ENERGY M&A IN THE NEW ABNORMAL

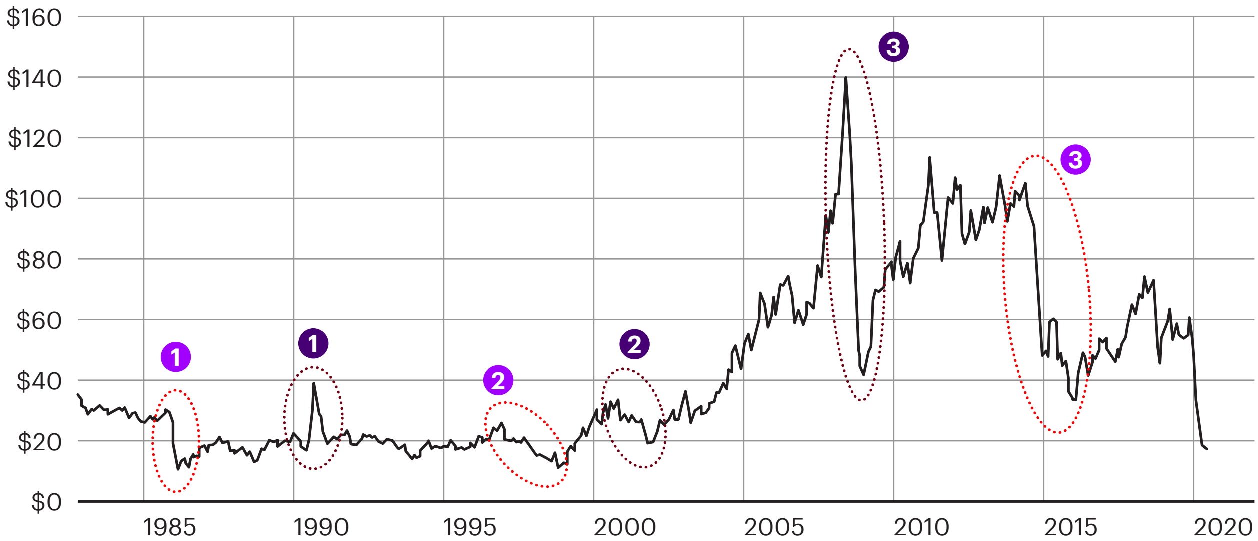
Unique times present unique opportunities

The oil and gas (O&G) industry today is operating in unchartered territory that few would have thought possible as we entered 2020.

For weeks, Russia and Saudi Arabia were in all-out competition for market share, driving crude prices down. Such supply driven price shocks are rather infrequent, but we've seen them before—first in 1985 with a year-long OPEC fracture; again in 1997, with the Saudi-Venezuela price war; and most recently in 2014 with the Saudi "pump-at-will" policy (Figure 1).

Each of these events lasted more than 12 months, with the 2014 shock dragging on for nearly two years. We are, however, seeing response from this with OPEC+ nations coming to a resolution to reduce output of global production by 9.7 million barrels per day in May 2020 with staggered reduction into 2022. The deal only puts a dent in the issues facing the industry and has obstacles to implementation.

Figure 1: Past price wars and other shocks to oil supply and prices



Price/Supply Wars

1. 13 Months of Saudi Arabia Flooding the Market after OPEC Fractures, leading to a 60% decrease in prices over 6 months
2. 17 Month Saudi/Venezuelan Price War for Market Share of Americas leads to a 50% decrease in prices
3. 22 Month Saudi "pump-at will" policy leads to a 60% decrease in prices

