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Deloitte Oil & Gas Mergers and Acquisitions Report – Year-end 2014

A world in flux

Deloitte Center *for* Energy Solutions

Contents

Vice Chairman's introductory comments

The oil and gas industry marched into 2014 with global oil prices holding steady at around $100 per barrel and strong growth forecasts for demand, particularly in non-OECD economies. These conditions set the stage for a remarkable high-value year for mergers and acquisitions (M&A) in the oil and gas industry. In the first half of 2014, four transactions in the exploration and production (E&P) sector each exceeded $5 billion. Even these deals were dwarfed by the fourth quarter announced $38 billion merger of Halliburton and Baker Hughes, the third largest industry deal during the past 10 years.

The sharp decline in global oil prices initiated in July 2014, however, was sufficient to slow M&A deal activity by the fourth quarter as industry participants and financial lenders began to recalibrate for a potentially prolonged period of low and volatile global oil prices. The rise of US unconventional production may very well effect the pace and slope of this recovery. The short-cycle economics of tight oil production allow capital to be deployed and withdrawn from the industry more quickly than during past price declines. This factor may allow production to fall more quickly to adjust to global demand. However, it could also result in a longer, slower price recovery as relatively small-price increases could trigger capital deployment capable of bringing more supply online quickly and driving global oil prices back down.

As we consider drivers for deal activity in 2015, global oil prices are paramount and have yet to stabilize. Many would-be buyers will probably have less disposable cash and some will experience reductions in available debt financing; others will wait out the downward spiral of global oil prices anticipating the emergence of high-quality, strategic M&A inventory. As such, we expect activity to be muted early in 2015, in comparison to the first half of 2014, as companies focus on greater cost reductions and improved operational efficiency to increase their leverage to deal with a lower oil price environment.

Regulatory developments worldwide will also be important drivers to monitor in 2015. Reductions to country-specific fuel subsidies, approvals of new cross-border pipelines, monetary policy adjustments in key consuming nations, emerging regulations on fracking, and enhanced carbon emission standards will all contribute to industry uncertainty concerning demand growth, the timing and economic cost of projects, and the complexity and cost of compliance.

This report was developed to provide some context for M&A developments in 2014 and to help make sense of the buyers' market that could emerge once commodity markets regain stability. The report cuts across industry sectors to provide insights into the unique challenges and opportunities facing each.

John England
Vice Chairman
US Oil & Gas Leader
Deloitte LLP

Industry overview

An altered reality

The surprisingly rapid and steep decline in global oil prices during the second half of 2014 stifled global M&A deal activity in the oil and gas industry, but it was insufficient to counter the strong M&A performance earlier in the year. While it is too early to answer critical questions about the precise timing and trajectory of an oil price recovery and corresponding investor response, this year-end report provides an assessment of the dynamics of the 2014 deal market and what to watch for in 2015.

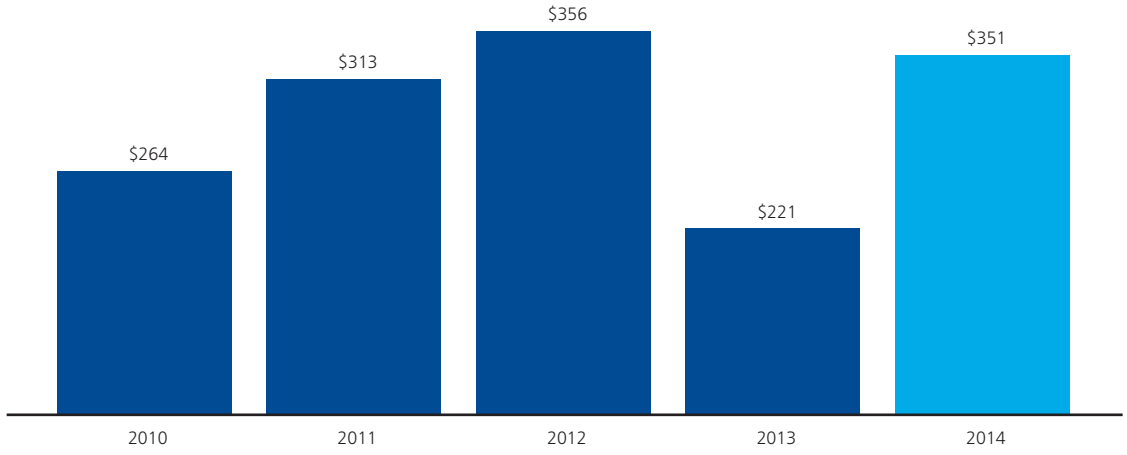
The global oil and gas industry M&A deal market in 2014 started stronger than in 2013 and, with a total year-end deal value of $351 billion, surpassed 2013 total deal value by $130 billion (see Figure 1).

