Enhancing Return on Invested Capital: Three Actions for Oil and Gas Companies
As oil and gas companies are being challenged by volatile crude prices, enhancing return on invested capital (RoIC) has never been more critical. Current conditions are proving strategies linked solely to growing top or bottom-line earnings are not sustainable for long-term value creation. By taking a more integrated approach to RoIC across the asset portfolio we estimate oil and gas companies could potentially benefit from up to 20-32% RoIC uplift.

While the industry has historically focused on enhancing RoIC, growth in capital investments, volatility of prices and complexity in managing unit margins of both upstream and midstream assets have hindered its ability to act on both sides of the RoIC equation. A number of pressures, including the need to sustain capital-intensive investments in unconventional plays and to increase exploration & production (E&P) activities to maintain reserve replacement ratio above one, have been aggravated by increased competition among government-backed national oil companies (NOCs) prioritizing supply security over return optimization.

As a result, between 2004 and 2014 the industry suffered valuation discounts against its global peers on an enterprise value (EV)/EBITDA and a price/cash flow (P/CF) basis of over 40% and 35%, respectively. This prompted the need to define strategies for enhancing long-term shareholder return. However, while operating profit provides insights into expected earnings or cash flow growth, shareholder value will only be achieved if adequate compensation exists for the incremental capital needed to generate that growth. This confirms the imperative for optimizing RoIC.

In approaching RoIC enhancement strategies, oil and gas players need to take an integrated approach across their respective portfolio across three core pillars:

1. **Achieve commercial optimization through asset-backed trading:** Leading oil and gas portfolio players and traders have employed trading strategies including quality, locational, real asset, pricing and seasonal arbitrage to extract incremental unit net margin on crude oil, petroleum products, refining cracks and liquefied natural gas (LNG) trading. To enhance trading net operating profit after taxes (NOPAT) by an estimated 5-7%, these strategies must be actively employed and supported by advanced contract structuring capabilities and logistics optimization models focused on maximizing portfolio optionalities and frequency of arbitrage trading. Achieving this will require a trading-centric operating model that optimizes long and short positions in an integrated portfolio.

We worked with an Asian national oil company (NOC) to develop an oil and gas portfolio optimization model that underpins the development of its long-term strategy for supply and sales trading and contracting, balancing its term and spot commitments on different pricing structures for the next 20 years. The portfolio-centric approach to oil & gas trading ultimately helped the national oil company optimize future contracting decisions, which could represent long-term multi-billion dollar commitments.
2. Optimize balance sheet through alternative capital structures: Alternative commercial arrangements and capital structures, such as off-balance sheet greenfield investments with retained usage rights through tolling, provide an effective means to secure asset capacity without having to commit full capital funding. Additional working capital financing solutions intermediated by new trade financing funds or risk capital management solutions can further reduce working capital requirements for operations. Overall, depending on their asset base, oil and gas players’ total capital employed could be reduced by 10–20%, while maintaining the same level of commodity throughput or asset capacity to generate return. Developing such capital-light balance-sheet structures would, in turn, necessitate advanced enterprise risk management, commercial and capital structuring capabilities.

We worked with the executive management of an international oil company (IOC) to develop its long-term balance sheet strategy, with heavy reliance on alternative contractual and commercial structures to support an ambitious US$15bn five-year investment plan focusing on E&P assets. Through the development of alternative balance-sheet structure models, we identified US$3–4 billion of incremental alternative financing options targeting midstream assets (e.g., FPSO, products pipelines, terminals and tank farms). Capital released through identified capital-efficient structures ultimately supported the long-term strategic objectives of the international oil company in strengthening its balance sheet while enhancing its reserve replacement ratio.

3. Portfolio expansion through sophisticated investment and M&A deal execution: Investments to grow production and processing capacity are needed to generate the volume growth required for oil and gas players to sustain their reserve replacement ratio. However, investment execution can benefit substantially from value engineering, commercial and capital optimization techniques that maximize risk-adjusted return. With a productive assets growth ratio of c.2x in 2014, future NOPAT will rely heavily on future capital investments and M&A. Oil and gas players will therefore need to enhance their transactions execution, leveraging advanced financial and risk analytics models to improve risk-adjusted returns.

We worked with the management of an NOC to develop the optimal technical, capital and commercial structure for a 200,000 barrels per day (bpd) refinery joint venture project. As a result, the NOC was able to evaluate investments structures based on an efficient-frontier framework and select the optimal risk-adjusted investment model for final investment decision.

Our work with leading oil and gas players in developing value-enhancing strategies across trading, balance sheet optimization, investments and M&A has highlighted a potential for up to 20–32% uplift and demonstrated the benefits of an integrated approach to RoIC across the assets portfolio. As financial globalization drives companies across all sectors to compete for an affordable cost of capital, the oil and gas industry must now construct and deploy sophisticated RoIC enhancing strategies to attract shareholders and bridge the valuation gap with other sector equities. Ultimately, industry leaders will be those optimizing their balance sheets to achieve superior returns through trading-centricity, alternative capital financing and best-in-class M&A and investment deal execution.
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