Canacol Energy Ltd.

Third Quarter Year 2020 Financial Results Conference Call

November 13, 2020 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Charle Gamba, *President and Chief Executive Officer*

Jason Bednar, *Chief Financial Officer*

Carolina Orozco, *Director, Investor Relations*

PRESENTATION

Operator

Good day and welcome to the Canacol Energy Third Quarter 2020 Financial Results Conference 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 0. After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I would now like to turn the conference over to Carolina Orozco, Head of Investor Relations. Please go ahead.

Carolina Orozco

Good morning and welcome to Canacol's Third Quarter 2020 Financial Results Conference Call. 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 team can include projections of the corporation's future performance. These projections neither constitute any commitments as to future results nor take into account risks 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 U.S. dollars.

We will begin the presentation with our President and CEO, Mr. Charle Gamba, who will cover the operational highlights for the third quarter 2020. Mr. Jason Bednar, our CFO, will then discuss financial highlights. Mr. Gamba will close with a discussion of the corporation's outlook for the remainder of the calendar year 2020 and beyond. A Q&A session will follow. Mr. Gamba is joining us today from the line in Bogotá, and Mr. J. Bednar is joining us from the line from Calgary.

I will now turn the call over to Mr. Charle Gamba, President and CEO of Canacol Energy.

Charle Gamba

Thank you, Carolina. Good morning and welcome to Canocol's Third Quarter 2020 Conference Call. Gas sales during Q3 were 163 million expanded cubic feet per day, a 7 percent increase from the second quarter of 2020 and an 11 percent increase from the same period in 2019. Revenues during Q3 were $57.4 million U.S., a 1 percent increase over the same period last year.

Realized gas sales have been recovering from a low point of 136 million standard cubic feet per day in April, to 168 million standard cubic feet per day in September of this year and 173 million standard cubic feet per day in October of this year, as demand is recovering after the country-wide lockdown related to the COVID virus.

Production operations during the third quarter ran smoothly, with no major interruptions. Drilling operations, which have been completely suspended from March 26th to May 27th, due of course to the nationwide lockdown, were ramped up in the third quarter with the secondary commencing during operations in July. The second rig's first job was to drill our first significant exploration well in our 2020 drilling program, and in early September, we announced a new gas discovery with the Porro Norte-1 well.

As announced in August, in a major show of confidence in the stability of Canacol's business model, our syndicated lenders expanded our existing $30 million term debt facility at an approximately 2 percent lower interest rate than before and expanded us a further $121 million in new low-interest term and revolving credit during a period when many oil and gas producers had their borrowing bases redetermined and lowered.

Finally, during the quarter, we continued to deliver on our return of capital to shareholders via the continuation of our quarterly dividend, with no cut to yield. In September, we also started actively buying back shares under the previously announced normal course issue [unintelligible].

I'll now turn the presentation over to Jason Bednar, our CFO, who will discuss our second quarter financials — our third quarter financials, I should say — in more detail. When he is done, I will provide a detailed outlook for the remainder of 2020.

Jason Bednar
Thanks, Charle. Although impacted by the global pandemic, Q3 2020 was another strong quarter for Canacol, both operationally and financially, as we continue to execute our plan and drive our growing natural gas business forward. Focusing on the third quarter of 2020, financial highlights include revenues increasing very slightly by 1 percent, to $57.4 million compared to $56.6 million for the same period in 2019; cash flow from operations increasing 36 percent, to $50 million from $37 million; adjusted funds flow from operations decreasing 8 percent, to $33 million from $36 million; cash capex decreasing 11 percent to $27 million from $31 million; EBITDAX decreased 8 percent to $42 million from $46 million; our cash position increasing 127 percent to $94 million from $41 million at September 2019; net income increased 294 percent to $2.6 million from $0.7 million.

Gas fields increased 11 percent compared to the same period last year, as the commissioning of new pipeline infrastructure and associated ramp-up in sales volume was still ongoing in the third quarter of last year. That said, increased gas sales were offset by lower interruptible realized gas prices as compared to 2019, mainly due to lower demand for spot sales as a result of the COVID-19 pandemic. July and August 2020 had the lowest interruptible prices of the year for Canacol; however, those prices rebounded sharply in September to average $4.00 per Mcf.