Deal activity through June 2014 remained at the high end of the previous five-year range (i.e. 2009 to 2013), but transaction rates began to slow in July before plummeting late in the year along with global oil prices (see Figure 2). Total deal count in the fourth quarter of 2014 was 40 percent below the fourth quarter of 2013, and 55 percent below the fourth quarter of 2012. Falling oil prices spelled unpredictability for company budgets and operational plans, stifling deal activity, as buyers and sellers had disparate views on valuations. The oil price uncertainty also contributed to difficulties obtaining financing, resulting in delayed or canceled deals.

Amidst these conditions, Western integrated oil companies were largely absent as acquirers, preserving cash and rebalancing portfolios through divestitures and organic growth, much as they did during the 2008-2009 global financial crisis. During 2014, most of these companies' divestments were of E&P assets, including several in North America. The divestment focus contrasts the more balanced acquisition and divestment activity of this group in recent years to more effectively allocate capital within their core portfolios (see Figure 3) as well as the continued interest of state-owned companies in acquiring reserves in other parts of the world. For instance, between 2012 and 2014, six national oil companies each paid at least $5 billion in an acquisition, whereas only one Western major, Royal Dutch Shell, made any acquisition of that size.

Figure 1. 2014 oil and gas M&A deal value rebound

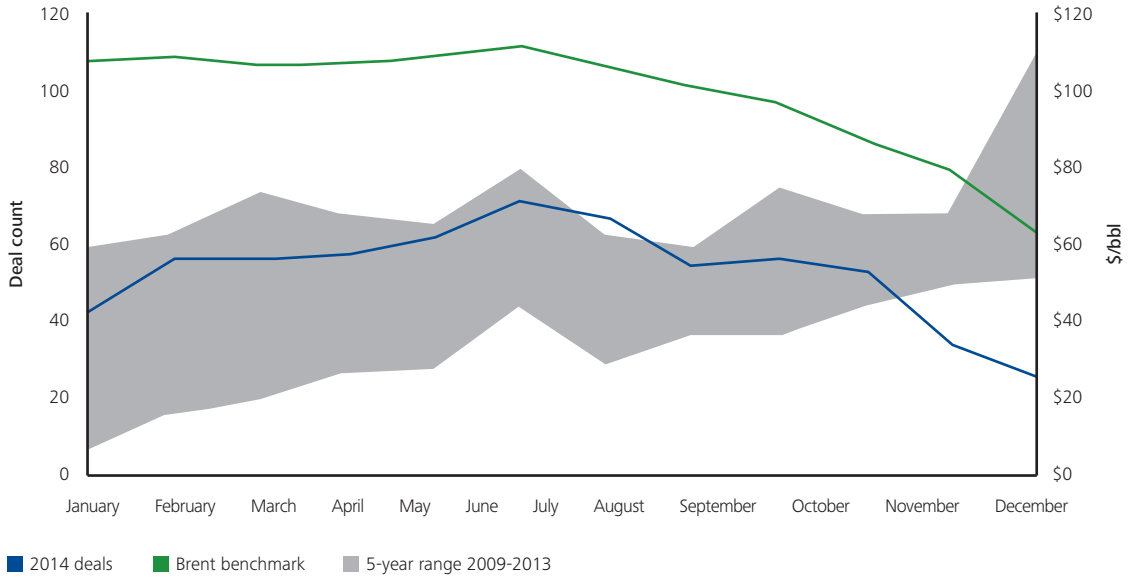
Billion USD



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

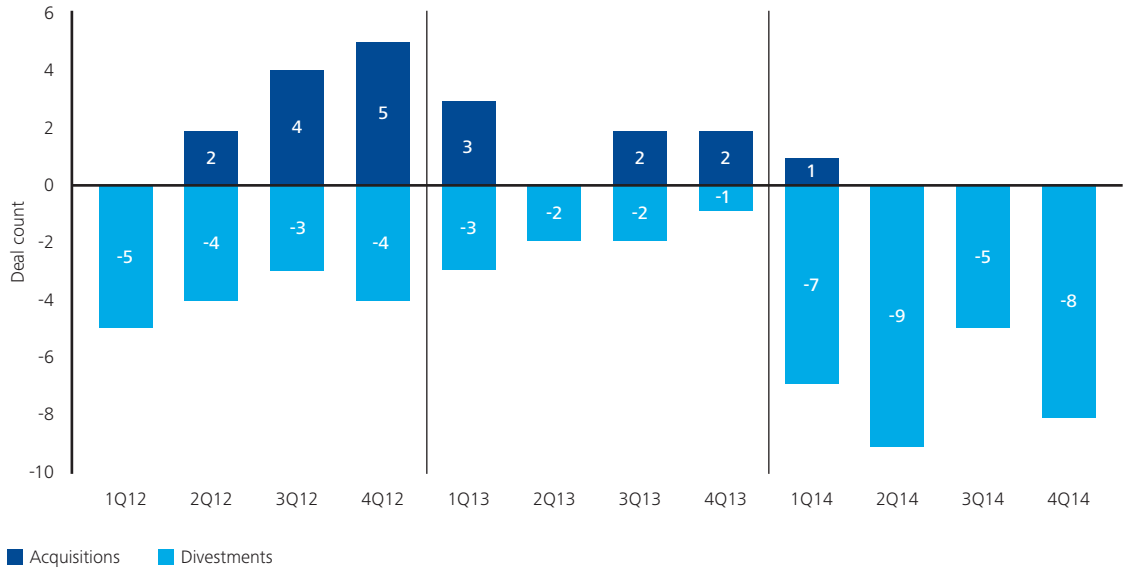
Note: M&A activity examined in this report is based on data from PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015. The data represents acquisitions, mergers, and swaps with deal values greater than $10 million, including transactions with no disclosure on reserves and/or production. Our analysis has excluded transactions with no announced value as well as transactions between affiliated companies, to provide a more accurate picture of M&A activity in the industry.

Figure 2. Oil and gas industry M&A stifled by global oil price decline



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

