Canacol Energy Limited

Fourth Quarter and Year-End 2020 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Charle Gamba, *President and Chief Executive Officer*

Jason Bednar, *Chief Financial Officer*

Carolina Orozco, *Director of Investor Relations*

PRESENTATION

Operator
Good day and welcome to the Canacol Energy Fourth Quarter Year-End 2020 Financial Results Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by 0. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then 1. Please note that this event is being recorded.

I would 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 Fourth Quarter and Year-End 2020 Financial Results Conference Call. This is Carolina Orozco, Director of Investor Relations. I am with Mr. Charle Gamba, President and Chief Executive Officer, and Mr. Jason Bednar, Chief Financial Officer.

Before we begin, it's important to mention that the comments on this call by Canacol senior management can include projections of the corporation's future performance. These projections neither constitute any commitments as to future results nor take into account risks and 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 U.S. dollars.

We will begin the presentation with our President and CEO, Mr. Charle Gamba, who will cover the operational highlights for 2020. Mr. Jason Bednar, our CFO, will then discuss financial highlights. Mr. Gamba will close with a discussion of the corporation's outlook for 2021. Mr. 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
Great. Thank you, Carolina. Good morning or good afternoon, and welcome to Canacol's Fourth Quarter 2020 Conference Call. In 2020, the corporation achieved several important goals with respect to growing its gas base in Colombia, including a 20 percent increase in realized natural gas sales year over year, a 16 percent return on capital employed, strong and stable operating margins with an average of 79 percent, a 2 percent increase in [unintelligible] reserves year over year, with the continued exploration and development success representing a 122 percent [unintelligible] reserve [unintelligible] ratio.

We were also awarded two new conventional gas exploration blocks in the 2020 exploration bid round. All of this was achieved despite the global COVID-19 pandemic impacting demand for gas in Colombia and our ability to operate in the field when countrywide or local pandemic-related restrictions were in place.

Our success was possible thanks to the hard work of our teams that have strong processes in place to deal with the pandemic and the strong long-term fundamentals of the Colombian gas markets, which have allowed us to contract the majority of our production capacity under fixed price take-or-pay gas sales contracts.

Realized natural gas sales during Q4 were 170 million standard cubic feet per day, a 6 percent decrease from the same period in 2019 but a 4 percent increase from the third quarter of 2020. Realized gas sales have continued to recover from a low point of 136 million standard cubic feet per day in April of 2020 to 182 million standard cubic feet per day on average in January and February of 2021, with an average of 172 million standard cubic feet per day for the year 2020, which is 20 percent higher than average gas sales for 2019.

Drilling operations were halted in late March by COVID, which was the main reason why despite restarting drilling operations with two rigs in July, only six wells were drilled and completed compared to the 12 we had originally planned. All six wells drilled in 2020, of which two were exploration wells and one was an appraisal well, successfully encountered gas, contributing to the continued growth in reserves we were able to report at year-end. We achieved the 122 percent 2P reserves of [unintelligible] ratio and a 2 percent increase in our 2P gas reserve base to 637 billion cubic feet, approximately a ten-year reserve life index under current production. Our gas exploration drilling results over the past seven years have yielded an industry-leading 83 percent hit rate for commercial discoveries.

The net present value of future net revenue from reserves discounts are 10 percent. It is now estimated at $1.3 billion on an after-tax basis and $1.7 billion on a pre-tax basis, respectively, which equates to a Canadian $11.97 per share of reserve value and a Canadian $9.55 per share of 2P net asset value as of the end of December 2020, respectively.

2P finding and development costs came in at an industry-leading $1.33 per Mcf and 84 cents per Mcf for the one- and three-year periods ending December 31, 2020, respectively, and we achieved a 2.7 times and a 4.4 times [unintelligible] cycle ratio for the one- and three-year periods ending on December 31, 2020, respectively.

We also continued to deliver on a return of capital to shareholders in 2020, with our quarterly dividend program with no cuts due to the impact of COVID-19 and by buying back shares under our previously announced normal course issuer bid.