While Q3 funds flow from operations was slightly reduced relative to Q3 2019, capital expenditures were also lower as we were working on completing and commissioning the Hovel-3 gas plant expansion in the third quarter of 2019. Our capital spending this year has been somewhat constrained by COVID-related restrictions, particularly in the second quarter of 2020 as Charle just mentioned, and the capital program has benefited from cost savings stemming from lower drilling rates than we had originally budgeted for, amongst other things.

As a result, we were still able to generate $6 million in free cash flow before interest payments, relatively unchanged from the same period last year. That free cash flow supports our unchanged quarterly dividend that was initiated in the fourth quarter of last year, which currently represents an annual dividend yield of approximately 5.5 percent, with the last dividend being paid in October.

With respect to our share buyback program, we began actively repurchasing shares for cancellation on September 10th and bought 462,000 shares at an average price of $3.50 Canadian in the month of September, as reported in these Q3 financial statements. During the month of October, we repurchased an additional 763,000 shares at an average price of $3.47 Canadian, bringing total purchases to approximately $3.2 million U.S. over that two-month timeframe. We remain actively repurchasing shares in November.

Our net-debt-to-EBITDAX ratio was 1.7 times at September 30, 2020, reduced from 2.3 times at September 30, 2019, obviously well within our financial covenants of 3.25 times.

To compare Q3 of 2020 to Q2 of 2020, during the second quarter of 2020, Canacol felt the peak of the impact on gas demand from COVID-19. Q3 results showed an uptick in gas demands. As such, revenues increased 6 percent in Q3 as compared to Q2; cash flow from operations increased 32 percent quarter over quarter; adjusted funds flow from operations increased 7 percent to $33 million from $31 million; cash capex increased by 129 percent to $27 million from $12 million in Q2 as we were able to re-engage in drilling and other operations; EBITDAX increased 5 percent to $42 million from $40 million; and ending cash increased 60 percent to $94 million at September 30 up from $59 million at June 30, 2020.

Our operating netback decreased slightly to $3.47 per Mcf in the three months ended September 30, 2020 compared to $3.86 per Mcf for the same period in 2019. Once again, this decrease is due to lack of premium-price, spot market gas sales as a result of the lower demand driven by the COVID-19 economic downturn. Despite the reduction in netbacks caused by the lower gas demands, it's worth noting that we maintained relatively high and stable netbacks as well as strong operating margins of 79 percent during the quarter, which speaks to the strength and stability of our business and the value of our sales contracts in particular.

The financial strength and stability of our operations is giving us increased financial flexibility. We've — and what we've done to make sure it isn't just theoretical is to reprofile our debt as announced in August. We were able to lower our cost of capital and secure substantially increased financial flexibility during the third quarter. Although I did go through these initiatives on our last quarter's call, I'll briefly touch on two of the components that closed in Q3, on July 31st specifically, as outlined on the right-hand side of this slide.

We put in place a new $46 million revolving credit facility, which is at approximately 5 percent if and when drawn. Given Canacol ended Q3 with approximately $94 million of cash, this facility remains undrawn. Although Canacol can fund its capital and dividend programs with existing cash and cash flows, we thought it prudent, given the favorable rates stats and our financial flexibility.

We also completed a $75 million bridge term loan at approximately 4.5 percent, which resides inside the company that will build the Medellin pipeline. The first $25 million was drawn in August and will be used to fund expenditures such as engineering and environmental permitting through to mid-2021. The remaining $50 million could be used toward our long-lead-timeline, such as pipe, when the timing is appropriate. We anticipate that during the term of the bridge, Canacol would invest between 75 percent to 100 percent of the shares of the subsidiary to an equity partner, while maintaining up to 25 percent working interest in the ownership of the pipeline project. Once the equity partners and bank syndicate agreements have been signed and any applicable conditions precedent have been met, we anticipate the long-term funding will be advanced and the bridge will be repaid in its entirety.