Figure 3. Upstream deals by selected integrated oil companies, 2012-2014



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

2015 industry outlook

A resurgence in oil and gas M&A activity may not occur until later in the year. If it comes to pass, it will be driven by oil and gas companies seeking some form of "reset," whether through restructurings, financial recapitalizations, asset sales and other forms of monetization, or, in the more severe cases, creditor protection through bankruptcy. Buyers with the financial ability to pursue inorganic growth opportunities at reduced values compared to recent periods and synergistic mergers may also contribute to M&A activity. This M&A transaction landscape will be shaped by several factors:

Recovery of global oil prices and production response of US shale producers. The nature of US tight oil production may perpetuate volatility in global oil markets. Short capital cycles could allow US shale producers to respond quickly to global oil price changes, becoming a new group of "swing" producers outside of OPEC, even as other countries continue to increase production globally. Production in the near term from highly-leveraged and minimally-hedged independent producers will uniquely contribute to global oil surpluses as these companies sustain or increase production to generate revenue to service debt and meet other cash requirements.

Cost and availability of credit. Financial institutions and investors may impose a new reality for capital expenditures and project selection. Some companies, particularly drillers who have experienced significant decreases in the value of the properties used to collateralize their debt, as well as some service providers, may be forced to take action as lenders recalculate collateralization requirements for credit facilities in the spring of 2015 and potentially reduce facilities. Asset impairments tied to lower crude oil prices and cash shortfalls all potentially reduce certain companies' abilities to meet leverage and interest coverage ratio requirements. Private equity funds may step in to provide alternative sources of credit and infusions of equity capital to capitalize on the lower valuations generated by depressed global oil prices. Previously, some of these funds had been sitting on the sidelines as valuations were not aligned with targeted returns.

