of which, Aguas Vivas 2, we started in June and completed in late July. This well encountered 229 feet of net gas pay, confirming a significant gas discovery. We're currently casing the well and plan to tie it in, and upon completion we plan to immediately start the next appraisal well, Aguas Vivas 3.

During the second quarter, we also provided an ESG strategy and published our 2020 sustainability report, which showed continued improvement in our already strong reporting and performance. As we highlighted in the press release, we have been focused on increasing diversity and inclusiveness, and I am particularly proud of the 88% satisfaction score we achieved in our 2020 work climate survey.

It's worth highlighting that we produce almost pure methane of 97% without any significant quantity of natural gas liquids, condensate, light oil, water, carbon dioxide, measures of sulfur, or any other gas or impurities. The pure nature of our produced gas stream allows sales via the gas distribution grid after only minimum energy-efficient processing, thereby reducing operating costs and supporting high rates of return with a low-carbon footprint. Our GHG emissions intensity, which was already industry-leading in 2019, was reduced by a further 25% in 2020 thanks to reduced use of diesel for power generation, which has now been almost completely eliminated, as well as efficiency achieved with increased production levels. Per dollar of revenue generators, our greenhouse gas emissions in 2020 were not only significantly lower than the vast majority of oil and gas producers globally, they were significantly lower than the average for broad market indices and stock indices focused on carbon-efficient stocks. These measures don't take into account that we produce a fuel with significantly less CO2 emissions when consumed than all other hydrocarbons do. Natural gas is also highly complementary as a backup fuel in electricity generation, supporting the development of unconventional renewals as part of the energy transition here in Colombia. We're happy to note that our ESG ratings have been steadily improving and we've also seen a growing recognition of our ESG credentials.

I'll now turn the presentation over to Jason Bednar, our CFO, who will discuss the financial results in more detail. When he is done, I'll discuss the outlook for the remainder of this year.

Jason Bednar
Thanks, Charle. We continued to execute our plan to develop our growing natural gas business in Q2 of 2021. We reported the following key results during the quarter.

$54 million of revenue, net of royalties and transportation, effectively unchanged from levels reported for Q2 of 2020. $34 million in funds from operations, which represent an 8% increase from the same period in 2020. EBITDAX of $45 million, which represents a 10% increase from the same period in 2020. We reported net income of $2.4 million of $0.01 per share for Q2 of 2021. The reduction in net income for the comparable period in 2020 is attributable to a lower deferred income tax recovery compared to the same period in the prior year, as well as expenses for the unsuccessful Milana 1 exploration well.

Our operating net back was $3.14 per MCF in the three months into June 30, 2021, which was 13% lower than in the same period of 2020 and 6% lower than the prior quarter. I realize gas prices of $4.09 per MCF was slightly below our guidance for the 2021 year average of $4.10 to $4.50 per MCF. The production allocation of the Esperanza block was lowered during the second quarter of 2021 as the corporation continues to perform routine maintenance. The maintenance is expected to increase the production of the Esperanza block going forward, and as such, the overall royalty rate is expected to decrease for the remainder of 2021.

The decrease in the average gas sales price in the second quarter of 2021, compared to the first quarter of 2021, was mainly due to off takers under high fixed price contracts performing regular maintenance during the three months ended June 30, 2021. In addition, the Q2 2021 spot market average sales price was negatively impacted by Colombia experiencing La Niña climate phenomenon during the quarter, which increases rainfall and as such, decreases demand for natural gas. Secondly, the shutdown in Colombia due to the recent political unrest also resulted in lower demand for natural gas.

Subsequent to the quarter end, the demand for spot market volumes has increased, as evidenced by the July 2021 realized contractual natural gas sales volumes of approximately 90 million cubic feet per day, mainly due to the political unrest in Colombia recently improving and the COVID vaccination rollout in Colombia being well underway. Lastly, the La Niña climate phenomenon has weakened. All this results in higher demand for natural gas. In turn, the spot market average sales price has recently significantly increased with recent interruptible pricing being approximately $5 net of transportation.

