Second quarter 2016 results
July 28, 2016
Conference call notes

Kam Sandhar – Vice-President, Investor Relations & Corporate Development

Thank you operator and welcome everyone to our second quarter 2016 results conference call.

I would like to refer you to the advisories located at the end of today's news release. These advisories describe the forward looking information, non-GAAP measures and oil and gas terms referred to today, and outline the risk factors and assumptions relevant to this discussion. Additional information is available in our most recent Annual Information Form or Form 40-F.

The quarterly results have been presented in Canadian dollars and on a before royalties basis.

We have also posted a link to our quarterly results, including updated guidance, on the home page of our website at cenovus.com.

Brian Ferguson, our President & Chief Executive Officer, will begin with some opening remarks and then turn the call over to Ivor Ruste, Executive Vice-President & Chief Financial Officer, who will discuss our financial performance. Following that, Kieron McFadyen, Executive Vice-President & President, Upstream Oil & Gas will provide an update of our upstream operating performance. Bob Pease, Executive Vice-President, Corporate Strategy & President, Downstream, will then provide an update on our downstream results before turning the call back to Brian for some closing comments. We will then begin the Q&A portion of the call.

Please go ahead Brian.

Brian Ferguson – President & Chief Executive Officer

Thanks Kam. Good morning.

I am pleased to be reporting strong operating and improved financial results for our second quarter. Our focus on costs and production efficiency is paying off.

Cenovus is benefiting from continued strong operational performance, sustained cost savings, operational efficiencies, as well as improved commodity prices and seasonally stronger refining margins.

We remain focused on the commitments we've made to our shareholders over the past eighteen months to build a stronger company; one that is fit to withstand and take advantage of a period of prolonged commodity price volatility that we are experiencing.

We have made some tough, but necessary decisions with respect to capital, workforce reductions and dividends. We believe that these actions have positioned Cenovus to generate superior value for our shareholders over the long-term.

Company-wide, we remain on track to achieve up to $500 million in capital, operating, and G&A cost reductions compared to our original 2016 budget. Of the cost reductions realized over the past eighteen months, we expect about two-thirds are sustainable over the long-term and in a higher commodity price environment.

Continued improvements to our cost and operating structure will help reinforce our position as a cost leader, able to compete globally.

We have a strong portfolio of organic investment opportunities.

Our upstream business continues to deliver strong operating performance. Our oil sands facilities continue to perform at high utilization levels and are demonstrating a steady ramp-up, with volumes averaging about 143,000 barrels per day net in the quarter, primarily as a result of base production optimization and strong performance from new sustaining pads.

As of today, the expansion facility at Foster Creek G is now producing oil and Christina Lake F remains on track for first oil in the third quarter. These two phases are expected to add 40,000 barrels per day net increase in capacity to Cenovus, which represents about a 25 percent increase to our current oil sands productive capacity.

Our downstream integration continues to benefit Cenovus. Our refining business demonstrated excellent operational performance in the second quarter and benefited from seasonally stronger crack spreads.

I am excited to be part of a company that is in a position of such strength. We have created a leaner organization with a strong balance sheet and a top tier portfolio of opportunities to invest in when the timing is right.

Given the strength of our balance sheet and financial position, as well as our high level of confidence that the cost reductions we have achieved will be largely sustainable, I am optimistic about the potential to resume construction on some of our deferred projects. However, we still need additional clarity on federal fiscal and regulatory policies that could impact our operating environment.

We are spending a small amount of capital now to progress Christina Lake G where we are in the process of completing detailed engineering and rebidding work. We expect to provide specific timing and cost estimates on this project, as well as our other deferred projects, as part of our 2017 budget announcement in December.

I want to also take a minute to talk about the devastating forest fires that impacted the city of Fort McMurray and surrounding area during the quarter. Our hearts go out to the many families and businesses that were impacted by this tragedy. I am proud of the way that Cenovus supported the disaster relief efforts and we will continue to offer our support to the community as the rebuilding continues. Cenovus was fortunate that these fires did not affect any infrastructure or operations at our Foster Creek or Christina Lake properties.

Overall, I am pleased with our operational and financial performance during the quarter and look forward to maintaining our momentum through the second half of 2016.

I'm now going to turn the call over to our Chief Financial Officer, Ivor Ruste to provide more details on our financial performance during the quarter.

Ivor Ruste – Executive Vice-President & Chief Financial Officer

Thanks Brian. Good morning, everyone.

Strong operational performance combined with improved commodity prices allowed us to maintain our robust financial position. We exited the quarter with approximately $3.8 billion of cash on our balance sheet and $4 billion in unused credit capacity. Our good debt metrics as at June 30, 2016 were 17 percent net debt to capitalization and 1.9 times net debt to adjusted EBITDA.

