EVALUESERVE

Q2 Oil and Gas Industry M&A Update

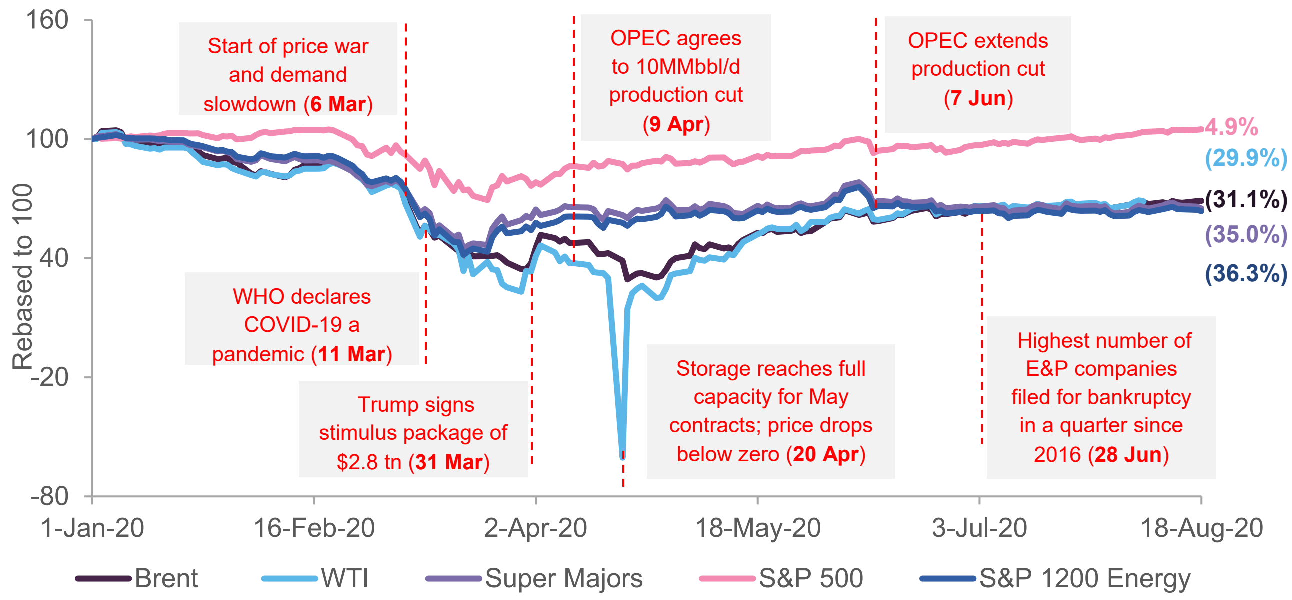
Oil and Gas Sector: Situation Overview

The global economy is still reeling under the pressure of the COVID-19 pandemic. Starting June 2020, many economies began lifting lockdown measures that were implemented to curb the spread of the virus. The opening up of the economies has been able to bridge the mismatch between oil consumption and production. According to the EIA, the global consumption and production gap is now positive (4.7 million barrels per day (MMbbl/d) in July 20 from negative (-4.3 MMbbl/d) in May 20. In September, this gap is forecast to move further in a positive direction (5.3 MMbbl/d). However, some countries, such as China, the US, and South Korea, have again started imposing lockdown measures to control COVID-19 outbreaks. We believe this uncertainty around oil demand is far from over. A second wave of outbreak in countries that have shown improvements can again put downward pressure on the global economy.

Nonetheless, in July 2020, OPEC countries and Russia agreed to ease the oil production cut from 9.7 MMbbl/d for May 2020 and June 2020 to 7.7 MMbbl/d for August till the end of the year.

A recent report by the EIA forecasts that crude oil production from the seven major shale formations would fall by 56,000 bbl/d to reach 7.5 MMbbl/d in August 2020. From June onward, a steady increase in oil demand, along with these production cuts, has buoyed crude oil prices and narrowed the gap between major O&G companies and the S&P 500 compared with their position in April 2020. In our view, the O&G industry has still a long way to go until the situation stabilizes.

