Oil and Gas Industry M&A Update for FY'2021

Corporate and Investment Banking Practice

Situation Overview

2021 was yet another challenging year dedicated to fighting the various variants of COVID-19. Delta wreaked havoc in India in April and May and spread across the world (even in U.K., U.S., Israel, etc., which had vaccinated more than 50% of their population). The second half of the year saw the emergence of Omicron, which was mild in comparison to Delta, but it spread faster than any other past variant. These developments derailed the confidence around the pandemic ending in 2022.

As of now, multiple mutated strains, particularly those of Omicron, are spreading rapidly across the world. According to DW (Deutsche Welle), 146 countries reported an increase in new cases in January 2022. This led to India, Japan, Australia, and U.K. once again putting restrictions on foreign travel.

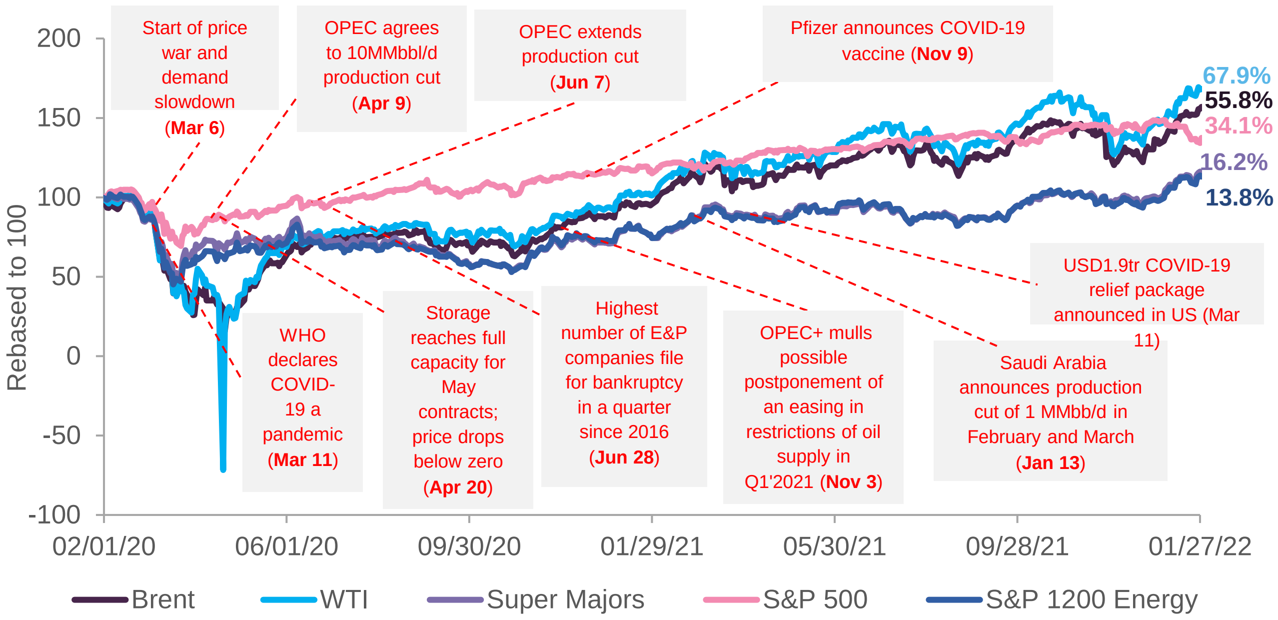
Countries across the world are focusing on vaccinating their entire population as quickly as possible. According to Bloomberg, more than 10.1 billion doses have been administered across 184 countries, as of January 2022. Globally, about ~32 million doses are administered per day, with majority of them in developed countries, such as U.S., Israel, Canada, U.K., France, and Germany, and developing countries, such as India and China. However, a large proportion of the population in emerging economies will not be vaccinated before 2022 (World Economic Outlook July 2021). The vaccination rate in countries with higher incomes is 10 times than those in low-incomes economies. In addition, governments are now providing booster doses to people who had received their second dose six months back. These aspects have dampened the optimism around economic recovery.