Tax and regulatory changes. The US Federal Reserve is expected to begin raising interest rates in the summer of 2015, which will tighten credit in the US, the largest M&A deal market. Meanwhile, the OECD is progressing on policies that could alter corporate-effective tax rates to counter treaty-shopping and to reduce perceived inequities in the global taxing of multinational companies.

Whether through consolidations, transformations, distress sales or even bankruptcies, M&A activity in 2015 will likely foster the emergence of a more efficient oil and gas industry capable of operating on thinner margins. The chief question remains the timing in which M&A inventory will emerge despite the efforts of oil and gas companies to preserve cash flow and margins in the current price environment. An eventual M&A recovery will likely begin in the North American market ahead of international markets because of its relative economic strength, attractive resource base, and lower geographic risk profile. A buyer's market for US energy assets is already developing and more robustly capitalized energy companies, private equity firms, and buyers from abroad are poised to acquire assets.

North American spotlight

Figure 4. North America's thriving deal environment

90 Percent of top 10 deals in the US market. One top 10 deal, worth $7 billion, was announced outside the US (Europe – Germany).

62 Share of US transactions in unconventional assets. In Canada, conventional assets made up 57 percent of deal activity.

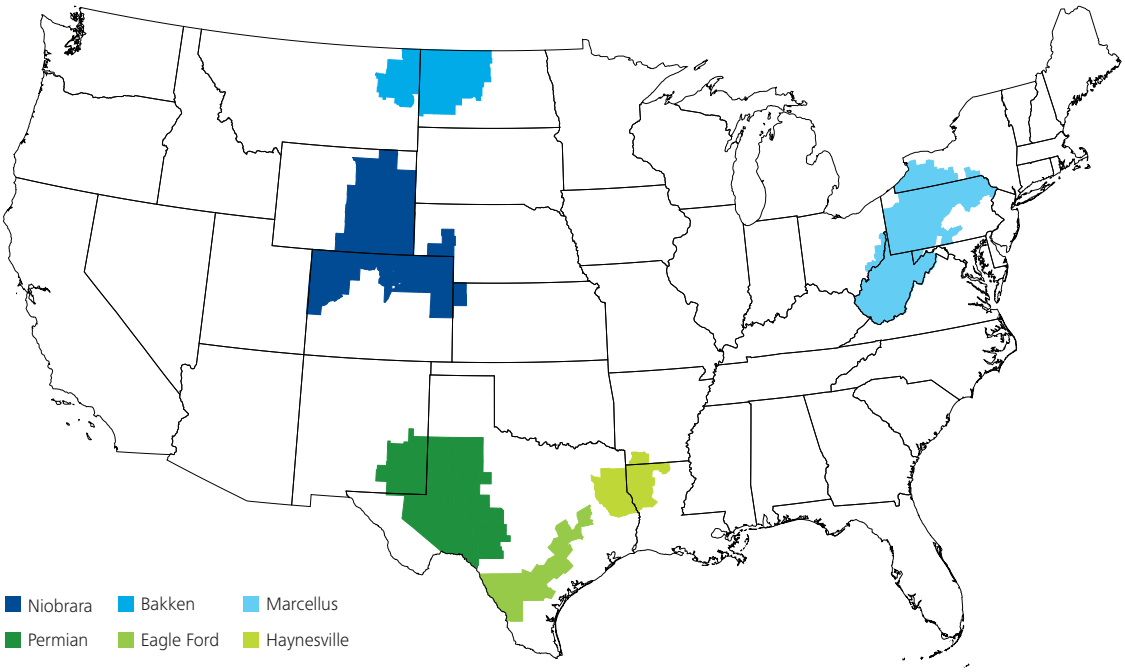
73 North America's share of M&A deal value; driven by 140 percent year-on-year increase in US market deal value.

81 US share of global oilfield services deal value, spurred by two mega deals worth a combined $45.6 billion. These deals ranked among the top 10 deals of 2014.

Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

Figure 5. M&A spotlight – US unconventional resources

	Select US unconventional plays				US deepwater
2013 / 2014	Bakken	Eagle Ford	Permian	Niobrara	Gulf of Mexico
Deal count	25 / 21	22 / 22	29 / 28	5 / 12	5 / 3
Deal value (Billion USD)	$3.1 / $8.5	$8.7 / $8.5	$7.3 / $15.5	$0.1 / $1.2	$2.5 / $2



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

Four of the five largest US E&P deals in 2014 were in unconventional resources. Bakken, Eagle Ford, and Permian basins remained the most active regions with similar performance to 2013; the regions attracted four deals each exceeding $1billion (total $19 billion).

