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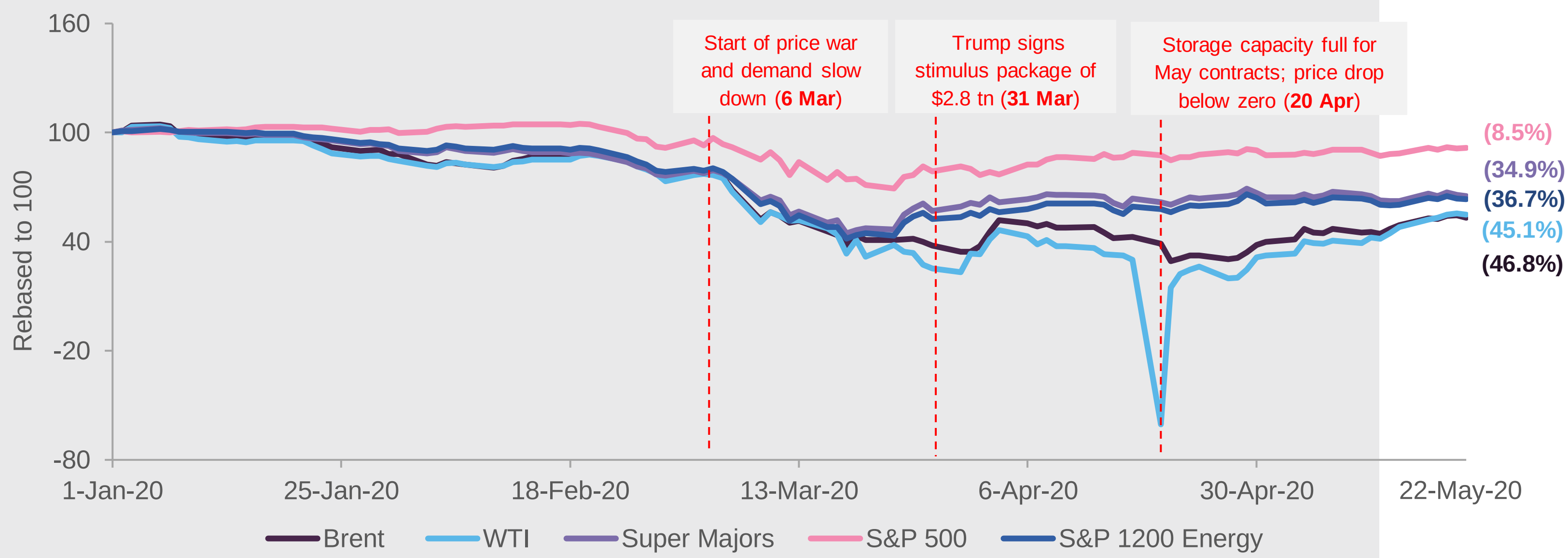
COVID-19: Impact on Oil and Gas Industry M&A

The global oil demand has been heavily impacted due to the COVID-19 pandemic, disrupting M&A trends across O&G Sector.

Industry Intelligence: Views on current M&A scenario, contributing factors and outlook in O&G Industry.

Currently, the world economy is facing unprecedented uncertainties due to COVID-19. The lockdown measures implemented globally to curb the spread of the COVID-19 pandemic have led to a weakening of oil demand in an already volatile and fragile Oil and Gas (O&G) market, with the EIA forecasting, the global consumption and production gap to broaden to -11.4 million barrels per day (MMbbl/d) in Q2' 20 from -6.6 MMbbl/d in Q1' 20. Further, the lack of agreement on production cuts between the OPEC countries and Russia, in March 2020, put additional pressure on crude prices. However, in April 2020, the OPEC countries and Russia agreed to cut oil production by 9.7 MMbbl/d for May 2020 and June 2020. Additionally, in early May 2020, Saudi Arabia announced an additional cut in production by 1.0 MMbbl/d from 1st June 2020 onwards. US has also seen a recent decline in crude oil production and a recent report by the EIA forecasts that the crude oil production from the seven major shale formations is forecasted to fall by 197,000 bbl/d to 7.8 MMbbl/d in June 2020. While these production cuts will provide some support to the crude oil prices, but all the recent events have created an unwarranted situation for the O&G industry, widening the gap between major O&G companies and the S&P 500 in 2020.