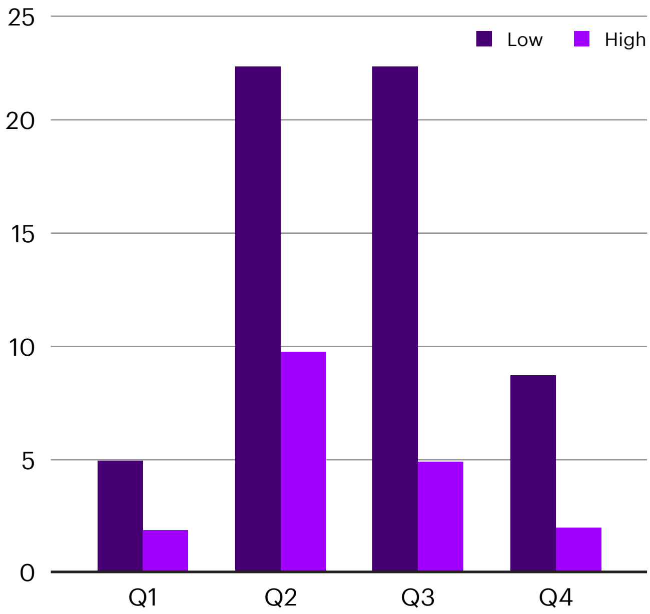
Other "Shocks"

1. Gulf War leads to 100% increase and subsequent 50% decrease in prices over only a few months
2. 9/11 leads to 35% decrease in oil prices within a month
3. Great Recession leads to a rapid 65% decrease in oil prices

Supply shocks and their impact on prices are not new. However, the combination of the supply surge with a demand destruction, due to the current economic slump, is truly novel and unprecedented. This has delivered crippling blows to O&G companies across the globe. The industry's supermajors had lost upwards of 50 percent in enterprise value and an average of $105 billion in under two months (from late January to late March). The entire industry is scrambling for solutions to the existential problems companies have faced in the past 2 months and bleak demand outlook (Figure 2).

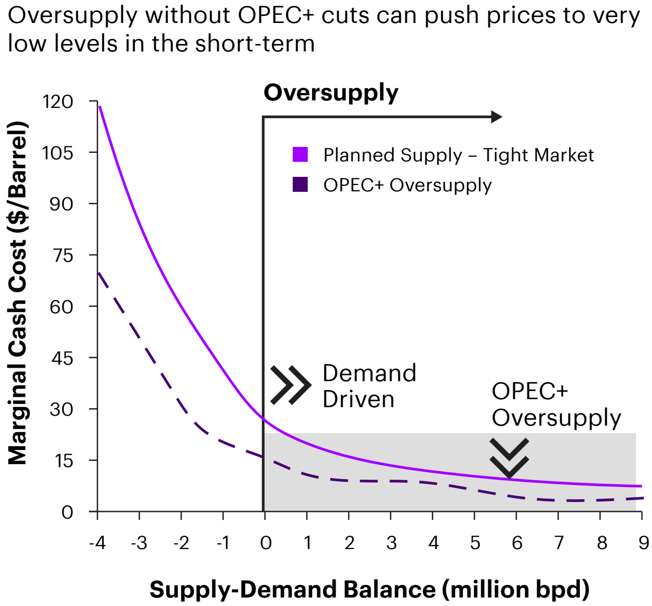
Of course, both of these developments are unfolding against the backdrop of the industry's ongoing shift to a broader mix of energy sources which will force the industry into a structural transformation in the near future. The recent events won't dramatically change that reality and, in fact, may even hasten its arrival. Furthermore, the double supply-demand shock the industry is currently experiencing will more than likely serve as a catalyst for sweeping change in the geographies of the upstream operations of national oil companies (NOCs) and majors. These broader and longer-term dynamics are important considerations and can't be ignored. However, in the short term, we believe O&G leaders shouldn't lose sight of the significant value opportunities in upstream North America consolidation and other transactions made possible by the current one-two punch supply-demand shock. And time is of the essence.