I'll now turn the presentation over to Jason Bednar, our CFO, who will discuss our fourth quarter financials in more detail. When he is done, I will provide detail on the outlook for 2021.

Jason Bednar
Thanks, Charle. Although the global pandemic made it a uniquely challenging year, 2020 was nonetheless a great year financially for Canacol and its stakeholders as we continued to execute our plan and develop our growing natural gas business. Largely driven by having a full year with higher gas transportation capacity, following the completion of the pipeline expansion in August of 2019, we reported approximately $145 million in funds from operations for the full year of 2020, a 16 percent increase from 2019, despite sales volumes being negatively impacted by a temporary COVID-related reduction in demand that impacted funds from operations for the second quarter of 2020 in particular.

Cash capital expenditures decreased 6 percent as we were forced by COVID-related restrictions to defer some of our planned spending and as we focused on the most value-enhancing activities within our core gas operations. Increased funds from operations combined with lower capex allowed us to achieve four positive results.

First off, we generated approximately $60 million in free cash flow before interest. Secondly, we maintained our quarterly dividend, declaring approximately $28 million to shareholders. Third, we applied approximately $6 million to the repurchase of shares, and, lastly, we increased our holdings of cash and cash equivalents by approximately $27 million.

Our dividend currently represents an annual yield of approximately 5.7 percent, with the last quarterly dividend paid in January and the next one due to be paid on April 15, 2021. Our year-end net debt position of approximately $342 million was effectively unchanged from a year ago. As we announced in August, we were able to reprofile our credit facilities during 2020 to substantially lower our cost of debt capital thanks to lower interest rates. While increasing the financial flexibility we have to invest in strategic growth projects, including the Medellin Pipeline and El Tesorito Power Plant projects. Our net debt-to-EBITDAX ratio is reduced from 2.1 times at December 31, 2019 to 1.85 times at December 31, 2020, well inside covenant limits.

We continue to plan to pay down our debts in due course rather than building up large cash balances, but we'll do so strategically to minimize our financed expenses while we maintain our financial flexibility and our ability to continue investing in our business and buying back shares when it makes sense to do so.

Focusing on the fourth quarter of 2020, financial highlights include revenues net of transportation and royalties decreased 6 percent to $62 million compared to $66 million for the same period in 2019, mainly due to a 6 percent decline in sales volumes which was due to reduced gas demand resulting from the gas markets still not being fully recovered from COVID-related weakness in Q4.

Adjusted funds flow from operations increased 7 percent to $35 million from $33 million in 2019 as lower revenues were more than offset by lower G&A expenses and cash taxes. EBITDAX increased 6 percent to $46 million from $43 million. Our cash position increased 66 percent to $68 million from $41 million, and net income decreased 96 percent to $1 million from $25 million. That year-over-year decline in net income is largely attributable to a deferred tax expense of $12 million in Q4 of 2020 compared to a deferred tax gain of $16 million in the comparable quarter of 2019.

Focusing solely on 2020, we see a [unintelligible] as more important when we look at the revenues, funds from operations in EBITDAX, all steadily recovering from the lows seen in Q2 2020 at the height of the COVID first wave in Colombia. As Charle already highlighted in his opening statement, we have reported that monthly sales volumes continued to recover in January and February so were up and we think that this trend will continue throughout 2021.

Our operating netback was unchanged at $3.58 per Mcf in the three months ended December 31, 2020 compared to the same period in 2019, while our operating margin declined only very slightly from 78 percent to 77 percent. These results again highlight the stability and high margin nature of our gas business.

What wasn't shown in the preceding operating netback and margin slide is the success we've achieved in lowering our corporate costs, including G&A, finance, and other expenses, particularly when measured in proportion to our sales volumes and revenue. G&A for the first 12 — for the 12 months ended December 31, 2020 averaged just 42 cents per Mcf, 23 percent lower than the 55 cents per Mcf for the prior year.

To further highlight the strength and stability as well as growth that we see in our business and financial results, we want to highlight the return on capital employed, implied by our financial statements over the last eight quarters. The COVID pandemic curtailed deposit trajectory, our return on capital employed was showing a year ago, but our return on capital employed remained very high by E&P standards at 16 percent on average for the full-year 2020, up from 15 percent in 2019. And quarterly results are now demonstrating a clearly positive trend that we are optimistic will continue as we move forward.