YTD Share Price Performance: Super Majors Vs. S&P Oil & Gas Vs. S&P 500



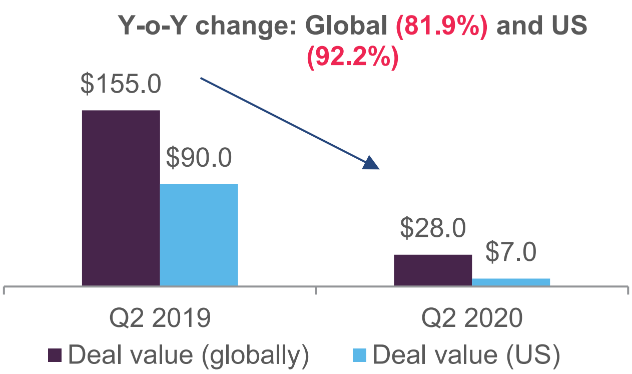
Source: FactSet

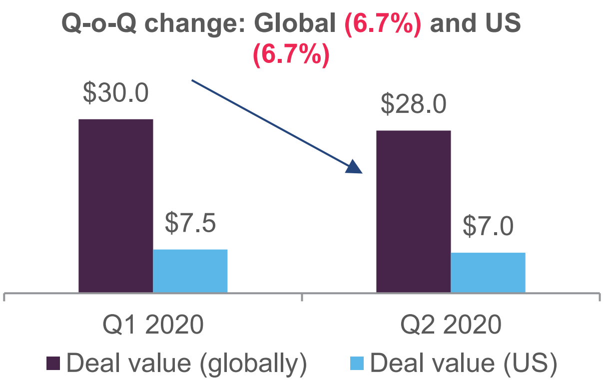
Note: Super majors include Exxon Mobil, Royal Dutch Shell, Chevron, BP, Total, Eni, and Equinor.

Current M&A Scenario

1. **No upward movement in deal activity**: According to GlobalData, 405 O&G deals, totaling USD28bn, were announced globally in Q2'20, down 6.7% (in terms of value) over the previous quarter and 68.1% compared with the average of USD87.9bn during the last four quarters. During Q2'20, the US recorded 83 deals with a total value of USD7.0bn, down 83% compared with the average of USD41.0bn during the last four quarters. Compared with historical numbers, current M&A values are certainly disappointing and there is no sign of recovery. In H1' 20, O&G M&A deals worth USD50.83bn were announced globally, down 79% year on year

M&A Deal Value (in USD bn)



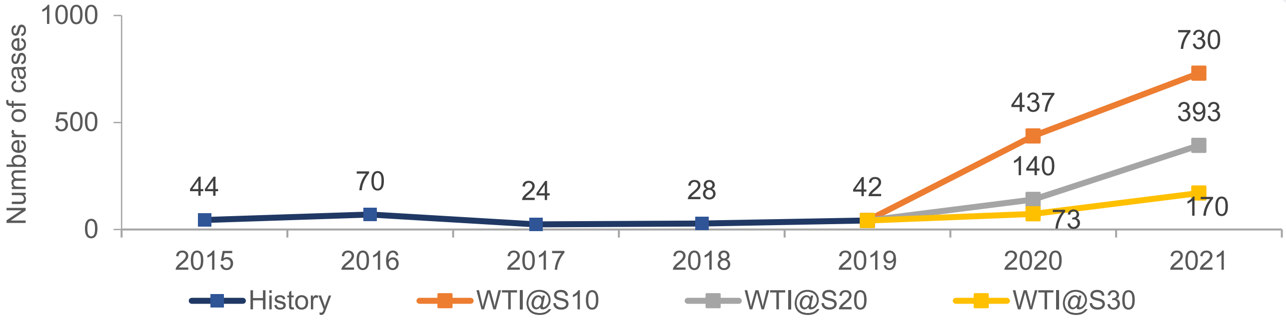


Source: GlobalData

2. **Rise in bankruptcy and restructuring in the 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 USD48–54. The EIA in its August 2020 short-term energy outlook expects WTI Spot average prices to reach USD 38.50 and USD 45.46 for FY'20 and FY'21, respectively. 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.

