SUNCOR AND PETRO-CANADA: CREATING A NATIONAL CHAMPION

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ABSTRACT

The primary subject matter of this case concerns valuation of cost synergies and accretion/dilution in Suncor/Petro-Canada merger in 2009. This case can be used in a corporate finance course or in a mergers and acquisitions course to introduce synergies. It intentionally leaves out stand-alone valuation of Petro-Canada to focus on synergy categorization and valuation, accretion/dilution and synergy split based on agreed-upon exchange ratio. Specifically, it provides students with an opportunity to: (1) estimate weighted-average cost of capital for a combined company; (2) apply discounted cash flow analysis to determine value of cost synergies; (3) estimate accretion/dilution per share for target firm and acquirer firm.

Keywords: Merger, Accretion, Dilution, Cost Of Capital, Synergy.

INTRODUCTION

It was late Friday, July 31, 2009, and Christopher Kelly sat down to have another look at the closing prices on Suncor (SU) and Petro-Canada (PCA), two integrated oil companies that announced merger plans earlier that year. Kelly, an oil & gas analyst with Gor & Associates, an investment adviser firm based in Calgary, AB, had to issue a recommendation on the stock of a new Suncor company (Table 1 displays timeline for the merger). Suncor handed over 1.28 shares in a new company in exchange for 1 share of Petro-Canada stock, giving away 40 percent of new company to legacy PCA shareholders. Shareholders of Suncor, whose top managers heavily dominated the executive team at merged firm, kept 60 percent of the business. The exchange ratio represented an approximate 25% premium for the Petro-Canada shares to the 30-day weighted average trading price of such shares.

The deal heralded creation of a fifth-largest oil producer in North America capable of competing with Exxon Mobil Corp., Royal Dutch Shell PLC, and Total SA in the Canadian oil sands. The investment community was abuzz about the merger and its implications for the industry (Krugel, 2009). Dom Grestoni, managing partner at IG Investment Management, said the deal would create a "*New integrated national champion*" (Reuters, 2009). Ben Dall of Sanford C. Bernstein & Co. in New York issued a report, suggesting further industry consolidation was imminent given that purchase of undeveloped reserves through acquisition cost $11 a barrel versus $21 to find and develop new reserves through exploration (Reuters, 2009). UBS Securities Canada Inc cited benefits of the deal but voiced a concern that it removed Suncor's "*Pure play*" nature, which investors have rewarded with a premium valuation (Decloet et al., 2009).

Petro-Canada History

Petro-Canada was created as a crown corporation by the Trudeau liberal government in response to the first OPEC price shock of the early 1970s. In the early 1980s, it came up with "*Pump your money back into Canada*" slogan. Later, the Progressive Conservative government of Prime Minister Brian Mulroney (1984-1993) stopped using Petro-Canada as a policy tool. In July 1991, the firm went public, and in 2004 the government sold its remaining 19 percent stake in it. The Petro-Canada Public Participation Act 20-percent cap on single shareholder ownership remained in place, but the deal with Suncor was structured as an all-stock merger and did not directly interfere with the law, which, however, imposed a 20 percent cap on the combined firm. Reflecting on Petro-Canada's legacy, some observers described it as a case of collectivist delusion, whereas others argued that Petro-Canada was worth "*Every penny spent on it*" (Foulkes, 2004).

Suncor History

Suncor was founded in 1919 in Montreal as Sun Company of Canada, a subsidiary of Pittsburgh-based Sun Oil (now Sunoco). Suncor inherited the first commercial plant in the oil sands, which had been operational since 1967. The oil patch lore has it that Sunoco CEO John Howard Pew once threatened the board to resign if he failed to get approval for the oil sands project. It was a telling sign of changing times that a company created by Canadian nationalists was taken over by a company founded by the U.S. interests and headed by an American, Rick George.