Also recall that the majority of our guidance is based on fixed sales, fixed price take-or-pay contracts with an average fixed price of $4.50 per MCF. Our operating margin at 77% for the quarter was effectively unchanged from the prior quarter, again demonstrating the remarkable stability and high-margin nature of our business. To further highlight the strength and stability of our business, we want to again highlight the return on capital employed implied by our financial statements over the last ten quarters. Our return on capital employed remains high by E&P industry standards, at 10% in this second quarter and slightly higher than that on a 12 month trailing basis.

During the second quarter, we continued to manage our debt in order to minimize our interest payments. In June, we entered into a three-year term credit agreement with Banco Davivienda for a principal amount of 12.9 million, denominated in pesos, which is subject to an annual interest rate of IBR plus 2.5%. The Colombian bank debt was used to repay the corporation's litigation settlement liability, which was subject to an 8.74% annual interest rate. As a result of this lower interest rate, we expect to realize annual interest savings of approximately $600,000 annually.

With cash position of $35 million, a working capital surplus of $45 million and undrawn credit facility availability amounting to almost $100 million, Canacol has a lot of financial flexibility to adjust our investment plans, when we find good reasons to do so.

During the second quarter, we restarted buying back shares under our normal course issues bid, taking advantage of what we perceive as unfounded weakness in our share price. Adding the $2.8 million we spent on buying back shares during the quarter to the $7.4 million we paid with our quarterly dividend means we returned over $10 million to shareholders in the second quarter. As we outlined in our press release on August 2nd, we continued buying back shares during July, totaling an additional $2.5 million in the month of July alone.

In closing, our Q2 financial results were strong and relatively stable despite the challenges that the coronavirus pandemic continued to present. We remain well positioned to continue to grow our business and return cash to shareholders going forward. At this point, I'll hand it back to Charle. Thank you, everyone.

Charle Gamba
Thanks, Jason. For the remainder of 2021, we expect to continue delivering results within our previously-stated guidance, allowing us to continue operating from a position of financial strength and returning capital to shareholders while also investing in growth.

We're focused on the following objectives for the remainder of this year: targeting drilling of up to twelve exploration appraisal and development wells, and a continuous program with the objective of targeting a 2P reserves replacement ratio of more than 200%. To date, the corporation has drilled seven exploration and development wells, with a significant gas discovery being made at Aguas Vivas, which is currently being appraised.

Secondly, the acquisition of 655 square kilometers of (INAUDIBLE) seismic under corporations VIM-5 and SSJN-7 blocks to expand its exploration prospect inventory for future drilling. To date, the corporation has completed the seismic acquisition on SSJN-7 and is currently in the process of acquisition on VIM-5.

Three, the execution of a definitive agreement to construct a new gas pipeline from Jobo, our gas processing facility at Jobo to Medellin, Colombia, which will increase the corporations' gas sales by an additional 100 million cubic feet per day in 2024.

Fourth, the continued strength of our environmental, social and governance strategy, and reporting. The corporation has released its 2020 sustainability report, making substantial gains in all key metrics. Finally, the continuation of our return of capital program to shareholders. The corporation has continued to issue quarterly dividends with no reduction in dividend amount. Since May 25th, we've also been buying back shares at a steady rate, amounting to approximately 1 million shares per month on average.

I'd like to thank the entire Canacol team, as well as our contractors, partners and clients for their continued support and hard work. We're now ready to answer any questions you might have.

QUESTION AND ANSWER

Operator
We will now begin the question-and-answer session. To ask a question, you may press star then 1 on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then 2. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Matthias Entfilet from UBS. Please go ahead.

Matthias Entfilet
Hi, good morning. Thank you for taking my questions.

Canacol has delivered important returns to shareholders, but looking forward, can you provide more color on how we should be thinking on capital allocation for the next year and looking forward? Should the marketing continue to expect these levels of returns and dividends, and share buybacks, even as the company starts to think on new projects such as the Medellin pipeline and the continuation of the drilling campaign? That was my first question.