For clarity, although the $25 million draw appears as debt on our balance sheet at September 30, along with the corresponding cash amounts, we do expect this debt to no longer be on our balance sheet once partner deals have been finalized on this project.

We're seeing our cost of capital decline as market participants come to understand the value of our business. On the debt side, that is clearly reflected in these new terms and expanded debt capacity, while on the equity side, it's reflected in a very stable share price compared to many other oil and gas producers.

During the remainder of 2020, the corporation plans to use excess cash, firstly to maintain our quarterly dividend payment — $7 million a quarter — which is 5.2 cents a share Canadian, representing approximately a 5.5 dividend yield at current share prices. And, secondly, to continue to repurchase common shares of the corporation under its Norma-Course Issuer Bid.

In closing, our Q3 financial results were strong and relatively stable, despite the challenges that the coronavirus pandemic presented, and now we are in an increasingly enviable position of financial strength, with increased flexibility to wrap 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. The stability provided by our six take-or-pay gas sales contracts have allowed us to continue weathering the financial effects of this pandemic, and we have maintained robust cash flow and operating margins as just discussed by Jason.

We've also maintained our return of capital to shareholders via the continued issuance of dividends, with no change in yields, and we have been buying back shares since September. Our lenders, as Jason has just discussed, have renewed our existing bank facility at a reduced interest rates and extended new lending and revolving credit facilities to put us in a position of strong liquidity. All of these aspects reinforce the long-term stability of our business model.

Mainly due to the two-month delay in the drilling program related to the lockdown in the second quarter and to the implementation of COVID protocols in the fields, we anticipate drilling eight of the originally planned 12 exploration and development wells this year, with the remainder being pushed into 2021. We anticipate commencing the drilling of the Flauta-1 and Siku-1 exploration wells shortly here in December.

In October of this year, the corporation tested the Arandala-1 exploration well, which was drilled in late 2019. The well encountered 30 feet of play within the Porquero sandstone and was tested, with a final production rate of 13 million cubic feet per day. Flow is currently tied to production [unintelligible] and ready for production.

The corporation also plans to add two exploration and production contracts to its portfolio — the VIM-44 block, which is located in the lower Magdalena Basin adjacent to our main gas-producing areas, and the VMM-47 block located in the Middle Magdalena Basin, which complements our large existing gas exploration position in this basin, while we are chasing a major new conventional gas play.

The corporation is having ongoing discussions with our partner Promigas S.A. with respect to ship-or-pay contracts and expects to reach an agreement in the very near term.

I would like to thank the entire Canacol team as well as our contractors, lending partners, and clients for their support and hard work during these very uncertain times, which has 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. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2

The first question is from Joseph Schachter from SER. Please go ahead.

Joseph Schachter
Good morning, and thanks for taking my questions, and congratulations on a very nice quarter and the financing changes. Can I get a little more light shed on the Celsia expansion, the 200-megawatt power plant? You have in the presentation, an estimated start date December ‘21, but it has it subject to COVID-19, and then there’s a comment about firm energy obligation December ’22 QEF. Can you walk us through a little more in detail on that? And also, how much delay do you see potentially happening because of COVID and — yeah, that would be much appreciated.

Charle Gamba
Yeah, the Tesorito power plants, which we are part of a joint venture with Celsia and Prolectrica in Colombia, is a 200-metawatt power plant located approximately seven kilometers to the southwest of our Jobo facility. That facility — or that project was awarded in March of last year as part of a 2,500-megawatt bid round that the government orchestrated. It’s operated under the Cargo de Consilidad System here in Colombia, primarily to act as back-up generation at times of need.

The project itself is well underway. The EPC contracts for the motors were awarded in June of this year. The civil works started in July of this year, and it’s anticipated that the civil works will be completed in the first quarter — late first quarter 2021— and the motors should be arriving to be installed mid-year of 2021. All environmental permits related to the connection of the power plant to the adjacent sub-station have been received this past summer, so there are no permits pending with respect to the connection of this station to the main power grid. At this particular moment, the project is on schedule, and the Consortium anticipates that the project will start to generate December 1st of 2021.