MERGER MERITS

Kelly knew synergies were often touted in merger deals, but much less frequently delivered. At the same time, mergers in the 1990s worked out better than those in the late 1980s, and there was some evidence that the trend continued into the next decade. Suncor–Petro-Canada merger had several characteristics of a successful merger deal:

1. Synergies. Mergers focused on cost synergies were more likely to achieve success. The Suncor–Petro-Canada merger appeared to have created a good match - PCA was a cash-cow but a slow-grower, whereas SU was a fast-growing oil sands operation which needed capital to expand. Further, stable cash flows from Petro-Canada's downstream operations would allow Suncor to invest through the commodity cycle (Tait, 2009).
2. In-depth integration planning. The two companies tried to work out a deal for the first time in August 1999 and kept an eye on each other since then. At the time of the announcement, they estimated annual operating expenditure reductions of $300 million and annual capital savings of approximately $1 billion (Suncor, 2009)[2]. Under these assumptions, the deal was accretive for shareholders of both firms (see Table 2).
3. Industry effects. Mergers in the oil patch had a higher success rate than in other industries. Accenture surveys (Spence & Johnson, 2000; Dinkin & O'Connor, 2001) reported that 39% of merging oil firms fully achieved their anticipated gains. Exxon/Mobil merger in 1999 and Texaco/Chevron deal in 2001 each achieved more than double the level of initially announced savings.

Merger Challenges

Yet, some of the deal characteristics were potentially troubling:

1. Size. Mergers of equal-sized firms work less often than others, often due to overpayment.
2. Cultural clash. Most merger deals fail due to poor integration efforts rather than failed strategic concepts. When Suncor and Petro-Canada announced the merger, they touted "complementary cultures" as one of the strengths, but even before the merger was completed, Suncor CEO Rick George made it clear that *"The*

Suncor culture and processes will dominate" (Cattaneo, 2009). Further, two of twelve Petro-Canada directors voted against the merger.
3. Means of payment. Large mergers performed worse when means of acquisition was stock, not cash. Was Suncor paying for Petro-Canada shares with overvalued stock? Few investors wanted to take cash payment at the low point in the cycle of oil prices.
4. Change in investor base. The new Suncor stood to lose appeal of a company that provided direct exposure to Canadian oil sands.

Synergy Valuation

Kelly knew that he had to parlay qualitative analysis into numbers and decided to focus on valuation of synergies. Combined market capitalization of the two oil companies increased by $13.0 billion since March 23 when merger plans were announced (see Figure 1). However, often merger news was leaked into the market prior to the official announcement, so Kelly decided to backtrack another couple of months and examine change in market cap for both companies. There was no evidence to conclude that merger news had been leaked to the market; Petro-Canada market capitalization was practically unchanged in the two months prior to the announcement on March 23, 2009 (see Figure 2 and Table 3). Following deal announcement, Suncor and Petro-Canada disclosed some steps they took to prevent a news leak. Suncor's gains in January – March 2009 could be attributed to recovery in oil prices (Table 4 reports changes in market capitalization). Following the announcement, combined Suncor and Petro-Canada added USD 15.2 billion in market capitalization.

Kelly chose to compare stock performances against the Amex Oil Index (XOI), which gained 12% over the same period, implying that approximately $11 billion in market capitalization gain could be attributed to merger news (see Table 4). He knew that revenue synergies[3] were much less often achieved in mergers than cost synergies (Christofferson et al., 2004). Prior to the merger, he maintained a "*Hold*" recommendation on both firms. Was the market getting in over-drive or could $11 billion gain be justified by announced cost cuts? (see Table 3 for financial data to estimate weighted-average cost of capital for a combined firm). Given investors' interest in the Canadian oil patch and the size of the new firm, Kelly felt pressured to issue a recommendation. He also knew that issuing a "*Sell*" recommendation on a company that comprised 6.46 percent of the TSX S&P 60 index could be a tough call.