YTD share price performance: Super Majors Vs. S&P Oil & Gas Vs. S&P 500



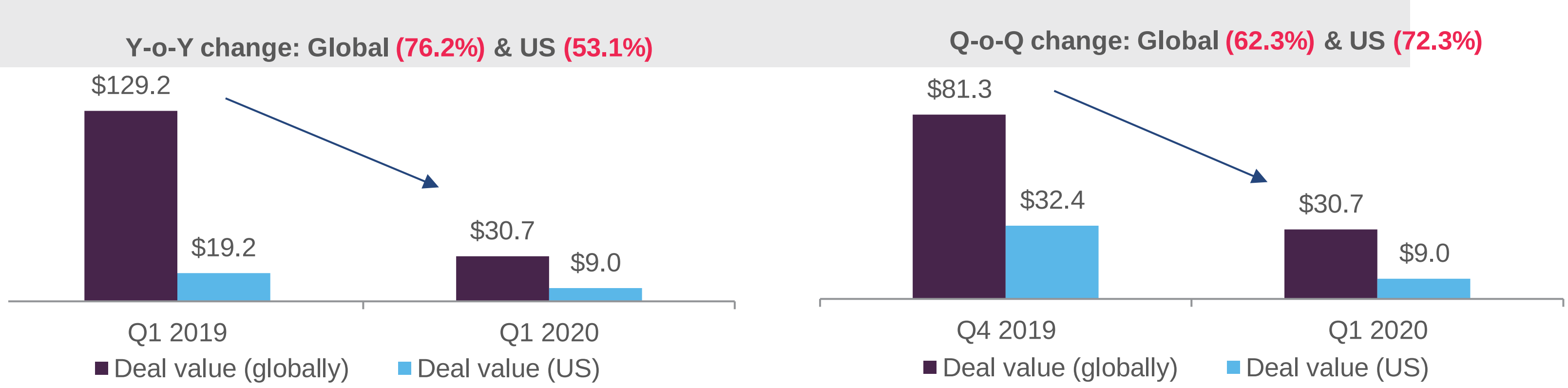
Source: Factset.

Note: Super majors include Exxon Mobil, Royal Dutch Shell, Chevron, BP, Total, Eni, and Equinor.

Current M&A Scenario in Oil and Gas Sector

1. **Crash in global deal activity:** According to GlobalData, 478 O&G deals, totaling USD30.7bn, took place globally in Q1' 20, representing a 73% decline in value and 18.7% decrease in volume compared with the average of USD113.6bn and 588 deals during the last four quarters. During Q1' 20, the US recorded 102 deals with a total value of USD9.0bn, a drop of 79.3% compared with the last four-quarter average of USD43.4bn. Compared with historical numbers, these M&A values are certainly disappointing. Moreover, a majority of the Q1 deals took place before March 2020. We believe any pending Q1' 20 deals could be negotiated with lower deal value or may even be terminated, further exacerbating the situation.

M&A Deal Value (in USD bn)