- Canadian company, Encana, spent $13 billion between two transactions in the Eagle Ford and Permian basins.
- Niobrara basin deal activity matched 2012 and 2013 combined; total acquisition value jumped 60 percent over 2012 and 2013 combined.
- US and Canadian buyers made nearly 85 percent of the announced acquisitions in US unconventional assets in 2014.

Freeport-McMoRan reallocates its portfolio. The company sold some of its interests in the Eagle Ford to Encana and purchased offshore Gulf of Mexico assets from Anadarko and Apache in 2014. Published reports indicate the company plans to monetize additional US onshore energy assets as part of its ongoing portfolio rebalancing program.[1]

1 Freeport-McMoRan, Fourth-Quarter and Year Ended 31 December, 2014 Results, 27 January 2015; 4th Quarter 2014 Earnings Conference Call, 27 January 2105; Year-End Earnings Call; and, FCX Announces Agreement to Sell Eagle Ford Interests for $3.1 Billion, 7 May 2014.

Exploration and production

North American hot spot persists

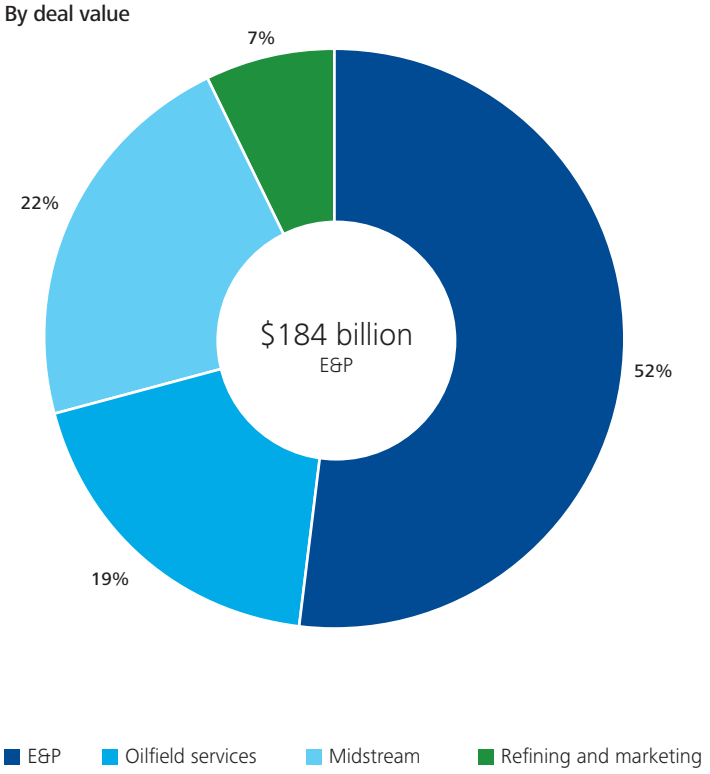
2014 E&P review

Deal value in the E&P sector made a strong recovery in 2014 after declining nearly 50 percent by deal value from 2012 to 2013. Overall, E&P deal value improved by 33 percent in 2014 on a strong first half and five mega deals with total announced deal values of $38.5 billion. The largest of these mega deals was Repsol's announced $13 billion purchase of Talisman Energy in December. The deal is expected to increase Repsol's access to US Marcellus and Eagle Ford basins, among other basins globally, and boost production by 76 percent to 680,000 barrel of oil equivalent per day. The global oil price decline aided Repsol's acquisition. Talisman Energy shares were trading at about $3.75 when Repsol approached them in December, down from about $11 in July when Repsol made its initial overture.

Despite the Repsol/Talisman Energy deal, the E&P sector's share of total deal value in the oil and gas industry shrunk to 52 percent, a three-year low, because of two announced deals in excess of $30 billion in the oilfield services and midstream sectors (see Figure 6). The M&A market also had insufficient momentum in the second half of 2014 to offset the influence of declining global oil prices. As a result, the number of E&P transactions fell by 20.5 percent compared to the same period in 2013. In comparison, E&P transactions in the second half of 2013 declined by 11 percent from the same period in 2012.