[1]All numbers in this case, unless noted otherwise, are reported in U.S. dollars.
[2]Synergies are reported in Canadian dollars as in Suncor's press release. Exchange rate on March 20, 2009 was 1.2371 Canadian dollars per U.S. dollar.
[3]Revenue synergies= growth synergies

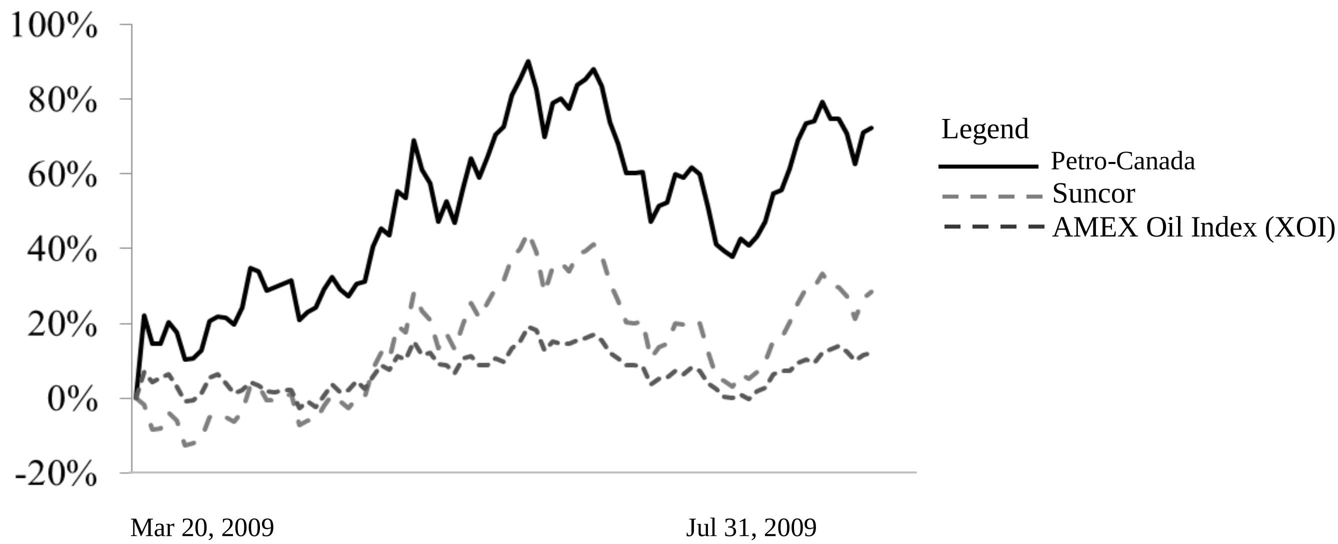


FIGURE 1
CUMULATIVE STOCK RETURNS IN USD, MARCH 20, 2009–JULY 31, 2009 (MARCH 20, 2009=100)

Source: Center for Research in Security Prices, Yahoo! Finance.

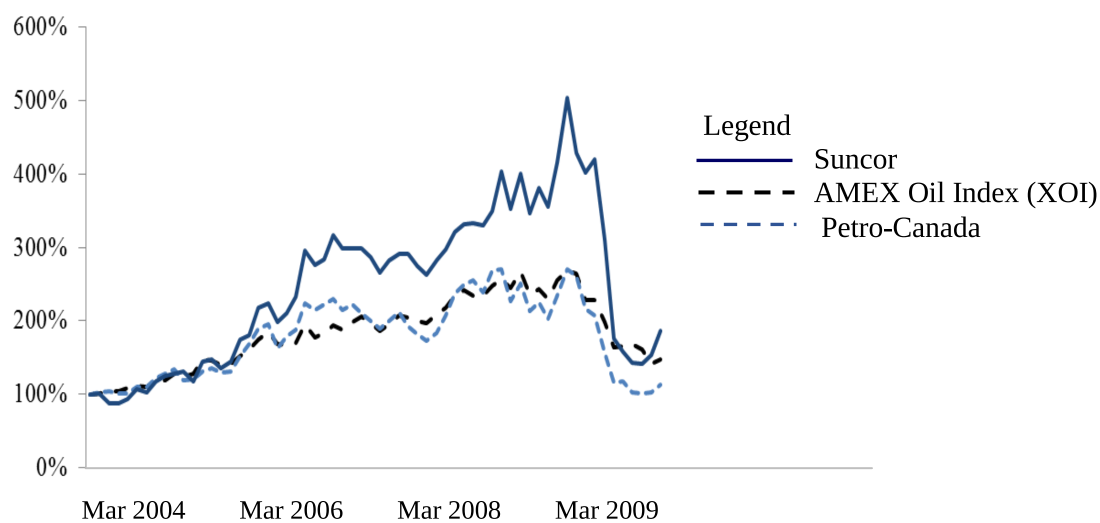


FIGURE 2
CUMULATIVE STOCK RETURNS, JAN 2004-MAR 2009 (DEC 31, 2003=100, Pautler)

Source: Center for Research in Security Prices, Yahoo! Finance.