For my second question, more generally on the natural gas industry in Colombia, there has been a lot of news in the media with mixed signals pointing to a potential deficit in production in the country. What could justify a regasification plant in the Pacific? Has Canacol seen this movement, and can you provide a bit more color on the potential new supply for imports into Colombia? How could that affect Canacol in two to three years, or perhaps a longer-term timeframe? Thank you.

Charle Gamba
Thanks. I'll let Jason take the first question and then I'll answer the second.

Jason Bednar
Okay, thanks.

The question of capital allocation and specifically returns to shareholders, we answered that on the last conference call. My answer isn't going to be significantly different here. Yes, our debt levels are well under control at under two times, and projected to decrease as EBITDA grows, as the pandemic weakens, I suppose. So, we're down to dividends and share buybacks. We are at the tail end of six-year strategic plans the board has been reviewing and at the end of that exercise, we hope to be able to relate to the market what our allocation will be, moving forward with respect to the mix between dividends and share buybacks. We're not quite there yet.

Having said that, it is of critical importance to us that we keep shareholder returns at high levels. We'd be able to relay the exact formula in doing so at a later date.

Charle Gamba
So, with respect to the question about supply and demand, obviously supply remains tight with the continued decline in production of Ecopetrol's main producing gas fields in the Guajira and Piedemonte. So, those metrics have not changed basically, and those fields continue to decline without pause. That puts us in a very strong position to backfill all of Ecopetrol's decline, which it's essential we do.

With respect to the importation of LNG, it's important to note that no LNG has been imported into Colombia this year via Cartagena. The regasification terminal in Cartagena has not received any shipments of LNG. Of course, that is due to the extremely high price of LNG globally, which in no means can compete with our pricing domestically. So, imported LNG currently is no threat whatsoever to our business in the near to median term, given the very high price of liquified natural gas globally. That situation is predicted in all the future forecasts and European loads. Pricing is expected to remain very robust, certainly through the mid- to long term.

With respect to the Pacific regasification terminal, that project has been delayed now for six years. It will continue to be delayed due to how uneconomic that project actually is and due to the recent issuance of a regulatory demand against the government of Colombia by the regulator here in Colombia, arguing that facility which is going to be paid for with public moneys as well as consumers having to pay increased tariffs--the project is simply not viable and will likely never see the light of day.

Operator
Again, if you have a question, please press star then one. The next question is from Roman Rossi Lores from Robbins Capital. Please go ahead.

Roman Rossi Lores
Hi, this is Roman from Balanz Capital. So, I have a couple of questions.

First, if we are correct, Canacol's drilled and effectively connected four wells during the first half of the year. But I would put this flat versus Q4 of 2020. So, did you shut some wells during the second quarter or something else is at play? So, that's the first question.

Charle Gamba
Yes. The drilling program has been impacted by various delays, the most recent one being the very long national strike here. We've seen we've also suffered from COVID-related delays with respect to quarantines and whatnot, so the drilling program has been rolling out at a slower pace. We're still anticipating to drill up to 12 wells this year.

Roman Rossi Lores
Okay, thank you. Then you mentioned that the July output was around 190 MCF per day. This is due to the increased uptake from a particular client or sector, or is this an increase of market share by lowering prices in the spot market?

Charle Gamba
We are seeing a bit of tightness in supply, primarily from Ecopetrol, and we're seeing an uptake in thermoelectric power generation as well. So, certainly through the latter half of July and now into the first week of August, we're seeing very high interruptible sales at very good pricing, wellhead prices. Wellhead pricing for the interruptible for the past three weeks have been about $5 in MMBtu. We're seeing very robust demand at the moment and very high interruptible pricing. We expect that situation to continue through the remainder of this quarter.

Roman Rossi Lores
Just a final one, regarding the Tesorito contract. Is this still expected for the first quarter of 2022 and the uptake is full, take-or-pay?

Charle Gamba
Yes, the project should come online in February or March of next year. Construction is rolling out according to schedule. It was somewhat delayed as well by the national strike in May, slightly delayed but everything has run very well there. We will be supplying all the gas to that facility. That 200-megawatt project has a capability of consuming up to 40 million cubic feet per day of gas.