In closing, our Q4 financial results were strong and relatively stable despite the challenges that the corona virus pandemic presented, and we are now in an increasingly enviable position of financial strength with an ability to easily maintain the steady return to shareholders and increase flexibility to ramp up investment levels when we think it makes sense to do so and if operational restrictions don't prevent us from doing so.

At this point, I'll hand it back to Charle. Thank you, everyone.

Charle Gamba
Thanks, Jason. Our results for the fourth quarter of 2020 show a positive impact to our investments in growth when we return to a slightly more normal operating environment and gas market. Results for the full year demonstrate the long-term stability provided by our business model, including our fixed take-or-pay gas sales contracts.

For 2021, despite the impact of COVID-19 lingering in the short term, we are optimistic we will continue to see demand and related sales volumes and pricing gradually strengthen, allowing us to report continued growth in sales volumes, revenues, and funds from operations. We therefore expect to remain well positioned to continue returning capital to shareholders while reducing our leverage ratios and investing for growth.

Although the pandemic is not over, we are progressing our drilling program with two rigs currently drilling at the Milano-1 exploration well in the Cañahuate-4 development well and a total of 12 wells planned for the year. With nine of those wells being exploration wells, our drilling and seismic programs for this year has a significant focus on exploration to support long-term production growth.

In addition to investing in drilling and seismic to allow us to grow production reserves over the long term, we are working diligently to progress important strategic projects that will support increased transportation capacity and demand for our gas, such as the Medellin Pipeline and the El Tesorito Power Plant project. And, of course, in order to build a sustainable business, we will seek further continuous improvement in our strategy and execution as it relates to all ESG matters.

Given currently prevailing optimism around COVID-19 incident rates, hospitalizations, and vaccines, as well as the positive dynamics we see taking place in Colombia's gas market, it is probably worth reminding you that we could yet look at investing beyond our base budget program as indicated in our guidance press release in December. Conversely, if gas demands were again impacted by a third or fourth wave of COVID-related restrictions, we maintain flexibility in our capital programs to adjust accordingly.

I'd like to thank the entire Canacol team as well as our contractors, partners, and clients for their support and hard work during this challenging year that 2020 was and the somewhat uncertain times that continue as we seek a return to more normal operating conditions. It was our team, partners, and clients that allowed us to continue operating safely, sustainably, reliably, and profitably while investing for future growth.

We're now ready to answer any questions that you might have.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. I will hand it over to Carolina Orozco to read the — read and answer questions from the webcast frame.

Carolina Orozco
Thank you. We have our first question from Alejandro Demiteli [phonetic] from [Unintelligible] Security. Alejandro is asking, "Could you please comment how you see the situation with the fracking pilot?"

Charle Gamba
Yes. Well, as you know, Ecopetrol is preparing to execute a fracking pilot, a non-conventional pilot for oil in the Middle Magdalena Valley, and Exxon Mobil recently announced that they are applying for a permit to execute a similar pilot also in the Middle Magdalena Valley. So the regulatory environment at the moment is favorable for these fracking pilots. By no means does that ensure that they will be able to execute them without difficulty, especially from the communities who remain heavily opposed to fracking from an environmental perspective. These pilots are non-commercial pilots. They're not intended to establish commercial production. As a matter of fact, these pilots do not have any commercial terms associated with them. They're simply designed to apply massive hydraulic fracturing techniques here in Colombia and monitor the impact of those operations on the environment, specifically groundwater, micro tremors, et cetera, so really these pilots are designed not for commercial test bases, but really to prove or to collect information with respect to the potential environmental impacts of this type of technology in the study areas.

Carolina Orozco
Thank you, Charle. Operator, I believe we have someone in the queue who wants to ask some questions?

Operator
Yes, the next question will be from Joseph Schacter — excuse me if I got that wrong. Go ahead, Joseph.