Table 1
TIMELINE FOR SUNCOR MERGER WITH PETRO-CANADA

June 1998	Canada's Competition Bureau rejects Petro-Canada's plans to form a joint venture with San Antonio-based Ultramar Diamond Shamrock Corp.
August 1, 1999	Petro-Canada and Suncor Energy Inc. hold merger talks. Petro-Canada walks away from the deal at the last minute.
March 22, 2009	Petro-Canada and Suncor Energy Inc. enter in Arrangement Agreement to merge
March 22, 2009	Merger announcement made.
June 4, 2009	Petro-Canada shareholders and Suncor shareholders approve merger at annual shareholder meetings.
July 21, 2009	Competition Bureau approves proposed merger of Suncor and Petro-Canada
August 1, 2009	Merger becomes effective.
August 4, 2009	Suncor announces merger completion.
August 7, 2009	"*New*" Suncor Energy begins trading on the New York Stock Exchange annual.

Source: SEDAR, Factiva.

Table 2
HISTORICAL AND PRO FORMA EARNINGS PER SHARE FOR SUNCOR AND PETRO-CANADA, IN CANADIAN DOLLARS

	2004	2005	2006	2007	2008	2009Q1	2009Q2	2009E
Actuals and forecasts, no merger								
Suncor	2.38	2.54	3.23	3.23	2.29	-0.2	-0.06	2.02
Petro-Canada	3.32	3.45	3.45	5.59	6.47	-0.1	0.16	1.07
Exchange ratio 1:1.28, without synergies								
Suncor	2.38	2.54	3.23	3.23	2.29	-0.2	-0.06	1.55
Petro-Canada	3.32	3.45	3.45	5.59	6.47	-0.1	0.16	1.98
Exchange ratio 1:1.28, with synergies								
Suncor	2.38	2.54	3.23	3.23	2.29	-0.2	-0.06	2.42
Petro-Canada	3.32	3.45	3.45	5.59	6.47	-0.1	0.16	3.1

Source: corporate filings in SEDAR, Factiva.

Table 3
SELECTED MARKET DATA FOR SUNCOR AND PETRO-CANADA

	SU	**PCA**
MCAP, March 20, 2009	USD 23.7 bln	USD 11.6 bln
Debt	CAD 7.9 bln	CAD 4.7 bln
Corporate tax rate in 2009	29%	29%
Unlevered beta for integrated oil firms	1.02	1.02
Risk-free rate	2.21%	2.21%
Equity risk premium	6.43%	6.43%
Credit rating	BBB+	BBB
Effective yield BofA Merrill Lynch US Corporate BBB Index	6.54%	6.54%

Source: Center for Research in Security Prices, Damodaran Online, SEDAR, Deloitte, BofA Merrill Lynch.

Note: USD/CAD rate was 1.2371 (one U.S. dollar buys 1.2371 Canadian dollars) on March 20, 2009. On July 31, 2009, USD/CAD exchange rate was 1.079.

Table 4
CHANGES IN MARKET CAPITALIZATION, Dec 31, 2008-Jul 31, 2009

Panel A Market Capitalization of Firms, USD, billion					
Date	Petro-Canada, USD bln	Suncor, USD bln	Combined, USD bln	S&P TSX Capped Energy Index (TTEN)	AMEX Oil Index (XOI)
Dec. 31, 2008	11.5	19.7	31.2	216.52	979.68
Mar. 20, 2009	11.6	23.7	35.3	214.52	856.23
Mar. 23, 2009	14.2	23.3	37.5	230.42	915.05
Jul. 31, 2009	20.1	30.4	50.5	263.25	961.2
Change, Mar. 20–Jul. 31, 2019	8.5	6.7	15.2		
Panel B Changes in MCAP Relative to TTEN Index					
TTEN Index-implied change	23%	23%	23%		
Abnormal change MCAP	51%	6%	20%		
Panel C Changes in MCAP Relative to XOI Index					
XOI Index-implied change	12%	12%	12%		
Abnormal change MCAP	61%	16%	31%		

Source: Center for Research in Security Prices, authors' estimates.