Joseph Schachter
And the firm energy obligation QEF, December 22, could you walk us through that?

Charle Gamba
Yes, as I mentioned, the project was awarded under a 2,500-megawatt bid round for something that’s known as the Cargo de Consilidad in Colombia, which is essentially back-up generation to be called upon should there be a need for additional electrical generation in the country related to increased hydroelectric generation, particularly during the dry seasons. This plant has that — how actually would I put it — it has that condition. It will receive a daily tariff from the government to be in standby mode. to be ready to instantly start up should power be generated. That’s one component of the project.

The plant is free to generate on its own under market conditions to sell electricity into the grid, into the regulated and non-regulated grid. And that’s where the majority of the generation will occur, essentially the plant will gain a revenue from the government, a 15-year PPI — PPA, I should say — on a standby basis, and then, separately, will generate revenue on its own, dispatching under normal operating conditions.

Joseph Schacter
What's the —

Charle Gamba
And it's that — it's that tariff, it's that standby that takes effect in 2022. That's when we expect to receive that particular revenue.

Joseph Schachter
Right. And then lastly for me, how much of the shortage of electricity in the area right now? How much of that $30 million capacity are impacted for you, or Canacol — are we looking at based on the shortage of electricity at this time?

Charle Gamba
It's important to say that the plant has a generating capacity of 200 megawatts, which is 40 million cubic feet per day. It's anticipated the Consortium estimates that it will be generating at approximately 75 percent capacity under normal conditions, which is a consumption of around 30 million cubic feet per day.

The bid round that was auctioned last year by the government, the 2,500-megawatt bid round, was done to cover a shortfall related to the significant delay of EPM's Hidroituango hydroelectric power generation project, which represents 2,500 megawatts of new hydroelectric power. That project was supposed to come onstream in December of 2018 but has been delayed due to significant issues associated with construction of the project, and the start-up of that project is anticipated now to be in 2024 at the earliest and only at less than 50 percent capacity, there is a shortfall of electricity in the market related to the delay of that very significant hydroelectric project. And for that reason, the government tendered this additional 2,500 megawatts, of which Tesorito was 200 megawatts of that shortfall.

Joseph Schachter
Okay. Thank you very much, and, again, congratulations on the nice quarter.

Charle Gamba
Thank you very much.

Operator
Again, if you have a question, please press star, then 1. The next question is from Daniel Duarte of Corficolombiana. Please go ahead.

Daniel Duarte
Hi, good morning, and thank you for taking the questions. I just have a couple of questions. What we're seeing right now in the spot market, that's how prices continue to push – how is gas [unintelligible] down? I guess [unintelligible] given that [unintelligible] since September. I guess I would like to know what level of production are you expecting to see in this last quarter?

My second question is related to the Jobo Cartagena pipeline. I recognize there is any update [unintelligible] transportation contract on this pipeline. And, lastly, I'd like to know how valuable is the exploration of the [unintelligible] taking the continental gas prices on the common market right now. I'd like to have your opinion on that. Thanks. Thanks for taking the questions.

Charle Gamba
I'm sorry, Daniel, I did not catch your first question. If you could please repeat it.

Daniel Duarte
My first question has to do with — it's about prices. I would like to know what's being [unintelligible] so far [unintelligible] on demand, and what can be the impact on that for gas prices on the last quarter? And in line with that, what level of production are you expecting to see on the fourth quarter?

Charle Gamba
Okay. I think Jason can — Jason went over the spot pricing, but, Jason, if you could just repeat the spot pricing leasing we have currently.

Jason Bednar
Yeah, sure. Let's just deal with the production first. Of course Q2 was 152 million cubic feet a day as reported. July and August were about 162 million cubic feet a day. September was 168, and we — I think last week or the week before we announced — or last week, I guess — we announced October at 173 million cubic feet a day. Typically, we'll report, you know, November and December within a week or two of those months closing, but, once again, October was at 173.