Commodity prices remained volatile but WTI improved by over $12.00 per barrel from the first quarter of this year. The upturn in oil prices benefited our total crude oil netback which increased by over $11.00 per barrel from the first quarter, including hedges.
Cenovus reported cash flow of $440 million in the quarter, or $0.53 per fully diluted share. Improved cash flow during the quarter was primarily as a result of strong operations, improved oil prices, higher crack spreads and continued cost improvements across the organization.

We continue to evaluate market opportunities to execute on our hedging strategy of stabilizing cash flow to support financial resilience. Our 2017 hedge positions are weighted towards the first six months of the year as we expect seasonal commodity price weakness to occur during that period. Details of all our hedging positions can be found in our corporate presentation posted on our website.

With today's release, we have updated certain items in our 2016 guidance to reflect actual results to date as well as our projections for the second half of the year. Oil sands capital is down reflecting continued improvements and operating costs are expected to be lower across all areas. Kieron will speak to these improvements shortly. G&A guidance has been increased to account for one-time charges related to staff reductions including severance and lease costs totaling $50 million year to date 2016. Go forward, we expect run rate G&A to be in the $260 to $280 million range on an annualized basis.

As Brian mentioned, we are building a stronger and more profitable organization. Our financial strategy remains unchanged. Our plan is to continue to maintain financial resilience to support our growth while ensuring safe operations and providing long-term value creation to our shareholders.

I will now hand the call over to Kieron to discuss our upstream operations.

Kieron McFadyen – Executive Vice-President & President, Upstream Oil & Gas

Thanks Ivor and good morning everyone. Since joining in April of this year, I have had a good opportunity to engage with our staff and review our operations. Overall, I am extremely impressed by the level of capability and talent across the organization.

I am also very encouraged by the many technical and operational achievements made to date. Building on this track record, my aim is to continue to focus Cenovus as a top tier operator and a cost leader in industry. A cost leader that continually demonstrates operational excellence, enabled by safety, innovation and of course technology.

Once again this quarter, we demonstrated strong operational performance. Plant uptimes have been high and we continue to improve both per unit operating and development costs. For the second quarter, total upstream operating costs were under $9.00 per barrel of oil equivalent.
That is down 12 percent from the previous quarter. It is also down about 25 percent since the fourth quarter of 2014. These improvements are largely a result of better supplier rates, workforce reductions, lower fuel costs and continued optimization efforts.

Once again, Christina Lake continues to demonstrate top-tier performance, with an average SOR of 1.8 in the quarter with the plant running near capacity of 80,000 barrels per day net. Foster Creek also continues to perform well and in-line with our expectations with field volumes ramping up as new sustaining pads are brought on. Production at Foster Creek averaged 65,000 barrels per day net during the second quarter. In the month of June, the field also averaged 69,000 barrels per day net. So overall, we remain on track to exit the year producing in excess of 70,000 barrels per day net from Foster Creek. The Foster Creek phase G and Christina Lake phase F phase expansions are on track and expected to add incremental oil volumes in the third quarter. We expect these phases to ramp up over a twelve to eighteen month period, bringing our total production capacity to 195,000 barrels per day on a net basis.

Our conventional oil and gas business continues to perform well, generating $166 million of free cash flow in the first six months. This part of our portfolio remains highly profitable and generates stable cash flow. As Brian indicated, we are currently reviewing capital allocation opportunities across our entire portfolio and we plan to provide more details and clarity over the coming months. So in summary, in the near term, our focus is to deliver on our operational commitments and at the same time, position for future phases of profitable growth. With safety top of mind, we will continue to seek further opportunities to sustain operational excellence and cost leadership across our asset base. So the measures we have taken, and our continued focus will help ensure our business remains competitive in the current volatile price environment.

Now over to Bob to review our downstream performance.

Bob Pease – Executive Vice-President, Corporate Strategy & President, Downstream

Thanks Kieron.

Our refining and marketing business rebounded from a challenging start to 2016.

As expected, refining margins were positively impacted by higher average crack spreads on increased seasonal demand. The Chicago 3-2-1 crack spread averaged approximately $17.15 per barrel in the second quarter, up over $7.50 per barrel from the first quarter of this year.

Operationally, both Wood River and Borger had very strong performance during the quarter, with average utilization of 100 percent.

The Wood River debottleneck project remains on track for start-up in the third quarter of this year. This light-ends processing project is expected to add 18,000 barrels per day of gross crude capacity, with added flexibility to process more light or dilbit heavy crudes.

Operating cash flow from refining and marketing in the quarter was $193 million. Using the LIFO inventory method as is done in the U.S., our operating cash flow would have been $107 million lower.
As expected, overall bitumen realizations improved substantially in the second quarter as we benefited from blending less expensive condensate purchased in prior periods and sold in a rising price environment. Realized bitumen field price during the second quarter averaged about $30.00 per barrel compared with $10.00 per barrel in the first quarter of this year.