RESULTS AND DISCUSSION

Weighted-average cost of capital

To estimate the value of synergies, one needs a discount rate. Weighted-average cost of capital can be estimated using the following assumptions:

$MCAP_{SUNCOR,\ CAD} = 23.7\times1.2371=29.3$ bln and $MCAP_{PETRO\text{-}CANADA,\ CAD} = 11.6\times1.2371=14.4$ bln

Suncor and Petro-Canada have similar capital structures.

$D/E_{SUNCOR} = 7.9/29.3 = 0.27$ and $D/E_{PETRO\text{-}CANADA} = 4.7/14.4 = 0.33$,

Use average D/E ratio of 30% to estimate cost of levered equity:

$$\beta_{LEVERED} = \beta_{UNLEVERED}\times\left(1+\left(1 - T_C\right)\times D/E\right) = 1.02 \times \left(1+\left(1 - 0.29\right) \times 0.3\right) = 1.24,$$

$$R_{E,SU} = R_{E,PCA} = R_{FREE} + \beta_{LEVERED}\times ERP = 2.21\% + 1.24 \times 6.43\% = 10.16\%$$

(all inputs are provided in exhibit 4 in the case)

$$WACC_{NEW\ FIRM} = R_E\times\frac{E_{SU}+E_{PCA}}{E_{SU}+E_{PCA}+D_{SU}+D_{PCA}} + R_{D,}\times\left(1 - T_C\right)\times\frac{D_{SU}+D_{PCA}}{E_{SU}+E_{PCA}+D_{SU}+D_{PCA}} =$$

$$= 10.16\%\times\frac{29.3+14.4}{29.3+14.4+7.9+4.7} + 6.54\%\times\left(1\text{-}0.29\right)\times\frac{7.9+4.7}{29.3+14.4+7.9+4.7} = 8.92\%$$

Cash flows

Information on cost synergies can be used to estimate present value of the synergy (Damodaran, 2015). Management anticipated cost reductions of $300 million a year and capital spending savings of $1 billion a year. The company does not report integration costs. Assume that cost of merger equals half of annual operating savings and that this cost is incurred immediately. Corporate tax rate of 29 percent will lower the present value of both costs and benefits associated with the merger. Even though capital expenditures are not paid out of operating expenses, future depreciation – capital cost allowance – will provide tax shields at marginal tax rate. Therefore, cash flows should be tax-adjusted.

-150	300	1,300	1,300	1,300
0	1	2	3	4

At a cost of capital of 8.92 percent for a merged company and assuming integration cost of $150 million[1], present value of synergies equals CAD 15.3 billion.

$$PV_{SYNERGY}=\frac{-150\times(1\text{-}0.29)}{(1+0.0892)^0}+\frac{300\times(1\text{-}0.29)}{(1+0.0892)^1}+\frac{300\times(1\text{-}0.29)+1000\Big/(0.0892\text{-}0.0221)}{(1+0.0892)^1}=15{,}311\text{ mln}$$

With exchange rate of 1.2371 CAD/USD on March 20, 2009, the present value of the synergies equaled USD 12.4 billion. At exchange rate of 1.079 on July 31, 2009, the present value of the synergies was USD 14.2 billion.

Cost synergy and total synergy valuation

The next question that needs to be addressed is whether the market assessment of synergies matches' calculations above is correct. Assuming that estimates are correct, three scenarios are possible: (1) if increase in market capitalization of Petro-Canada and Suncor is larger than estimated cost synergies, the market anticipates growth synergies in addition to cost synergies; (2) if market capitalization increases by the same amount, the market is willing to credit merging firms with cost synergies only; (3) if market capitalization increase is smaller, the market does not believe in management estimates of savings resulting from merger.