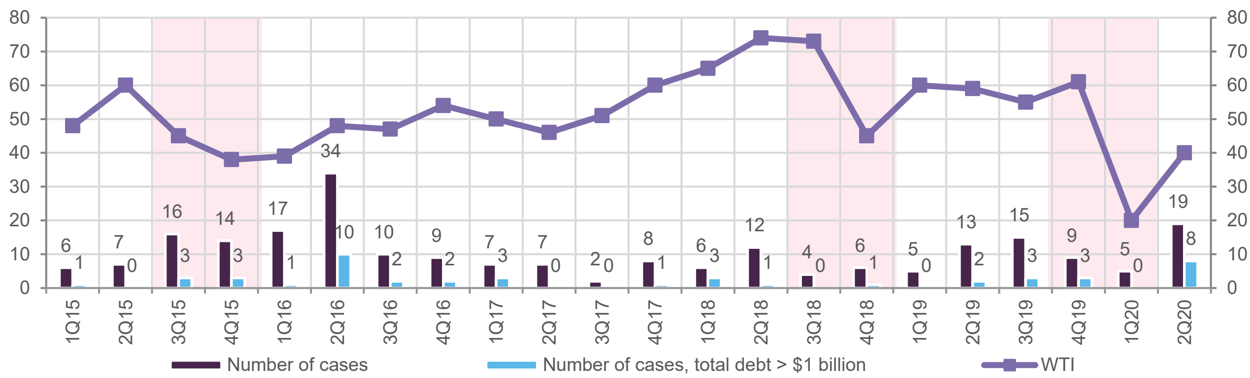
According to Rystad Energy, Chapter 11 filings for US E&P companies jumped to a four-year high in 2Q'20. This happened last time in 2Q'16 when WTI prices dropped below USD40, causing operators with higher breakeven prices to struggle to service their debt. Some of the largest companies that have filed for Chapter 11 in 2020 are Chesapeake Energy (debt: USD9.2bn), Ultra Petroleum (debt: USD5.5bn), Whiting Petroleum (debt: USD3.6bn), Denbury Resources (debt: USD2.1 bn), and Extraction Oil & Gas (debt: USD1.9bn)

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

Total US E&P Chapter 11 Cases and Historical WTI Oil Prices



Source: Rystad Energy research and analysis

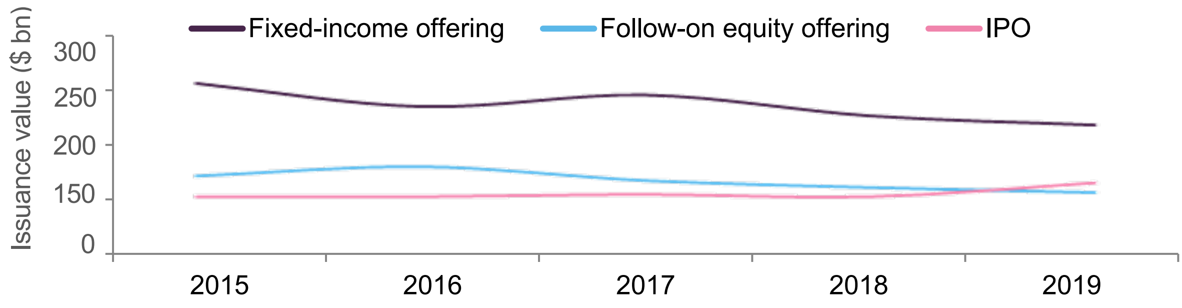
Factors Weakening M&A Situation

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 are 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, a few other factors 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 operational costs, rather than putting efforts into 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 there is limited availability of other financing routes (equity and debt). 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 and continue do so until now. For example, Exxon raised USD9.5bn in April and USD5.1bn in June, Equinor raised USD5.0bn in April and USD1.5bn

in May, Shell raised USD7.1bn in April, BP raised USD11.0bn to date since April. The key objective behind raising these funds was to ensure liquidity for any operational needs.

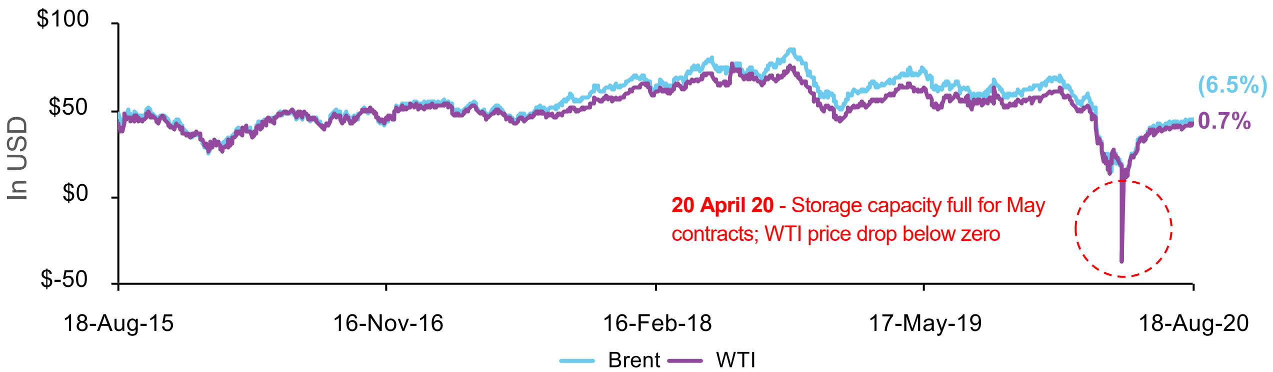
Financing Markets in O&G Sector Since 2015