According to the World Bank, the global economy is estimated to grow 5.5% in 2021, 4.1% in 2022, and 3.2% in 2023, from a contraction of -3.1% in 2020. The IMF's 2021 and 2022 outlook on the global economy remains positive but it stated that recovery momentum has weakened because of the spread of Omicron. The aggregate output of advanced economies is expected to regain its pre-pandemic levels in later part of 2022 but developing economies (excluding China) are expected to remain below the 5.5% pre-pandemic forecast levels (IMF October 2021 report). The impact of this positive sentiment can be seen in the oil & gas sector, where prices have remained stable even amid fear of a new pandemic wave. According to the Energy Information Administration (EIA), Brent oil prices averaged USD71 per barrel (/b) in 2021, up ~69% from USD 42/b in 2020 and will remain ~USD 75/b in 2022. This means demand in various economies have not dried up and is expected to be stable.

According to the EIA, the gap between global oil consumption and production in December 2021 (2.81 MMbbl/d) is now at the pre-pandemic level. This is because production levels have increased in anticipation of higher demand in the near future as well as a steady rise in oil prices. In January 2022, OPEC+ members (including Russia) agreed to increase their production by 400,000b/d from February 2022.

The reopening of many countries in H2'2021, particularly China and the U.S., has driven oil production and consumption, which in turn has buoyed crude oil prices. This has narrowed the price performance gap between major oil & gas companies and the S&P 500 in 2021, compared with 2020. We believe that the sector showed good signs of recovery in 2021 and will remain on a steady path in 2022.

Share Price Performance (since Feb 2020): Super Majors vs. S&P Oil and Gas vs. S&P 500

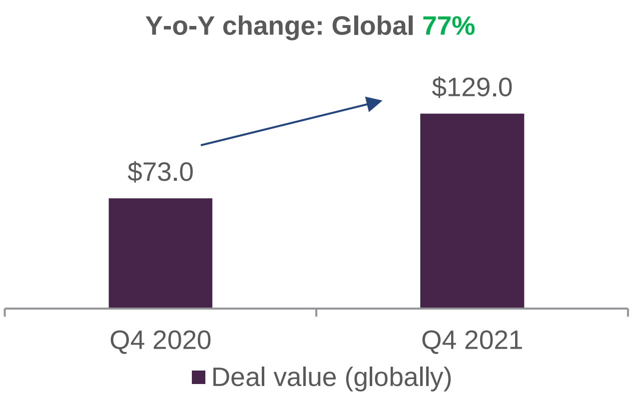


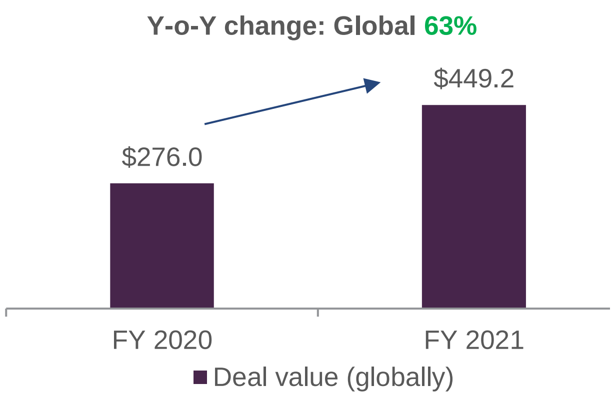
Source: FactSet
Note: Supermajors include Exxon Mobil, Royal Dutch Shell, Chevron, BP, Total, Eni and Equinor