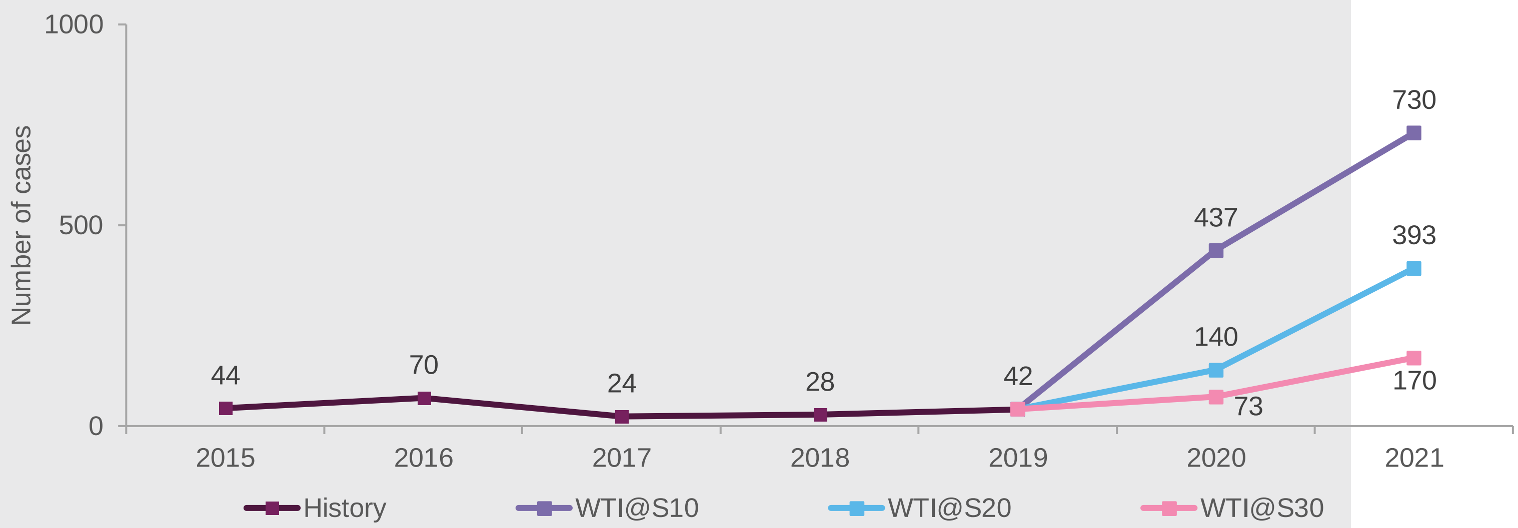


Source: GlobalData

2. **Rise in bankruptcy and restructuring in upstream and services sectors:** According to a Dallas Federal Energy survey, to generate a decent bottom line, shale oil producers require a per barrel breakeven oil price range of USD48 to USD54. EIA in its May 2020 short term energy outlook, is forecasting WTI prices for 2020 and 2021 at USD 30.10 and USD 43.31 respectively. Hence, US shale oil firms, with low revenues, high operational costs, and heavy leverage on their books, may not be in a position to remain afloat. Some of the weaker players may end up taking the bankruptcy route or could be taken over by stronger competitors.

   According to Rystad Energy, a USD20 oil environment will lead 533 American upstream companies to file for bankruptcy by the end of 2021, while a USD10 environment will lead to 1,167 bankruptcies. Further, in a USD20 scenario, more than USD70bn of oil company debt will get reorganized in bankruptcy in 2020, followed by USD177bn in 2021. There are a total of ~9,000 O&G operators in the US, with the top 50 accounting for 69% of oil supply last year. If the expected number of bankruptcies occur, not only will the upstream sector plummet, the cutbacks in E&P producers' capex budgets will also negatively impact oil field services (OFS) companies.

Total US E&P Chapter 11 Scenarios by Year and at different WTI oil prices



Source: Rystad Energy research and analysis, Haynes and Boone Oil Patch Bankruptcy Monitor