There's another couple questions in the queue which relate to the spot prices also, I'll just sort of jump the gun on those and answer your question more fulsomely. Obviously the COVID pandemic, it hampered — hindered, rather, gas demand, and with that hindering the gas prices, having said that, you know, in general terms, Q1 of 2020 saw those interruptible prices average slightly more than $4.00 in Mcfs. Q2 of 2020 saw those same interruptible prices average slightly less than $3.00 an Mcf, and when we got to Q3, July and August averaged right around $2.00 an Mcf. Having said that, September bounced back to $4.00, and October is in — October was in line at the same $4.00 price.

Daniel Duarte
Thanks, Jason.

Charle Gamba
I'm sorry, Daniel. Was there a — there was a — I think there was a second question, if you could just repeat that as well, please.

Daniel Duarte
Yes, okay. My second question is related to the Jobo Cartagena pipeline. I'd like to know if there is any update on the [unintelligible] with Promigas regarding the transportation contract on this pipeline.

Charle Gamba
Yeah, as I mentioned during the course of the presentation today, we're currently in discussions with Promigas regarding the ship-or-pay contracts there, and we'll have an agreement — we feel we'll come to an agreement very shortly.

Daniel Duarte
Okay. Again, and lastly, I would like to know your opinion as to how viable is the exploration of the [unintelligible] gas that's been announced by [unintelligible], taking into account [unintelligible] gas prices in the common market.

Charle Gamba
I think there have been a couple of potentially significant discoveries in the offshore over the past five or six years, by Petrogas, by Repsol, by Ecopetrol, and Anadarko [phonetic]. They are located in very deep waters, up to 2,000 meters of water depth, and they have yet to be fully appraised with respect to the drilling of additional wells to try and better estimate the sizes of those discoveries before a commerciality decision is made to invest in the infrastructure which will be necessary to develop those discoveries. I would say that the first — you know, the initial results are encouraging with respect to the presence of gas there.

The uncertainty lies within how large these discoveries are, that's going to require additional drilling, which was supposed to happen next year, although it has been delayed into 2022, I believe, now. And then a commercial decision has to be made with respect to developing those discoveries, and these — you know, given the water depths of these discoveries, these will be multi-billion-dollar-offshore-deepwater-type developments which would have a significant impact on price, obviously, if costs of that gas can meet the market.

On the one hand, you're looking at a seven-to-ten-year-type of development scenario before that gas can be put into the Colombian market, and then the costs will likely be quite high compared to gas developed and produced onshore.

Daniel Duarte
Okay, great. Thank you very much for your answers, Charle.

Charle Gamba
Thank you, Daniel.

Operator
The next question comes from Nicolas Erazo from Credicorp Capital. Please go ahead.

Nicolas Erazo
Hey, everyone, good morning, Charle and Jason and also Canacol's IR team. I just have one question, and, actually, if you could please share with us if you are perceiving any interest around the open season for Jobo [unintelligible]. And how could this be related — this project around the contract that's being actually renegotiated around the expansion of the 100 Mcfs per day between Jobo and Cartagena, which is also with Promigas? Just around that. Thank you.

Charle Gamba
Thank you. Thank you, Nicolas, for the question. The two subjects are completely different. They're not associated with one another. As I mentioned earlier, we're currently negotiating ship-or-pays with respect to Promigas at Cartagena and Barranquilla, and I suspect we'll reach an agreement shortly.

And with respect to the open season, that is a new pipeline project that Promigas has proposed or put to the [unintelligible], with respect to a bidding process — our open bidding process for a new pipeline from Jobo into the interior. But the two projects are very distinct.

Operator
The next question comes from Gabriel Barra from UBS. Please go ahead.

Gabriel Barra
Hi, [unintelligible]. Good morning. Thanks for the questions. I have two here. First, on these — on the — [unintelligible] from the last question, there isn't any update on the EPC contracts? There is any news here? I remember that, as you mentioned here, that Promigas would be one of those [unintelligible]. If you could give us more color on these, it would be very helpful.

And following up on the other question about Promigas contract — they have any kind of [unintelligible] here or [unintelligible] could share this timeline? It could be very helpful for us.