Roman Rossi Lores
And that's take-or-pay?

Charle Gamba

It's similar to the majority of our contracts.

Roman Rossi Lores
Thank you very much and congratulations on the results.

Operator
If you have a question, please press star then 1. The next question come from Ricardo Sandoval from Bancolombia. Please go ahead.

Ricardo Sandoval
Thank you for the call. I have three questions.

First, Charle, just to say maybe you are seeing a strong crisis in Colombia. I'm wondering if this is going to be the scenario for the second half of 2021 or if you see any specific dates when you see a significant recovery in natural gas prices in the country? That's my first question.

The second question, Ecopetrol wants to have more exposure to gas businesses. So, I'm just wondering if you may know how this can affect the view in the long-term for Canacol? How would the strategy of Ecopetrol trying to get more market share in this business in Colombia--that's my second question.

The last question is more about the gas trading revenues. You have presented for the first and second quarter. I'm wondering if you can comment about it and if we are going to see this trading revenue recovering for the second half of 2021 and going forward. Can you comment about this? Thank you.

Charle Gamba
Yes, with respect to the first question, as I mentioned a little earlier, through July interruptible or spot pricing increased significantly. As I mentioned, we're now selling spots above $5.15 into the spot market currently. That's a reflection of both the high demand, particularly on the part of the thermoelectric power plants, as well as tight supply.

You have to keep in mind that we are the only company that has actually been drilling gas well for the past year and a half. Ecopetrol, the biggest producer of gas in Colombia, has not drilled a single gas well in the past two years. That obviously has a significant impact on supplies. We, of course, have invested considerably in continuing to drill. We brought a lot of new production on stream precisely to backfill Ecopetrol's decline. That's a result of the lack of drilling on Ecopetrol's part. We are now enjoying full-swing demand, basically, based on our production potential we've invested in.

Secondly, I guess remaining on the theme of Ecopetrol. Yes, they have announced very large plans to increase natural gas production. Of course, they have to appear to be environmentally friendly like everyone else. However, keep in mind that their gas fields are very mature, almost completely drilled up. There's no drilling to be done. As a matter of fact, in the Guajira on the coast, it's fully drilled. They are planning to drill in the Piedemonte, in the Cusiana-Cupiagua field. Those plans have been delayed now for two years. They were meant to start drilling there in 2019 and here we are in 2021, and they've yet to start drilling there. So, that's a potential. There's a new supply of gas from new wells in the Piedemonte. But that of course is the interior market of Colombia which we do not currently sell in to.

Of course, Ecopetrol is very focused on the offshore. There's been several indications of gas in the offshore of very deep water, 2,000 meters of water. Those discoveries need to be appraised and need some more drilling offshore to figure out how big or how small these discoveries are, to see if they can commercialize them. However, given the water depths of 2,000 meters, these would be the deepest non-associated gas fields in the world, basically. No non-associated gas fields are in deeper water than these ones. So, that represents obviously a significant challenge to commercialization, not to mention a very long timeline to commercialize of eight to ten years.

With respect to your third question about gas trading, I'll let Jason answer that question.

Jason Bednar
Sure, thanks Charle.

So, just to refresh everyone's memory, we buy approximately $6.4 million of gas a quarter and sell about $6.4 million of gas a quarter, i.e., we don't produce it. Each and every quarter, as that is a fixed contract on both the buy side and the sell side, we make about $25,000 or $30,000 a quarter. It's something our gas team can easily handle. It's to an existing customer of ours. It helps us keep our finger on the pulse of the market. But that particular contract is a one-year contract, and it ends at the end of 2021. I have no color whether or not the off taker will want that renewed at the end of that.

But just to stress, we do not speculate in gas trading. This is a locked in, a fixed price number coming in and a fixed price number going out that all ends at the end of this year currently.

Operator
There are no more questions in the queue. This concludes our question-and-answer session, and the conference has now concluded. Thank you for attending today's presentation. You may now disconnect.