The revenue uplift achieved in the quarter covered incremental oil sands transportation costs resulting from higher rail and pipeline volumes to the United States. Our marketing and transportation strategy remains focused on maximizing the margin of every barrel we produce.

I will now pass the call back to Brian for some closing comments.

Brian Ferguson – President & Chief Executive Officer

Thanks Bob.

Cenovus is in a strong position, both financial and operational, as we enter the second half of 2016. I expect continued volatility in commodity prices and believe we are well prepared to deliver value to shareholders in this new reality.

I have confidence in our assets, our people and our track record. 2015 and 2016 have seen a significant transition in Cenovus's operating model. We have been playing defense for the past 18 months and are now well positioned to resume value added growth in the months ahead.

With that, the Cenovus team is now ready to respond to your questions.

ADVISORY
FINANCIAL INFORMATION

Basis of Presentation Cenovus reports financial results in Canadian dollars and presents production volumes on a net to Cenovus before royalties basis, unless otherwise stated. Cenovus prepares its financial statements in accordance with International Financial Reporting Standards (IFRS).

Non-GAAP Measures This news release contains references to non-GAAP measures as follows:

- Operating cash flow is defined as revenues, less purchased product, transportation and blending, operating expenses, production and mineral taxes plus realized gains, less realized losses on risk management activities and is used to provide a consistent measure of the cash generating performance of the company's assets for comparability of Cenovus's underlying financial performance between periods. Items within the Corporate and Eliminations segment are excluded from the calculation of operating cash flow.
- Cash flow is defined as cash from operating activities excluding net change in other assets and liabilities and net change in non-cash working capital, both of which are defined on the Consolidated Statement of Cash Flows in Cenovus's interim and annual Consolidated Financial Statements. Cash flow is a measure commonly used in the oil and gas industry to assist in measuring a company's ability to finance its capital programs and meet its financial obligations.
- Free cash flow is defined as cash flow less capital investment.
- Operating earnings is used to provide a consistent measure of the comparability of the company's underlying financial performance between periods by removing non-operating items. Operating earnings is defined as earnings before income tax excluding gain (loss) on discontinuance, gain on bargain purchase, unrealized risk management gains (losses) on derivative instruments, unrealized foreign exchange gains (losses) on translation of U.S. dollar denominated notes issued from Canada, foreign exchange gains (losses) on settlement of intercompany transactions, gains (losses) on divestiture of assets, less income taxes on operating earnings (loss) before tax, excluding the effect of changes in statutory income tax rates and the recognition of an increase in U.S. tax basis.
- Debt to capitalization, net debt to capitalization, debt to adjusted EBITDA and net debt to adjusted EBITDA are ratios that management uses to steward the company's overall debt position as measures of the company's overall financial strength. Debt is defined as short-term borrowings and long-term debt, including the current portion. Net debt is defined as debt net of cash and cash equivalents. Capitalization is defined as debt plus shareholders' equity. Net debt to capitalization is defined as net debt divided by net debt plus shareholders' equity. Adjusted EBITDA is defined as earnings before finance costs, interest income, income tax expense, depreciation, depletion and amortization, goodwill and asset impairments, unrealized gains or losses on risk management, foreign exchange gains or losses, gains or losses on divestiture of assets and other income and loss, calculated on a trailing 12-month basis.

These measures do not have a standardized meaning as prescribed by IFRS and therefore are considered non-GAAP measures. These measures may not be comparable to similar measures presented by other issuers. These measures have been described and presented in this news release in order to provide shareholders and potential investors with additional information regarding Cenovus's liquidity and its ability to generate funds to finance its operations. This information should not be considered in isolation or as a substitute for measures prepared in accordance with IFRS. For further information, refer to Cenovus's most recent Management's Discussion and Analysis (MD&A) available at cenovus.com.

Netbacks reported in this news release are calculated as set out in the Annual Information Form (AIF). Heavy oil prices and transportation and blending costs exclude the costs of purchased condensate, which is blended with heavy oil. For the second quarter of 2016, the cost of condensate on a per-barrel of unblended crude oil basis was as follows: Christina Lake – $26.24 and Foster Creek – $24.76.