And the third one, very [inaudible]. Looking to the demand for the next year, should you expect anything close to 200 million [unintelligible] or the company are working with a lower number than that? Thank you.

Charle Gamba
Thank you. Thank you, Gabriel. With respect to the Jobo Medellin pipeline project, we have received offers from three different EPC contractors which we're currently evaluating. And we will make a decision once we have executed the main off-take contracts [unintelligible] with respect to the sales. That's the status of that project.

With respect to the timeline of the project, we're — you know, it's all dependent upon the execution of the primary off-take contract to Medellin, we're still waiting for that to occur before we move on to EPC award and funding.

With respect to the demand for next year, we're currently working on our 2021 budget, and, as usual, we will publish our guidance, which will include gas sales as well as capital and whatnot in early December of this year. That will be coming out within the next three weeks or so.

Gabriel Barra
Okay. Great. Thank you.

Charle Gamba
Thank you, Gabriel.

Operator
There are no more audio questions in the queue. I will pass it over to Carolina Orozco for the webcast questions.

Carolina Orozco
Thank you. The first question is from Daniel [Unintelligible] from [Unintelligible]. "At which prices are you planning to roll over the take-or-pay contracts that expire this year?"

Charle Gamba
At the highest possible prices.

Carolina Orozco
The second question from Daniel is, "Are you planning to record in your balance sheet a contingent legal liability related to the early termination of the transportation contract with Promigas for the 100-million-cubic-per-day pipeline connecting Jobo to Barranquilla?"

Jason Bednar
Yeah, the answer to that is clearly no. As Charle pointed out, we're in discussions and expect to have an amicable resolution soon.

Carolina Orozco
This third question is, "How do you [unintelligible] in the spot market evolving, especially considering that the rainy season in Colombia has just started and water reservoirs are at record highs?"

Charle Gamba
Well, typically, there's a dry season and a rainy season. We're currently just coming off the crest of the rainy season. The water levels are not at record highs. The water levels are at normal highs, not record highs, and should start to fall as they usually do through December and through the first quarter and into the early second quarter of next year, as they always do. That tends to be the highest level of thermoelectric power generation, as a matter of fact, is in the first quarter. I expect that nature will repeat itself as it always does with respect to the course of the dry and rainy seasons.

Carolina Orozco
And his final question is, "What is preventing you from signing the take-or-pay agreements with EPM that will make feasible the pipeline project from Jobo to Medellin?

Charle Gamba
That is currently in the Board of Directors' hands at EPM.

Carolina Orozco
Now we have another question from [Unintelligible] from Credicorp. "Are you able to continue with this legal process with Promigas, or will you have [unintelligible] agreements with them?"

Charle Gamba
I think we've answered that a few times in this conversation.

Carolina Orozco
Yes. The next question is from [Unintelligible] Castro from Credicorp Capital. "How have evolved the negotiations with Promigas? Why did you need to use the funds from the bridge loans? Could you give us some details about that?"

Charle Gamba
Yeah, I think we've covered Promigas, but I'll deal with the bridge loan. The bridge loan, once again, is for — to — for early items on the Medellin pipeline project. That project is held inside a subsidiary company, a different company than Canacol legally, essentially, we're just temporary custodians of those shares, right? Once we sign a private equity deal, when the pieces fall in place, we'll transfer them, the bulk of the shares. The debt will be completely off our balance sheets as we can only hold a maximum of 25 percent interest in that company, which is the maximum allowed for a producer under Colombian law.

Jason Bednar
Just to round that out, I guess, obviously the funds that are spent or the interest that will be paid, et cetera, falls inside of that Medellin company, right? The intention is that it won't be on Canacol's books for long.

CONCLUSION

Carolina Orozco
Thanks, Jason. Just give us a few seconds to see if we have anymore questions from the queue. Okay. I think with that, we'll finish our conference call today. Thank you all for participating in Canacol's third Q conference call. The call now has been concluded. And have a great day.

Charle Gamba
Thanks, everyone.

Operator
The conference is now completed. Thank you for attending today's presentation. You may now disconnect.