Figure 2: Projected 2020 demand destruction (Million bpd)



Source: Accenture analysis

Figure 3: Double shock impact on oil prices



Source: Accenture analysis

Unique times present unique opportunities

O&G companies are accustomed to volatility, and in times like these the biggest immediate priority is always enacting short-term fixes—OPEX and CAPEX reductions, process efficiency evaluations, and organic growth strategy revisions—to stem the bleeding and remain solvent. That's Business Survival 101. The complete and sudden collapse of global oil prices since February has already led to severe cuts in capital spending across O&G companies, with many more actions on the horizon to cut their losses.

But the current dual shocks also present a limited window of opportunity to execute opportunistic transactions and undertake a fundamental strategic evaluation of the business in a unique environment. Leaders need to use this extremely rare confluence of events to assess potential acquisitions, conduct portfolio reviews and take a hard look at the fundamentals of their own business and the broader industry.

Challenging times can lead to opportunities for structural change, with successful companies coming out of a slump or crisis in an improved position. The supermajors are armed with significant capabilities and resources to make strategic and opportunistic investments that can be extremely important to their longer-term viability.

In fact, given the current market dynamics, some sort of consolidation is inevitable in the next year, and it's more than likely going to happen via M&A activity in three ways: opportunistic industry consolidation across the upstream segment to capture strategic value through potential acquisitions and mergers; increased financial firm activity to include activist investors; and a renewed focus on structural changes and consolidation across segments.

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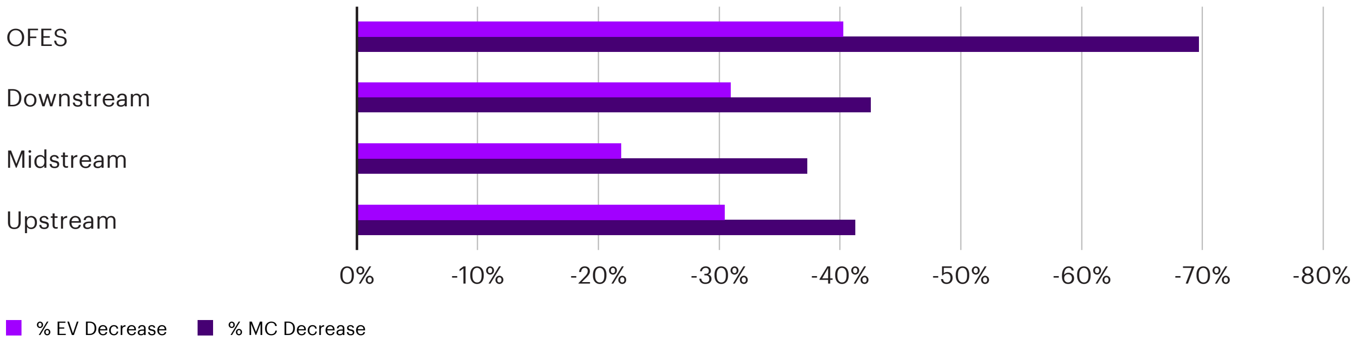
Industry consolidation on the horizon

The industry overall has seen a drastic decrease in value in the past three months (Figure 4), with market capitalization and overall enterprise value in free fall across all sectors.