FY 2021 M&A Scenario

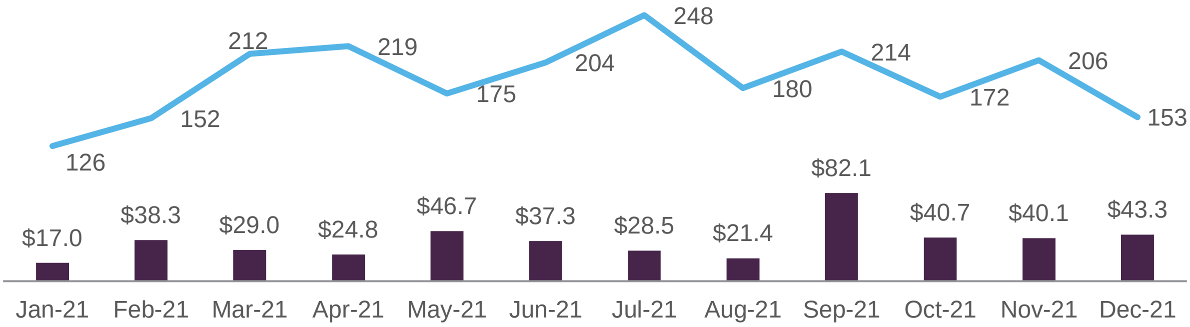
1. **Global deal activity increased significantly in FY'21:** According to GlobalData, oil & gas deals worth USD 449bn were announced globally in FY'21, up 63% (in value terms) from that in FY'20. Further, 2,261 O&G M&A deals were announced globally in 2021. Some of the key mega deals of FY'21 are the USD 21bn Speedway acquisition of 7-Eleven; the USD 17bn acquisition of Saudi Arabia Natural Gas Pipeline Network by various investors; the USD 13.9bn Aker BP merger with Lundin Energy; the USD 12.5bn Inter Pipeline acquisition of Pembina Pipeline; the USD 9.5bn acquisition of Permian assets by ConocoPhillips from Shell; the USD 4.75bn acquisition of Allnex Germany by PTTGC International (Netherlands), etc.

M&A Deal Value (USD bn)





Oil & Gas Sector M&A Deal Activity by Value and Volume (last 12 months)



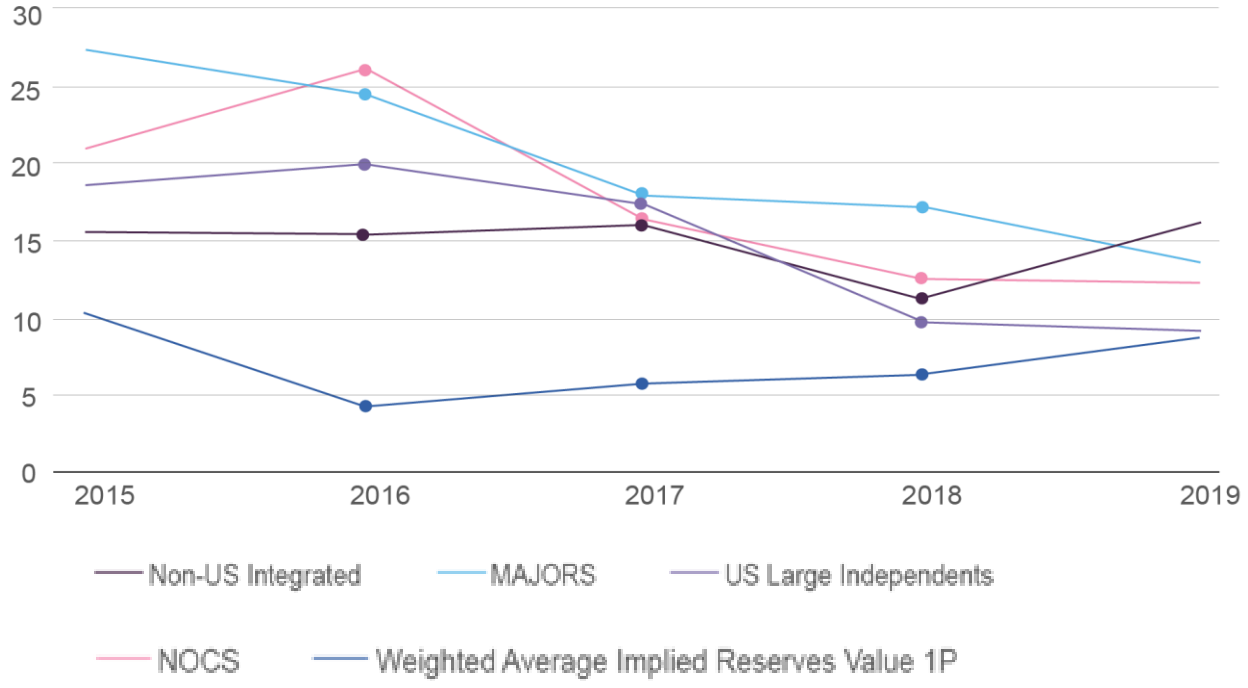
2. **Rising oil prices have put brakes on bankruptcy and restructuring filings**: According to Dallas Federal Energy, the range of breakeven oil price is USD 48–54/b. As per the EIA's Short-term Energy Outlook, WTI prices will likely average USD 68/b in 2021 – a positive sign for oil producers. Furthermore, Brent crude spot prices averaged USD 71/b in 2021, up USD 29/b from that in 2020. The upside has reduced the number and scale of bankruptcy filings in 2021. According to Haynes and Boone's H1'21 oil patch bankruptcy monitor, for the first time since Q3'18, there were no producers with billion-dollar bankruptcies in Q2'21. Further, 18 oil and gas bankruptcies were announced YTD Q3'21. We believe low bankruptcies trend continued in Q4'21 and will go on in 2022. This is a great sign for the oil and gas industry.