Market capitalization of Suncor and Petro-Canada increased substantially in January 2009-July 2009, but there is no evidence that information was leaked about the upcoming merger. From March 20, 2009, to July 31, 2009, combined market capitalization of Suncor and Petro-Canada increased from $35.3 billion to $50.5 billion. Over the same period, AMEX Oil Energy Index (XOI) increased 12%. Abnormal gain in combined market capitalization is as follows:

$$\text{abnormal MCAP increase}=\Delta_{MCAP_{SUNCOR}+MCAP_{PETRO\text{-}CANADA}}-\left(MCAP_{SUNCOR}+MCAP_{PETRO\text{-}CANADA}\right)\times\Delta_{XOI}=$$
$$=\left((30.4\text{-}23.7)+(20.1\text{-}11.6)\right)-\left(11.6+23.7\right)\times 12\%=\text{USD }10.9\text{ bln}$$

The abnormal increase in combined market capitalization of $10.9 billion is smaller than cost synergies valued at exchange rate of USD/CAD 1.2371 on March 20, 2009 or at exchange rate of USD/CAD 1.079 on July 31, 2009. It appears that the market is willing to credit Suncor and Petro-Canada with cost synergies only.

Accretion

Without cost synergies, the merger is accretive to target firm shareholders and dilutive for the acquiror. Data used to estimate accretion/dilution is reported in Table 5, and calculations are reported below:

$$EPS_{\text{SU, LEGACY SHARE}} = \frac{\text{net income of merged company}}{\text{shares at 1:1 conversion ratio}} = \frac{2{,}408{,}277{,}770}{1{,}555{,}808{,}758} = 1.55$$

$$EPS_{\text{PCA, LEGACY SHARE}} = EPS_{\text{SU, LEGACY SHARE}} \times \text{exchange ratio} = 1.55 \times 1.28 = 1.98$$

$$\text{accretion}_{\text{Suncor}} = \frac{\text{EPS per legacy share}}{\text{EPS 2009E without merger}} - 1 = \frac{1.55}{2.02} - 1 = -23.37\%$$

$$\text{accretion}_{\text{Petro-Canada}} = \frac{\text{EPS per legacy share}}{\text{EPS 2009E without merger}} - 1 = \frac{1.98}{1.07} - 1 = 85.17\%$$

If cost synergies are realized, the deal becomes accretive for both SU and PCA shareholders. Accretion/dilution for Suncor and Petro-Canada shareholders can be estimated as follows:

$$EPS_{\text{SU, LEGACY SHARE}} = \frac{\text{net income}_{COMBINED} + \Delta \text{ net income due to synergy}}{\text{number of shares at 1:1 conversion ratio}}$$

$$\text{synergy} = \frac{\Delta \text{ net income due to synergy}}{\text{WACC - g}}; \text{ with synergy = CAD 15.3 bln,}$$

$$\Delta \text{ net income due to synergy} = 15.3 \times (8.93\% - 2.21\%) = 1.028 \text{ billion}$$

$$EPS_{\text{SU, LEGACY SHARE}} = \frac{935{,}524{,}000 \times 2.02 + 484{,}597{,}467 \times 1.07 + 1{,}028{,}000{,}000}{935{,}524{,}000 + 484{,}597{,}467} = 2.42$$

$$EPS_{\text{PCA}} = EPS_{\text{SU, LEGACY SHARE}} \times \text{exchange ratio} = 2.42 \times 1.28 = 3.10$$

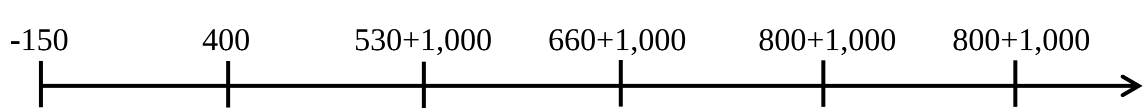
$$\text{accretion}_{\text{SU}} = \frac{EPS_{\text{SU, LEGACY SHARE}}}{\text{EPS 2009E without merger}} - 1 = \frac{2.42}{2.02} - 1 = 20\%$$

$$\text{accretion}_{\text{PCA}} = \frac{EPS_{\text{SU, LEGACY SHARE}}}{\text{EPS 2009E without merger}} - 1 = \frac{3.10}{1.07} - 1 = 189\%$$