Figure 6. Global M&A – E&P maintains M&A dominance

By deal value



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

Geographically, North America continues to be the most active E&P deal market, rising steadily from 67 percent of transactions in 2011 to 74 percent in 2014. Asia's share of deal activity increased from six to 10 percent as the number of transactions rose from 30 in 2013 to 48 in 2014, the largest regional increase last year. Africa, Europe, Russia, and Central Asia all lost deal share in 2014 as investments migrated toward more attractive assets and more secure markets.

Only Canadian and US buyers participated in deals that ranked in the top three by value, in any of the major US regions. In contrast, US producers, including Devon, Apache, and EOG Resources, withdrew from non-core assets in Canada to deepen their US portfolios. US companies also continued realigning their portfolios outside North America, including several divestitures in Asia.

Figure 7. Large deals outside E&P round out the top 10 of 2014

The E&P sector attracted 74 percent of total M&A deals in 2014, including five of the year's top 10 deals. That said, the E&P sector captured only 30 percent of the top 10 deal values since the proportions were skewed by mega deals exceeding $30 billion each in the oilfield services and midstream sectors. Announced deal values dropped-off sharply after the Repsol/Talisman Energy deal to $7.7 billion in the Targa Resources/Atlas Pipeline deal.

Oilfield services	**#1**	**HALLIBURTON/BAKER HUGHES** Third largest oil and gas industry M&A transaction in the past 10 years. On completion, the new company would be the second largest oilfield services company after Schlumberger. Merger expected to lead to spinoff sales to address anti-trust and cost-saving demands. Other unsolicited consolidation offers in oilfield services are anticipated in 2015.
Midstream	**#2**	**ACCESS MIDSTREAM PARTNERS/WILLIAMS PARTNERS LP** Merger would create one of the largest companies in US natural gas pipeline and processing infrastructure, particularly in the Marcellus shale.
E&P	**#3**	**REPSOL/TALISMAN ENERGY** Merger would increase Repsol's upstream operations share of total business and shift its upstream portfolio to about 50 percent North American assets.

Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

2015 E&P outlook

A protracted period of low global oil prices could further increase companies' risk levels, particularly in the upstream sector, leading to transformative M&A opportunities that will likely accelerate consolidation and spur divestitures by distressed players and financial investors. The question, again, is one of timing: will momentum slowly build or will a bold move by a key player trigger a crescendo of deals?

Despite the current global oil surplus, 2015 upstream M&A may well turn into a hunt for strategic, quality assets from distressed producers that could provide financially stronger upstream players with less expensive opportunities for inorganic growth. In 2014, buyers already demonstrated a preference for producing assets in 45 percent of announced E&P deals worth at least $1 billion. Mid-cap companies with robust balance sheets, which may have already been strengthened by divestment of non-core assets, could become opportunistic buyers in this space. For example, in late 2014, mid-cap E&P company Ophir Energy (market cap $1.5 billion) announced the acquisition of a small, independent E&P peer, Salamander Energy (market cap $385 million).[2]

Some upstream companies, including diversified, higher-capitalized independents and supermajors, may enter a wait-and-see period as oil prices find the bottom and views develop on the timing and extent of recovery in global oil prices. In the interim, the independents will operate at a slower pace because of the global supply surplus. Some of these companies entered shale plays early at low prices and have continually declining drilling costs per barrel that will potentially be bolstered by downward price pressure on oilfield service providers. Supermajors will likely focus on driving cost efficiencies, curtailing high-cost projects, including in their shale holdings, and improving the performance of core cash-generating assets worldwide.

Upstream North American assets and corporate prospects will likely sustain the interest of deep-pocketed investors, including private equity. M&A inventory in North America may also increase during the year as some within the large population of small, highly-leveraged independent producers in the US market sitting on acreage that is not economic to develop at current oil prices to divest focus on immediate priorities or succumb to financial pressure.