Joseph Schacter
And thanks for taking the call. Two modeling questions. El Tesorito, you've mentioned in your earlier remarks, that volumes were picking up in January and February. Can you talk about the COVID issue and how El Tesorito is moving forward, and should we be modeling in anything for volumes in Q1 of '22, or should we drag it out a little bit further? Like when do you expect the potential 30 million a day to come on, given the current status of construction with COVID rules?

Charle Gamba
Hi, Joseph. Yeah, El Tesorito is on schedule, basically. I mean, it's — the civil work has started there, and the licenses are all in order. The motors have all been commissioned and are in the process of fabrication in Europe. The start date is estimated between December and February — December of this year and February of next year — so that seems to be moving ahead. It's moving.

With respect to potential sales volumes, there remains a deficit still in the electrical market related to the delay in the Ituango Hydroelectric project, so there is a 2,500-megawatt deficit in the hydro space. So the forecast is that El Tesorito will be generating between 50 and 75 percent capacity, which will translate to between 20 to 30 million cubic feet per day of sales when it starts up.

Joseph Schacter
To model 20 to 30 million in — from Q2 — ’22 on, that would be —

Charle Gamba
Correct, yes, so —

Joseph Schacter
— [inaudible].

Charle Gamba
Correct.

Joseph Schacter
Second, you still have the oil production on with the high-60s for Brent. I would have thought somebody would have wanted to come by and buy them by now. Is there a sales process still underway, and do you see that potentially coming off the books in ’21?

Jason Bednar
Yeah, the Rancho Hermoso asset that you referred to, we’re netting 200 or 300 barrels a day. You know, the netbacks are actually very good. I think the netbacks are almost to $40 a barrel. [Inaudible] is reasonable there, but that’s a very complicated contract. It’s an Ecopetrol contract, and [unintelligible], you know, not an easy contract to manage, particularly with respect to selling the contract. So it’s the very first contract we ever picked up in Colombia in 2008 and it seems like it’s going to be with us for quite a while, Joseph.

Joseph Schacter
Yeah. Do you see, given the netbacks as you said are pretty lucrative, do you see potentially looking at opportunities on the lighter barrel side of oil and building a business from there as well?

Charle Gamba
No, we’re 100 percent focused on gas, and so we will not invest — we will simply invest in minimum work program type of investments in the Rancho Hermoso field, which is related more to maintenance and occasional workovers, but we do not foresee the drilling of any new wells, for example, regardless of what the price environment for oil is, which is of absolutely no interest whatsoever to us.

Joseph Schacter
Okay. Super. Thanks so much. Much appreciated.

Charle Gamba
Thank you.

Operator
Now Carolina Orozco will read and answer more questions from the webcast frame.

Carolina Orozco

We have a question from Mark Vanderbeek. Mark is asking, "What are your plans for the announced share buyback program? Can you provide any color on your plans to buy back shares in 2021?"

Jason Bednar
Yeah, I mean, as you know, we bought back 2 million shares in 2020 for approximately $6 million U.S. Under our bond covenant limits, we can buy back $15 million a year, but we are allowed to carry forward from prior years if we don't spend all that. You know, I can't — at this point in time, I can't give you any clear goals or targets. Obviously, we're cognizant of share price fluctuations and when it may be more [unintelligible].

I will say that some of you on the line probably received questionnaires that Canacol sent out. We're actively soliciting shareholders' thoughts with respect to what they viewed as more valuable, increased dividends or increased share buybacks or increased debt repayment. So we just got those back and we're starting to have a look at those, and there will be some Board discussions on that topic, but at this stage, I can't give you any defined limits.

Carolina Orozco
Thanks, Jason. Now we have a question from [Unintelligible] from [Unintelligible], and [Unintelligible] is asking, "Can you elaborate on your debt paydown strategy, please?"

Jason Bednar
Sure. So just to refresh everyone's memory, we of course have the bond that was issued in May of 2018, which is $320 million. That has typical no-call options and we'd be paying penalties if we paid that down earlier for another — a year or two on that. But just in the normal course of business, some of our other loans, we'll be paying down $7 million in 2021, $17 million of structured debt repayment in 2022, and $8.6 million in 2023.