FORWARD-LOOKING INFORMATION

This document contains certain forward-looking statements and other information (collectively “forward-looking information”) about Cenovus's current expectations, estimates and projections, made in light of the company's experience and perception of historical trends. Forward-looking information in this document is identified by words such as “anticipate”, “expect”, “estimate”, “plan”, “target”, “position”, “project”, “capacity”, “potential”, “may”, “on track”, “confidence” or similar expressions and includes suggestions of future outcomes, including statements about: milestones and schedules, including expected timing for new oil sands expansion phases; potential for resumption of deferred project construction; projections for 2016 and future years; forecast operating and financial results; targets for our debt to capitalization and debt to EBITDA ratios; planned capital expenditures; expected future production, including the timing, stability or growth thereof; our ability to preserve our financial resilience and plans and strategies with respect thereto; achieved and forecast cost savings and sustainability thereof; and dividend strategy. Readers are cautioned not to place undue reliance on forward-looking information as our actual results may differ materially from those expressed or implied.

Developing forward-looking information involves reliance on a number of assumptions and consideration of certain risks and uncertainties, some of which are specific to Cenovus and others that apply to the industry generally. The factors or assumptions on which the forward-looking information is based include: forecast oil and natural gas prices and other assumptions inherent in Cenovus's 2016 guidance (as updated on July 28, 2016), available at cenovus.com; projected capital investment levels, flexibility of capital spending plans and associated source of funding; future cost reductions; sustainability of cost reductions; expected condensate prices; estimates of quantities of oil, bitumen, natural gas and liquids from properties and other sources not currently classified as proved; future use and development of technology; ability to obtain necessary regulatory and partner approvals; successful and timely implementation of capital projects or stages thereof; the company's ability to generate sufficient cash flow to meet its current and future obligations; estimated abandonment and reclamation costs, including associated levies and regulations; and other risks and uncertainties described from time to time in the company's filings with securities regulatory authorities.

The risk factors and uncertainties that could cause the company's actual results to differ materially, include: volatility of and assumptions regarding oil and natural gas prices; the effectiveness of the company's risk management program, including the impact of derivative financial instruments, the success of hedging strategies and the sufficiency of liquidity position; accuracy of cost estimates; commodity prices, currency and interest rates; product supply and demand; market competition, including from alternative energy sources; risks inherent in Cenovus's marketing operations, including credit risks; exposure to counterparties and partners, including ability and willingness of such parties to satisfy contractual obligations in a timely manner; risks inherent in operation of the company's crude-by-rail terminal, including health, safety and environmental risks; maintaining desirable ratios of debt to adjusted EBITDA and net debt to adjusted EBITDA as well as debt to capitalization and net debt to capitalization; ability to access various sources of debt and equity capital, generally, and on terms acceptable to Cenovus; ability to finance growth and sustaining capital expenditures; changes in credit ratings applicable to Cenovus or any of its securities; changes to dividend plans or strategy, including the dividend reinvestment plan; accuracy of reserves, resources and future production estimates; ability to replace and expand oil and gas reserves; ability to maintain relationships with partners and to successfully manage and operate the company's integrated business; reliability of assets, including in order to meet production targets; potential disruption or unexpected technical difficulties in developing new products and manufacturing processes; occurrence of unexpected events such as fires, severe weather conditions, explosions, blow-outs, equipment failures, transportation incidents and other accidents or similar events; refining and marketing margins; inflationary pressures on operating costs, including labour, natural gas and other energy sources used in oil sands processes; potential failure of products to achieve acceptance in the market; risks associated with fossil fuel industry reputation; unexpected cost increases or technical difficulties in constructing or modifying manufacturing or refining facilities; unexpected difficulties in producing, transporting or refining of crude oil into petroleum and chemical products; risks associated with technology and its application to Cenovus's business; risks associated with climate change; the timing and costs of well and pipeline construction; ability to secure adequate product transportation, including sufficient pipeline, crude-by-rail, marine or other alternate transportation, including to address any gaps caused by constraints in the pipeline system; availability of, and ability to attract and retain, critical talent; changes in labour relationships; changes in the regulatory framework in any of the locations in which Cenovus operates, including changes to the regulatory approval process and land-use designations, royalty, tax, environmental (including in relation to abandonment, reclamation and remediation costs, levies or liability recovery with respect thereto), greenhouse gas, carbon and other laws or regulations, or changes to the interpretation of such laws and regulations, as adopted or proposed, the impact thereof and the costs associated with compliance; the expected impact and timing of various accounting pronouncements, rule changes and standards on Cenovus's business, financial results and consolidated financial statements; changes in the general economic, market and business conditions; the political and economic conditions in the countries of operation; occurrence of unexpected events such as war, terrorist threats and the instability resulting therefrom; and risks associated with existing and potential future lawsuits and regulatory actions.

Readers are cautioned that the foregoing lists are not exhaustive and are made as at the date hereof. For a discussion of Cenovus's material risk factors, see “Risk Factors” in the company's AIF or Form 40-F for the period ended December 31, 2015, together with the updates under "Risk Management" in each of the company's first quarter 2016 and second quarter 2016 MD&A, available on SEDAR at sedar.com, EDGAR at sec.gov and on the company's website at cenovus.com.

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