Factors Affecting M&A Situation

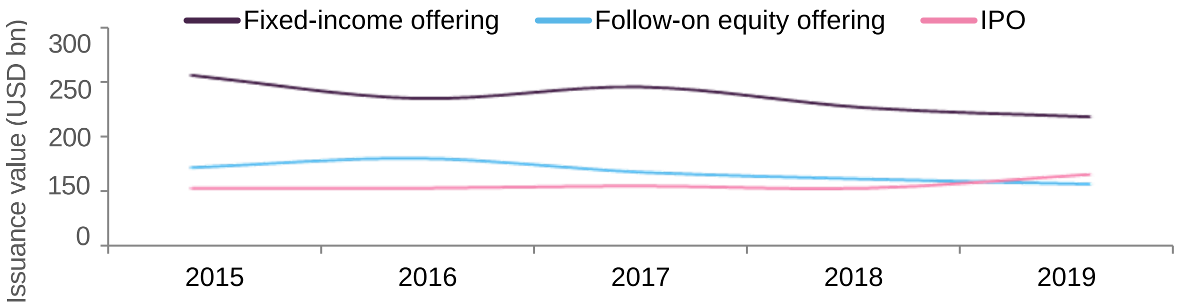
Oil prices surged in FY'21 vs. the average price of USD 42/b in FY'20, including deal activity during the same period (Globaldata). However, uncertainty in the market will likely continue, as a more infectious Omicron strain of coronavirus has emerged globally. Nonetheless, the rise in oil prices, coupled with an increase in energy demand, has renewed confidence and stopped the drag on M&A activity in 2021, but with a cautionary focus on value-adding M&A deals. Given the volatile nature of the sector, the following are a few factors that could affect M&A activity in the future:

1. **Cost cutting through non-diversification of assets in new regions:** Many mid-to-large oil & gas firms are focusing on cost-cutting efforts by concentrating only on acquiring key assets that are in line with their long-term goals or where firms know that volume scalability is viable. They have also reduced spending on exploring new regions. This can further drive consolidation in the industry.
2. **Preference for inorganic growth (acquisition) over organic growth (exploration)**: According to a Duff and Phelps report published in July 2021, to increase their reserve base, companies prefer buying proven reserves than investing in risky exploration projects. Historical data shows that the finding and development (F&D) cost of new reserves is higher than the acquisition cost of proven reserves of companies or assets already in production.