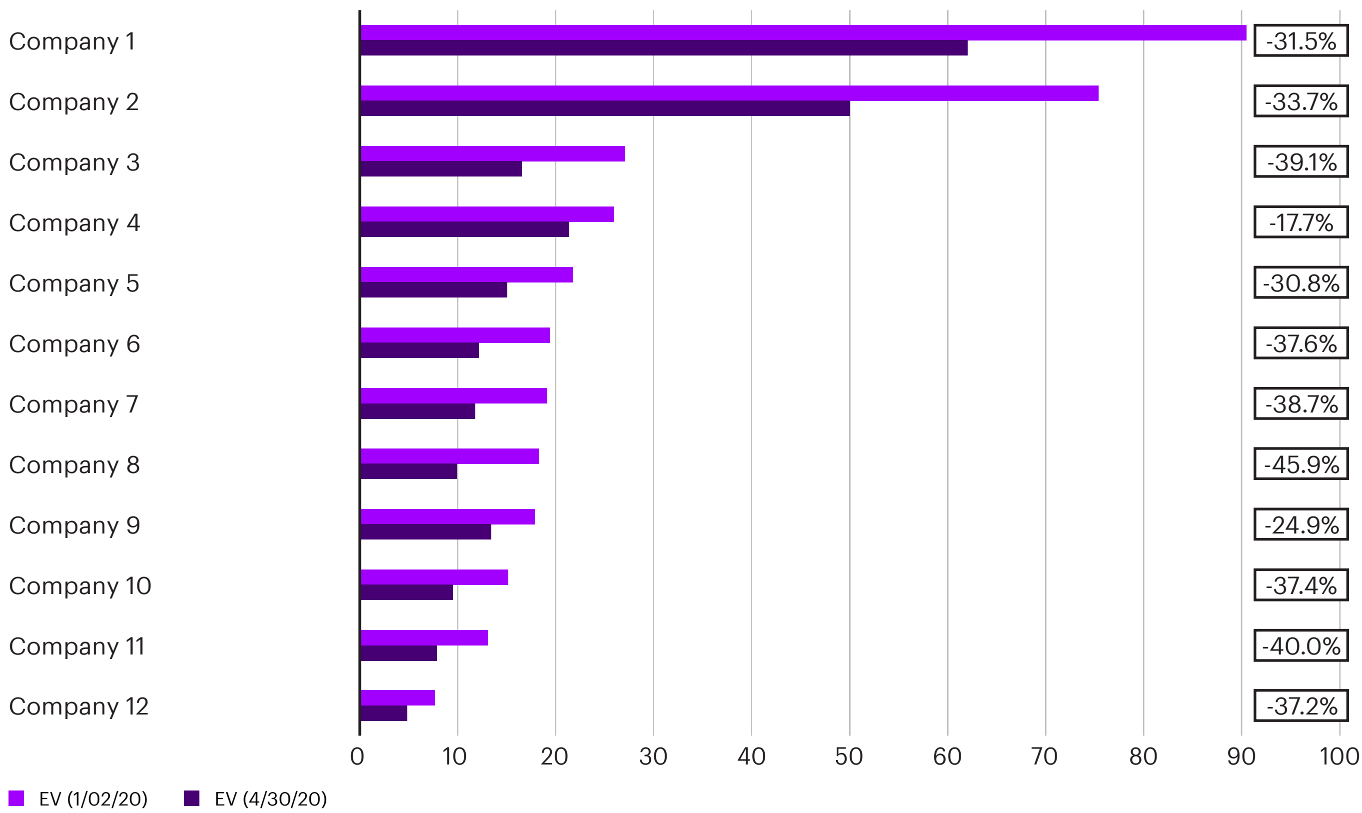
While companies across the value chain attempt to absorb the blow, significant pain is being felt by the independent, pure-play upstream companies and oilfield and equipment service (OFES) companies of all sizes (Figure 5).