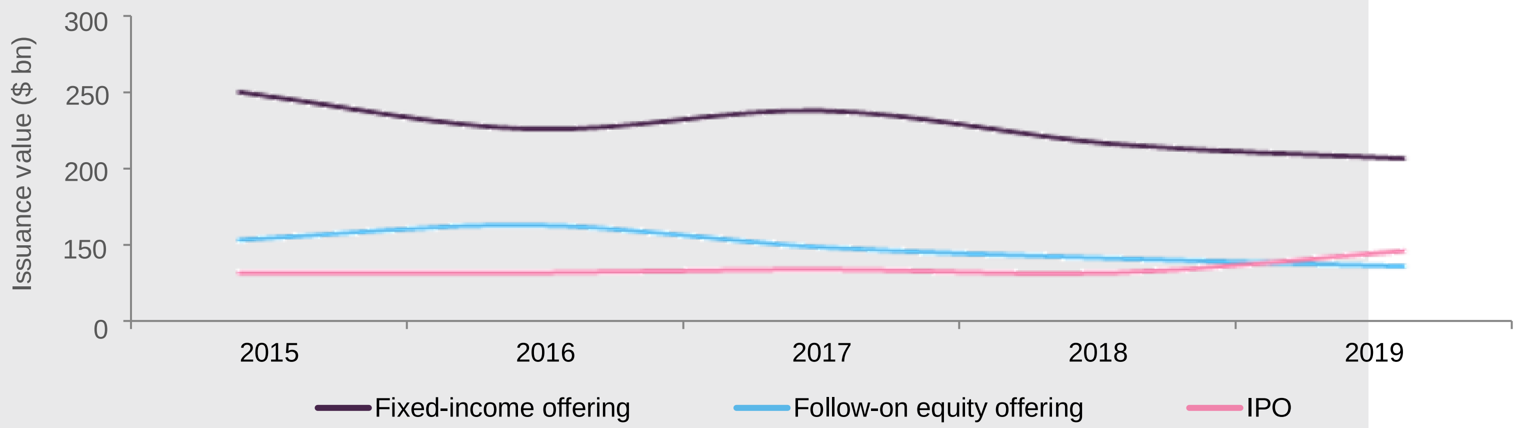
Factors Weakening M&A Situation

In the current situation, mid-cap and large-cap companies, including super majors and national oil companies with cash in hand, are refraining from pursuing any M&A activity and focusing on business survival. They are expected to become active when economic recovery picks up and prices are still a bargain for them. Nonetheless, given the volatile nature of the industry, there could still be a few other factors that could weaken M&A activity:

1. **Focus on current operations**: Many big O&G firms with the firepower to drive M&A are focused on devising new strategies to work efficiently and reduce the operational cost, rather than putting efforts on M&A due diligence

2. **Obstacles to raising capital for deals amid working capital needs:** The lockdown has led to a liquidity crisis, as companies / individuals may have started putting aside cash to meet future capital needs. This is further straining capital markets, which have declined over the past few years (as shown in the chart below). The IPO market has dried up in the last five years, and the availability of other routes of financing (equity and debt) have also declined. Nonetheless, debt offerings may work better, as larger players have sounder leverage management, backed by large proven reserves and yielding assets on their books. In fact, many super majors raised a considerable amount of debt in April 2020. For example, Exxon raised USD9.5bn, Equinor raised USD5.0bn, Shell raised USD7.1bn, BP raised USD6.9bn, etc. The funds were raised to ensure liquidity for any operational needs.

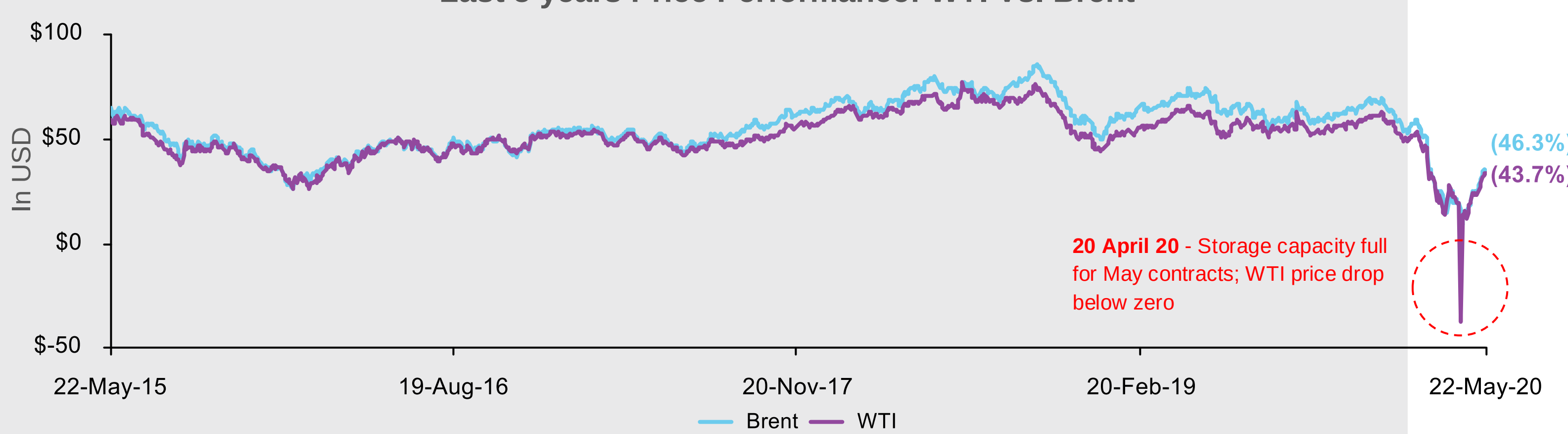
Financing markets in O&G sector since 2015



Source: Data and analytics provided by S&P Global Market Intelligence

3. **Limited or no acquisition activity by smaller upstream players:** Lower oil prices over the last few years (as shown in the chart below), coupled with higher capex involved in finding new wells, have simultaneously strained the top line and bottom line of small upstream players. This has stretched their books, further drying up their fundraising capacity, thereby reducing any M&A interest even if a few strategic opportunities may emerge.