F&D Cost (three-year average) and 1P Implied Reserve Value (USD/b)



Financing Markets in Oil and Gas Sector Since 2015



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

3. **Ultra-low interest rates can encourage M&A activity but for smaller players:** Although developed economies are recovering rapidly, COVID-19-induced uncertainties and variations in capital needs across sectors have compelled investors and capital providers to remain focused on their investment sectors. Furthermore, risks related to the emerging variants of the virus have resulted in companies taking a cautionary approach. This is leading to a liquidity crisis, as companies are saving cash to meet their future capital needs. This in turn has strained the capital markets, which have been declining over the past few years. In the current scenario, there is limited availability of other financing routes (equity and debt). However, global banks maintained ultra-low interest rates in 2021. In developed countries, such as the U.S., the U.K., and Canada, bank rates ranged from 0.1% to 0.25%. Developing nations, such as China, India, and Russia, saw rates of 3.75–6.50%. The situation may be advantageous for the sector, particularly for smaller players who are likely to have access to cheap capital. However, larger players might not be ready to tap credit markets for deals due to shareholder and market backlash if they are not able to align their actions with

shareholder value, ESG, and energy transition priorities.

4. **Focus on energy transition:** The COVID-19 pandemic has shown that the global economy is susceptible to systemic risks. Similarly, climate change is a major risk that energy companies need to address as investors are seeking more investments in sustainable and resilient assets. Thus, many oil & gas companies are aligning their long-term strategies with the zero-carbon emissions goal. This shift in focus will drive a few M&A in the traditional oil & gas sector, as companies will restrict themselves from adding more carbon emission numbers through this channel. However, it will increase M&A activity in the energy transition sector.

M&A Outlook: Deal-making to Return to Pre-COVID-19 Levels

Demand and supply are stabilizing but the fear of new COVID-19 waves still looms over the sector. Companies are focusing on cautious capital allocations and increasing shareholder value through selective transactions. Nonetheless, the rise in oil prices in 2021 provided the much-needed impetus to the struggling oil & gas sector. Companies looked to consolidate, but the pace was slower than that in H2’20. We expect the trend to continue in FY’22.

The following trends will emerge in FY’22:

1. **Consolidation to continue but at a slower pace:** Much of the consolidation had already taken place in H2’20 and H1’21 and is now slowing down due to higher and stable prices. Companies are not compelled to undertake M&A for survival and scalability and are focusing on finetuning their portfolios. Smaller players are expected to focus on production assets, while larger ones will likely choose assets that add value for their shareholders. For example, in Oct 2021, Altus Midstream announced its merger with BCP Raptor, a holding company for pipeline assets in the Permian Basin. The combined entity was estimated to be valued at USD 9.0bn, inclusive of debt. In Sept. 2021, ConocoPhillips announced its plans to acquire Shell’s Permian assets for USD 9.5bn in cash.
2. **LNG infrastructure and retail deals to drive downstream M&A as refiners focus on divestment:** According to a recent IEA Oil Market report, in 2022, the demand for refined products will lag compared with 2017 levels. The surplus capacity in the system (78% utilization) will restrict any rebound in refinery margins from the depressed 2020–2021 levels. Thus, refinery acquisition deals will be few, but divestment deals maybe plenty as independent refiners look to sell their assets to bigger, integrated players. Further, downstream sector deals will be driven by LNG infrastructure as the demand for LNG is increasing. According to Bloomberg’s Global LNG outlook, global LNG supply could reach 449 million tons by 2025, up 23% from 2020.
3. **OFS consolidation:** Oil prices are stabilizing within a range that will ensure that companies’ bottom lines are in green. In addition, there is an increasing demand for oil and many oil wells are going online. This is a good sign for the OFS industry. However, due to overcapacity, OFS companies may look to acquire competitors to generate cost synergies and improve their bottom lines. For example, in Nov 2021, Maersk drilling and Noble announced plans to form a multibillion-dollar company and NexTier Oilfield Solutions plans to acquire Alamo Pressure Pumping for USD 268mn in a cash-and-stock transaction.