Carolina Orozco
Thanks, Jason. We have a question now from Sophia Rojas from BD Capital. She's asking, "Has it been decided who will be the [unintelligible] contractor for the EPC contractor for the Medellin Pipeline project? Is there any updates regarding this project?"

Charle Gamba
Well, with respect to the project in Medellin, we continue to wait for the execution of the main sales off the contract, of the utility company there. We have received all the final offers from the EPC contractors, of which there are three, and we have essentially completed the financial structuring of the project with respect to debt and equity. But again, we wait — the main component that we're waiting for will be the execution of the — off the main [unintelligible] contract to the main to the main consumer [unintelligible].

Carolina Orozco
Thanks, Charle. The next question is from [Unintelligible] Torres [phonetic] from [Unintelligible] Analytica. He's asking if you can remind him about our investment plans for 2021 and its comparison with 2020.

Charle Gamba
I think Jason can take that.

Jason Bednar

Yeah. By investment plan, I assume we're talking about capital expenditures, so we put out a press release in January which has all the details, but the high case I believe was $140 million and included 12 wells, with nine of those being exploration wells, I believe. And this last year, we — in 2020, the capex number was $85 million, so we're certainly planning on increased investment and increased well count in 2021.

Carolina Orozco
Thanks, Jason. The next one is — we have another question from [Unintelligible] from [Unintelligible]. He's asking, "Should we expect any impact of the tax deal on your sales directly or impact in Colombia purchasing power?"

Jason Bednar
Yeah. That's a very good question. This relates directly to a deferred tax write-down we did in Q4, so in late 2020, a [unintelligible] state court ruling essentially disallowed the use of losses on merged companies, so the particular case that was in front of the court at that point in time was not an oil-and-gas case, and it had different fact circumstances than the Canacol case. It's probably important to note that the DN [phonetic] has yet to change the tax laws to reflect that particular court's ruling, so as you can imagine, that has affected many companies, and many challenges to that ruling are expected in the near future, with Canacol being one of those challenges. So many experts believe the ruling is unconstitutional, and it was due to the ambiguity surrounding that ruling that we de-recognized [phonetic] the deferred tax assets on our balance sheets.

You know, having said that, if — should Canacol or any other company prove successful in any challenge, which we believe some will be heard within the first 12 months, we would be able to use those $29 million of losses in the year where we are successful or someone else is successful. I should note that it was — that particular court's only disallowed certain tax losses in that particular case. So we're hopeful that we will get that back and obviously we're working with local experts, be it constitutional or tax-wise, on that particular topic, but we ended with — we ended the year with $68 million in cash. We've got a $46 million revolving line of credit that is untouched, and our budgets would not be looking to touch that, so it was unfortunate, but it has no impact on our plans at this stage.

Carolina Orozco
We have one last question from James Branch [phonetic]. James is asking, "Your production by field shows some interesting shifts. Nelson and Palmer are declining and being replaced by Clarineta and Pandareta. Are there exploration targets in 2021 of the size of Clarineta?

Charle Gamba
Yes, thank you, James. Yes, as we continue to add more fields to our production mix, we tend to back off production in some of the other fields to lower the production in order to capture as much reserves as we can, so we sort of lower the production from the big producing fields and — as we bring on new fields. But in general, you know, we've been shifting our exploration away from Esperanza, which is where Nelson and Palmer are located and where we did our first exploration five, six years ago. We've been shifting more and more exploration activity into VIM-5, which is where Clarineta and Pandareta are located, so, yeah, the new discoveries we're making, the big new discoveries we're making tend to be located in Clarineta and the VIM-5 area.

This year, with 12 wells, nine exploration wells being drilled out of those 12, this is our biggest exploration year ever for gas. Nine exploration wells are targeting over 300 BCF of [unintelligible] perspective gas resource that we've identified, and, yes, we do see some targets that are in the range of in between Clarineta and Pandareta size, you know, 100-plus BCF targets.

CONCLUSION

Carolina Orozco
Thank you, Charle. We don't have any more questions, so thanks to all who are participating in Canacol's Fourth Quarter Year-End Conference Call. Have a great day, and you may now disconnect.