Follow-Up

Re-estimated cost synergies

In 2009, Suncor confirmed capital expenditure savings, but increased expected operating savings to $400 million a year. In 2010, Suncor reported that operating synergies, originally targeted at $300 million per year, will grow to approximately $800 million by year 2012. The company also confirmed annual capital efficiencies of $1 billion a year. With these cost reductions, the value of the cost synergy in July 2009 could have been estimated as follows:



0 1 2 3 4 5

At a cost of capital of 8.92 percent for a merged company, present value of synergies is:

$$PV_{SYNERGY}=\frac{-150\times(1\text{-}0.29)}{(1+0.0892)^{0}}+\frac{400\times(1\text{-}0.29)}{(1+0.0892)^{1}}+\frac{530\times(1\text{-}0.29)+1{,}000}{(1+0.0892)^{2}}+\frac{660\times(1\text{-}0.29)+1{,}000}{(1+0.0892)^{3}}+$$

$$+\frac{800\times(1\text{-}0.29)+1{,}000}{(1+0.0892)^{4}}+\frac{\left(880\times(1\text{-}0.29)+1{,}000\right)\div(0.0892\text{-}0.0221)}{(1+0.0892)^{4}}=18{,}505$$

With exchange rate of 1.079 CAD/USD on July 31, 2009, the present value of the synergies would have been USD 17.2 billion compared to USD 14.2 billion in the original scenario.

Post-merger performance once again proved how difficult integration can be. Table 6 compares 3-year changes in market capitalization with changes in the value of the indices. In part, the impact was due to a combination of external factors: (1) unrest in the Middle East disrupted legacy Petro-Canada's operations in Libya and Syria; (2) gap between oil price fetched by Canadian oil producer's relative not only to Brent, but also to WTI Cushing oil prices.
Other operational and financial highlights for 2009-2012 were as follows: (1) in May 2012, Steve Williams replaced Rick George as CEO; (2) Moody's lowered Suncor overall debt rating to Baa2 from Baa1 in October 2009; the agency changed the rating back to Baa1 in 2012.

CONCLUSION

The study demonstrates the difficulty in estimating synergies in mergers/acquisitions and delivering on the promises. External factors-oil prices, exchange rate fluctuations, political risks -affect cash flows and valuation metrics.

Accretion/dilution is a factor of two factors-premiums paid for the target firm and realized synergies. In Suncor/Petro-Canada merger, most of the gains ended in the hands of Petro-Canada's shareholders. Suncor shareholders could capture growth synergies; realizing cost synergies would yield only a small accretion to legacy shares.

Table 5
SELECTED DATA TO ESTIMATE ACCRETION/DILUTION

	Suncor	Petro-Canada	Combined
Forecasted EPS	2.02	1.07	
Number of shares outstanding	935,524,000	484,597,467	
Total number of shares at 1:1 conversion ratio			1,555,808,758
Forecasted net income 2009	1,889,758,480	518,519,290	2,408,277,770
New shares actual at 1:1.28 ratio	935,524,000	620,284,758	

Table 6 CHANGES IN MCAP, JUL 31, 2009 - JUL 31, 2012			
Panel A Market capitalization of firms, USD, billion			
Date	New Suncor, USD bln (SU)	S&P/TSX Capped Energy Index (TTEN)	AMEX Oil Energy Index (XOI)
July 31, 2009	50.5	263.25	961.20
July 31, 2012	46.5	246.85	1196.76
Change, 2009-2012	(4.0)		
Panel B Changes in combined MCAP relative to TTEN Index			
TTEN Index-implied change	-6.20%		
Abnormal change MCAP	-1.70%		
Panel C Changes in combined MCAP relative to XOI Index			
XOI Index-implied change	24.50%		
Abnormal change MCAP	-32.40%		

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