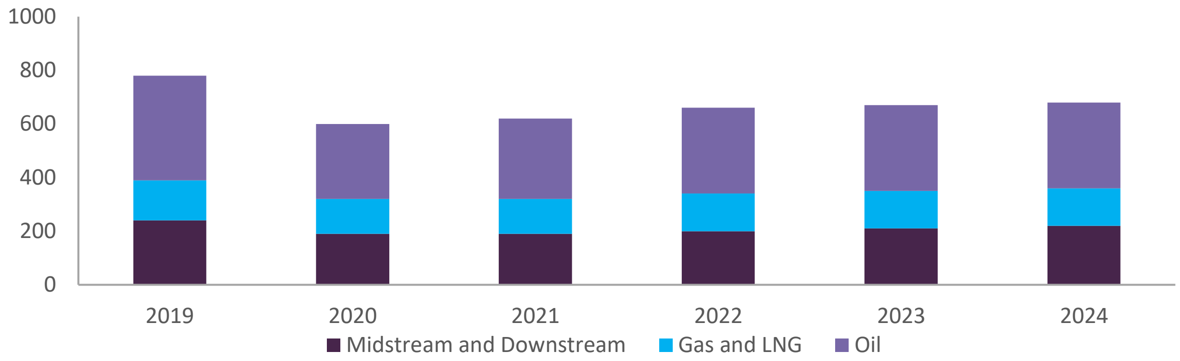
4. **Midstream sector to focus on asset deals or drop downs:** Given the stable revenue in the midstream sector, many midstream companies have an MLP structure, in which the company needs to provide distributable cashflow to its limited and general partners on a regular basis. However, given the low demand for oil since the pandemic started, oil producers have either curtailed their outputs or stop producing. This has decreased the revenue for MLP companies. General partners of these MLP companies are either looking to acquire them and take the privatization route or are looking to sell non-performing or non-core assets. Key transactions during the period included: Altus Midstream's merger with BCP raptor; Energy Transfer's acquisition of Enable Midstream for USD 7.0 bn; Kinder Morgan's acquisition of Stagecoach Gas Services for USD 1.3 bn; and Brookfield Asset Management's acquisition of Canadian midstream company Inter pipeline for USD 6.7 bn.

5. **All-stock deals to accelerate to save cash for operational purposes:** Most oil & gas firms are going for all-stock deals. As markets are rebounding, companies do not want to lose the opportunity to acquire value-adding assets and companies. At the same time, they want to save cash for any operational needs. In July 2021, Penn Virginia agreed to acquire Lonestar Resources U.S. in an all-stock transaction worth USD 370 mn. In June 2021, Independence Energy and Contango Oil & Gas announced their merger in an all-stock deal that could value the new business at about USD 5.5 bn, including debt. In May 2021, Cabot and Cimarex entered an all-stock merger deal worth USD 7.4 bn.

6. **Focus on energy transition or green acquisitions:** To achieve their goal of reducing carbon-emitting assets in their portfolios, large oil & gas companies are venturing out to acquire or develop renewable energy sources. For instance, BP aims to develop 50 GW by 2030, Eni plans to have 25 GW by 2035, Equinor established a range of 12 GW to 16 GW by 2035, and Repsol is aiming for 15 GW by 2030.

7. **Global oil and gas investments to rise:** According to Rystad Energy research, investments in the oil and gas sector will increase to USD 628bn in 2022 from USD 602bnin 2021, up 4%. Upstream gas and LNG investments will drive this increase and expected to reach USD 149bn in 2022 from USD 131bn in 2021. Upstream oil investments are projected to rise from USD 287bn in 2021 to USD 307bn in 2022, a 7% increase, while midstream and downstream investments will fall 6.7% to USD 172bn this year. Australia and the Middle East are likely to stand out. Australia could see a 33% jump in investment due to greenfield gas developments. In the Middle East, investments will rise by an anticipated 22% in 2022 as Saudi Arabia will increase its oil export capacity and Qatar will expand LNG production and export capacity.

Global oil and gas investments by market (in USDbn)



Source: Rystad Energy Research

Compared to 2020, M&A activity in the sector was far better in 2021 and we expect the trend to continue in 2022. More consolidation and all-stock deals can happen as big players look to increase shareholder value through any kind of synergies that can come through mergers or acquisitions, and small players look for portfolio optimization.

Digital initiatives aimed at better integration among divisions, increased automation for workforce safety and flexibility, and new hedging techniques across the energy value chain (upstream, midstream, downstream and OFS) can help O&G companies increase efficiency.

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

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