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 fundraising capacity and reducing any M&A interest even if a few strategic opportunities were to 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 that 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 – Survival Instinct

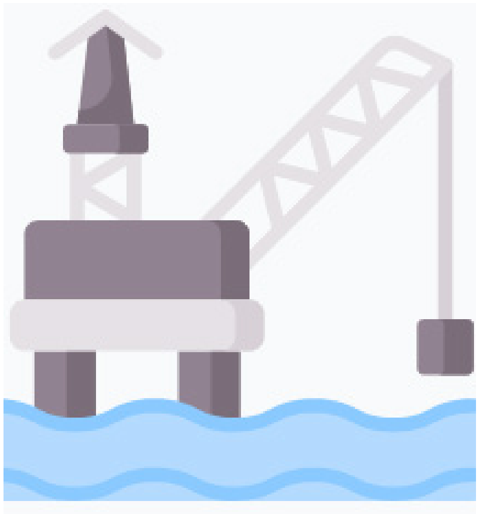
Given that oil price is trading around USD40 and economies are opening up, the short-term M&A outlook in the industry should be promising but of survival nature. We expect deals aimed at cutting down debt levels and losses. The following trends may pick up in the M&A space:

1. **Increase in consolidation activity:** With a substantial cut in revenue, small companies may also look for the consolidation route to cut costs by merging themselves with bigger player and sharing costs with them.
2. **Rise in joint ventures (JVs):** Companies may hedge their risks by going in for JVs rather facing risky asset deals alone.
3. **More stock deals or asset swap deals**: As cash is essential, large-cap and mid-cap firms may go for stock deals or asset swap deals, especially in this tough credit environment.
4. **M&A focus on portfolio optimization, along with debt burden reduction:** Bigger players, super majors, and national oil companies with varied asset bases, may look to sell their non-core assets to strengthen their liquidity and reduce debt. Simultaneously, these players may look to acquire quality assets as per their new strategic needs. Some of the big-ticket transactions in 2020 that could have resulted from a change in focus are listed below:
   a. In August 2020, Marathon Petroleum announced the sale of its filling station and store business, Speedway, to retail chain 7-Eleven, for USD21bn.
   b. In July 2020, Occidental Petroleum announced its decision to sell its energy assets in Africa and the Middle East to PERTAMINA, an Indonesian oil and natural gas company, for USD4.5bn.
   c. In June 2020, Abu Dhabi National Oil Company (ADNOC) sold its 49% stake in gas pipeline assets for USD20.7bn to a consortium of investors.
   d. In May 2020, Shell sold Appalachia shale gas assets for USD541mn to National Fuel Gas Company.
5. **Upstream companies to lead M&A, but as distressed targets:** According to a GlobalData research, in 2019, the upstream sector led the O&G M&A space, driving up the total deal value through some big strategic transactions. For example, in April 2019, Occidental acquired Anadarko for USD57bn. However, the recent fall in oil prices has led to chaos in the upstream sector. Many small players have shut their operations, as is evident from the fall in rig count in the US – 247 in August 2020 vs. 934 in August 2019 vs. 408 in May 2020 (as per Baker Hughes). This will bring a lot of distressed assets with discounted valuations into the market. In June, shale driller Tapstone Energy offered USD65mn as the lead bidder to buy the assets of Templar Energy LLC out of bankruptcy.
6. **Rise in consolidation across OFS industry:** The OFS industry involves multiple tiers of service providers, ranging from big contractors that provide a gamut of services to small contractors that provide specialized services. As production fields are closing fast, small service providers might need to shut shop. We expect companies to take a survival-focused approach to look for consolidation opportunities across service lines.
7. **Private equity players going for attractive deals but with caution:** 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). As corporations concentrate on survival, private equity players will have the opportunity to dig through the M&A space and make some high-yield investments at very attractive rates. However, they are holding off as of now in anticipation of the industry bottoming out, as a lot of portfolio companies in various PE firms have started declaring bankruptcies. According to Preqin, in H1'20, only two North America-focused O&G funds closed, total raising USD2.8bn vs. H1'19, when 16 funds raised USD17.1bn.

The M&A trend will remain the same for the rest of 2020. But we 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 activity. Healthier US producers, along with foreign buyers and private and institutional capital, could be potential acquirers once the market achieves a level of stability.

Better integration, increased automation aimed at workforce safety and flexibility, as well as new hedging techniques across the energy value chain – upstream, midstream, downstream and OFS – could help achieve improved efficiencies.



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Piyush's team supports the oil and gas team of a bulge bracket investment bank. He has more than 6 years of experience in the energy sector.

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