Figure 4: Average decrease in value by sector(%) – January 2nd to April 30th



Source: Accenture analysis

Figure 5: Falling enterprise values of pure-play upstream companies



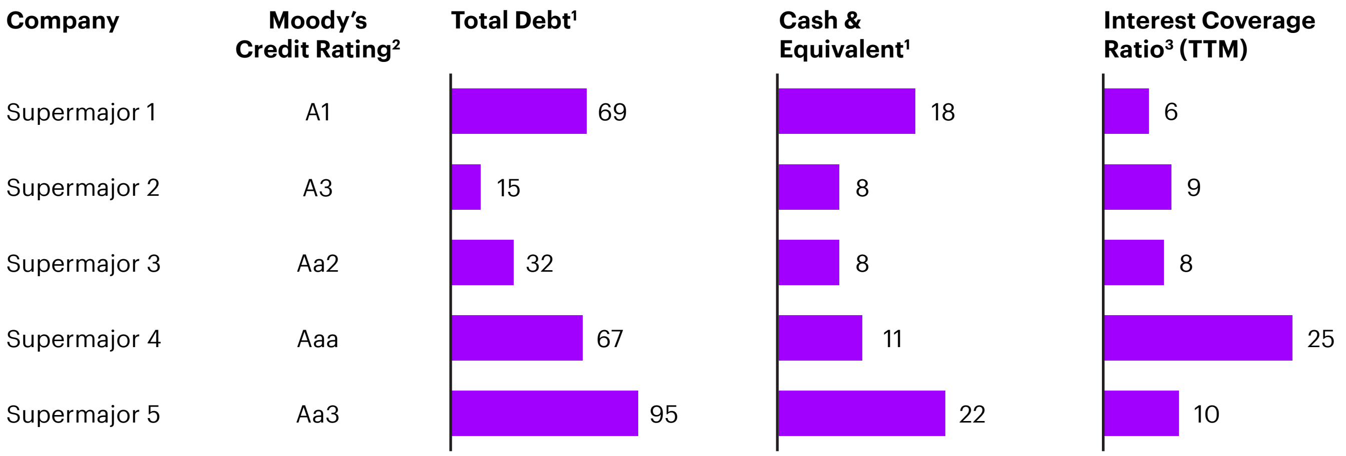
Source: Accenture analysis

On the other hand, the supermajors' integrated model has provided a small hedge to thinning margins as selling from the oil-head alone at current market prices simply cannot generate sustained profitability in current economic environments.

With prices tumbling, the supermajors have displayed more resiliency while maintaining the ability to make industry moves, if needed, by ensuring liquidity through cash on hand, cash equivalents, and access to additional debt. The largest players have highly rated investment-grade credit ratings, strong interest coverage ratios, and modest net debt (Figure 6). Extreme volatility has created a "freeze" in some of the debt markets with increasing interest spreads between investment and junk bonds leading to dry debt markets for most independents. Many companies are also significantly handcuffed given the evaporation of the option of stock deals due to depressed stock prices. A pullback of bank loans to upstream companies is expected, with pursuant increases in bankruptcies and write-offs likely over the next 12 or more months. However, although the overall desire to lend to the industry may diminish, we continue to see appetite for loans to supermajors even if their credit ratings are downgraded and the cost of borrowing rises.

These factors, combined with planned CAPEX reduction, suggests a supermajor play for an upstream independent is very achievable in this environment. Furthermore, we believe these larger and well-capitalized companies could make a play for regional and pure-play companies, such as those focused on the Permian basin. With a slew of potential bankruptcies on the horizon and the possibility of asset fire sales forthcoming to cover debt payments, industry leaders' corporate development teams will find a compelling reason to revisit potential asset purchases or acquisitions. Alternatively, in search for solvency, these independent organizations are already becoming prime targets for a financial buyer as well as vulnerable to influence from activist investors. This has significant strategic implications for both the supermajor and independent, especially if they are co-located. A consolidation of assets would allow organizations to find ways to address thinning margins by driving toward a process of physical integration.

Figure 6: Supermajors' financial picture



[1] As of March 31st, 2020
[2] As of April 2020
[3] As of Decemer 31st, 2019

Source: Accenture Analysis

The strategic implications are just as important as the value capture in buying in a down market, considering where the strategic benefits exist between two organizations. A prime example of this is what transpired in 2009 when a major integrated oil company diversified its portfolio by making a play for a large, natural gas-focused producer. While the deal was effective in strategic diversification, it became apparent that there was a premium paid given the timing of the deal. Making a move in today's environment would mitigate the risk of "buying high" in a transaction – especially if a company believes that oil markets will recover in the next year.