Last 5 years Price Performance: WTI Vs. Brent



Source: Factset.

4. **Drop in the quality of assets available for sale for bigger players:** In the current scenario of falling oil prices, distressed players with large assets may hold on to their assets to generate revenue for sustenance. Thus, for bigger players that are looking to buy these assets, M&A opportunities look restrictive.

5. **Private equity's paradigm shift leaves little room:** Previously, private equity investors in the sector focused more on early-stage shale oil producers. However, they have now started focusing more on companies with large proven reserves in their portfolio, which are less susceptible to oil price fluctuations, thereby hinting at fewer M&A opportunities for energy-focused funds. This paradigm shift is evident from the fact that O&G focused funds in the US have been among the lowest yielding asset classes for private capital over 10 years (according to Preqin), with a median internal rate of return about five percentage points lower than that of comparable buyout firms.

M&A outlook – All that Glitters is Not Gold

Given that oil price is trading at its lowest point in the last two decades, the short-term M&A outlook in the industry should be promising, as a lot of stressed deals with low or no acquisition premium could come up for sale. However, that is not the case due to the uncertainties related to the COVID-19 pandemic. Nevertheless, the following trends might pick-up in the M&A space:

1. **More stock deals or asset swap deals can take place:** Since cash is essential, large-cap and mid-cap firms may go for stock deals or asset swap deals, especially in this tough credit environment
2. **M&A focus on portfolio optimization in 2020:** Bigger players, that is super majors and national oil companies with a lot of varied asset bases, may look to sell their non-core assets to strengthen their liquidity and reduce debt. Simultaneously, these players might look to acquire quality assets as per their new strategic needs. Some of the big-ticket transactions in 2019 and 2020, which could have resulted from a change in focus, are listed below:
   a. In April 2020, Chevron sold its non-operating interests in the Azeri-Chirag-Deepwater Gunashli oil fields and the Baku-Tbilisi-Ceyhan oil pipeline to MOL, a Hungarian O&G company, for USD1.6bn
   b. In 2019, ExxonMobil sold its Norwegian O&G assets to Var Energi for a high deal value of USD4.5bn; ExxonMobil has exited from Norway entirely
   c. In 2019, Petrobras divested its midstream assets to an international consortium for USD8.6bn. This was done to reduce debt and cut down its monopoly in the country's O&G industry
   d. In 2019, ConocoPhillips sold its North Sea assets to Chrysaor Holdings for a value of USD2.7bn, to exit the North Sea area
3. **Upstream companies are expected to lead M&A space, but as distressed targets:** According to GlobalData research, in 2019, the upstream sector led the O&G M&A space, driving up total deal value through some big strategic transactions. For example, in April 2019, Occidental acquired Anadarko for a high value of USD57bn. However, the recent fall in oil prices has led to chaos in the upstream sector. Many small players have shut their operations, which is evident from the fall in rig count in the US – 408 in May 2020 vs. 990 in May 2019 as per numbers from Baker Hughes. This will bring a lot of distressed assets with discounted valuations into the market. One such example is Alta Mesa, which was bought by BCE-Mach III for USD220mm on April 6, 2020. The company had filed for bankruptcy in Sept 2019, and a previous sale of the company for USD320mm (announced in January 2020) had fallen through
4. **Rise in consolidation across OFS industry:** The OFS industry involves multiple tiers of service providers, ranging from big contractors that provide a whole gamut of services to small contractors that provide specialized services. As production fields are closing fast, small service providers might need to shut shop. A survival-focused approach may start in the industry with consolidation across different service lines through M&A
5. **Private equity players going for attractive deals:** According to a Bain Capital report, private equity players have a lot of dry powder (USD2.5tn for all fund types, including USD850bn for buyouts) in 2020. As corporations concentrate on survival, private equity players will have the opportunity to dig through the M&A space and do some high yield investments at very attractive rates

It is safe to expect that by the end of 2021, the sector should show definite signs of recovery from this shock and witness an improvement in M&A activities. Healthier US producers, along with foreign buyers and private and institutional capital, could be potential acquirers once the market achieves a level of stability. However, given the unpredictable times we are in, recovery will depend on when the COVID-19 pandemic shows signs of tapering off.

In the end, better integration, increased automation for workforce safety and flexibility, and new hedging techniques across energy value chain – upstream, midstream, downstream and OFS – could help achieve improved efficiencies, enabling the industry to be more resilient

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