In contrast to many O&G acquisitions of the past several years, the wave of "mega-mergers" from late 1998 to late 2000 are seen as value-adding. These transactions occurred at a time when prices were in a trough and the industry was structurally morphing to realize corporate cost synergies, gain the ability to invest in mega-projects, and ensure long-term sustainability and competitiveness. We may be entering a similar era.

If supermajors can't or won't make moves, the current economic situation may force pure-play upstream organizations to merge to find economies of scale, justify the severe cuts to OPEX, and ultimately avoid bankruptcy. For example, many upstream companies are announcing major cuts in planned 2020 OPEX with upwards of a 50% decrease (or much more) from 2019 figures. Most smaller firms have made even more drastic cuts since mid-March. However, a mere cutting of OPEX and CAPEX is not going to be enough in current environments. Faced with growing debt requirements that may become impossible to maintain, consolidating efforts in a merger of equals to leverage synergies may be the best option in this extremely low-price environment, similar to that in the late 1990s.

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Increase in private equity presence and activism

Alternatively, as they search for solvency, these organizations are already becoming prime targets for financial buyers, as it often happens in the industry. We saw this during the 2015 supply shock in which financial buyer-driven M&A activity among upstream companies spiked dramatically relative to years past. Private equity involvement may be magnified in this cycle.

In addition to financial buyers, activist investors will become a more significant force in the M&A environment as downward pressure on price forces additional cost cutting measures.

We can expect activists to make timely investments in stocks to prepare for a rebound or force M&A activity for quick profits. Alternatively, activists and hedge funds will look to the debt markets to buy junk bonds for a large potential upside or the ability to gain control of company assets if bankruptcies do begin in earnest.

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Structural change and cross-segment consolidation

The clear opportunity for disruption is not isolated to the upstream sector, however, as we see additional areas across the value chain where business may be fundamentally transformed. There are undoubtedly rumblings about the change in the landscape across the downstream sector, which has also been devastated by the current environment. Valuations have depressed significantly, which could elicit consolidation by independent refiners. Additionally, we expect capacity will be pulled out of the market given inefficiency in asset allocation and overall operations. Refiners with poor strategic positioning and cost structures will be in precarious positions.

Finally, with fundamental shifts in value, international oil companies (IOCs) may re-evaluate re-entering the retail business to better capture full value and effectively deploy capital in a depressed market environment.

The OFES sector faces a dismal scenario, as well, as many firms have seen crippling market cap declines ranging from 50 percent to 80 percent from January to March. This is another crushing blow to a sector that has already struggled through the past five years.

Thus, the stage is set for a litany of potential transactions, as current events have altered the M&A landscape in two significant ways:

1. More relaxed regulatory stance will emerge to help drive through mega-mergers in response to companies' current struggles and the industry's weak long-term outlook.

2. Additional opportunities for consolidation and synergies will appear with valuations plummeting, high excess debt and low prospects for positive cash flow crippling mid-size players, and bankruptcy or complete shutdown becoming the only options for small companies.

Another, less traditional method may be at play here as well: The concept of capitalizing on the evaporating oilfield service industry. With declining revenue, upstream organizations can look to reduce OPEX and find synergies by acquiring the OFES company that services them. This move would be best positioned for large players with dominant positions in specific basins with the goal of reducing market inefficiencies.

Only three things are certain

Never in history have O&G companies faced such a dual existential threat. With oil prices cratering, companies would typically be somewhat comforted by a boom in consumption of a much cheaper critical resource. But not this time. Prices at the pump are the lowest they've been in years, nonetheless the current situation has forced many people off the roads and out of the air. And there are no obvious clues when things will improve.

With all the uncertainty in the market, there are only three things that O&G companies know for sure: Other supply and demand shocks will occur, prices will be volatile, and the market will exert pressure to adapt and re-structure to meet changing needs of investors. It's not a stretch to say that how companies respond in the next six to 12 months could define the industry for decades to come.

1

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2

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3

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