- Recent analysis from the US Energy Information Administration indicates rising new-well efficiencies in several US shale basins, which could potentially attract buyers.[3]
- In Canada, potential approval of the Pacific Northwest LNG facility in 2015 could stimulate buyer interest. Lower-cost production from conventional oil fields and a strong US-Canadian dollar exchange rate could also lure back US investors.
- The North American market presents intriguing options for Asian energy companies seeking high-quality reserves to support national energy security objectives – despite demand growth being slower than anticipated in Asia going into 2015. One possibility: mid-sized, Chinese state-owned entities may pursue conventional upstream assets in Canada while also expanding their reach into US shale plays. Another possibility: ONGC plans to invest $170 billion through 2030 to increase oil output, including through foreign acquisitions, telling investors in late 2014 that $2 billion acquisitions were "not a problem."[4]

2 FactSet, market capitalization values as of 24 November 2014.

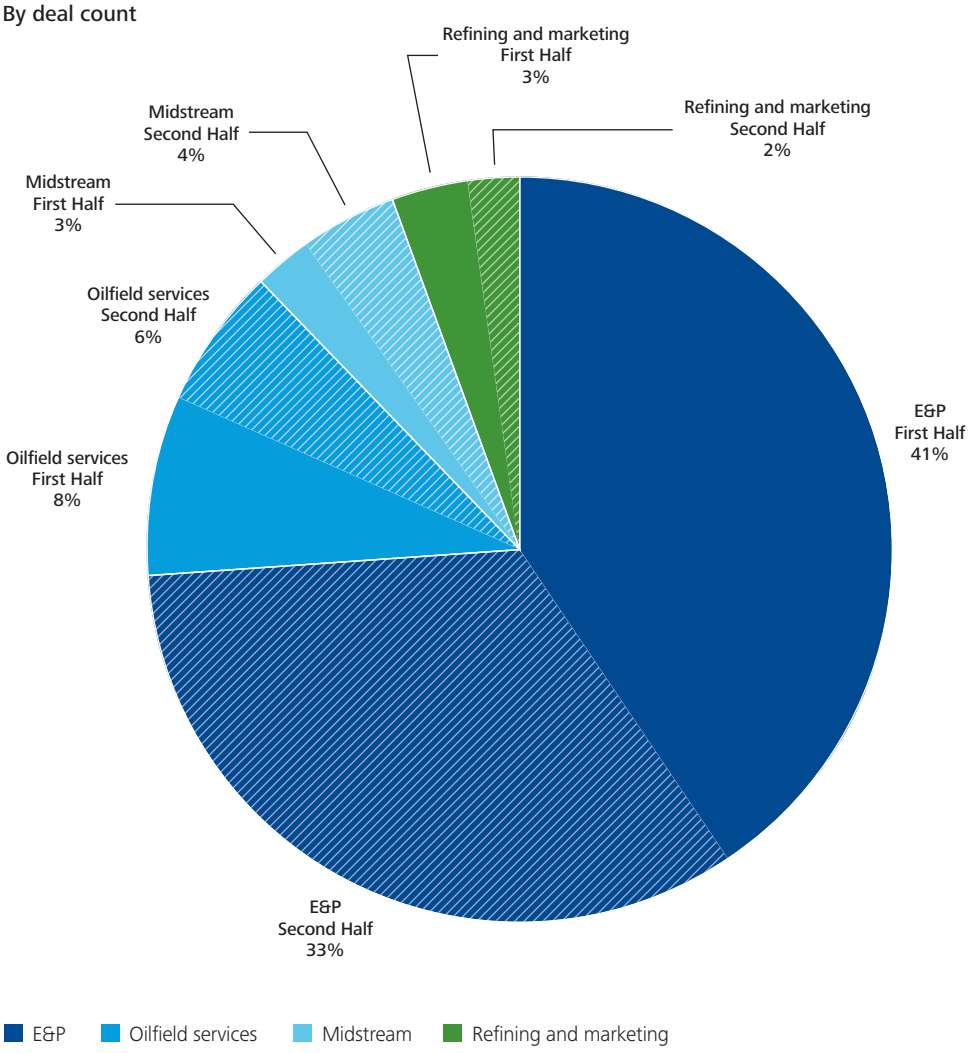
3 US Energy Information Administration, Drilling Productivity Report, December 2014. http://www.eia.gov/petroleum/drilling.

4 ONGC Limited Q2FY15 Results Conference Call, 14 November 2014. http://ongcindia.ongc.co.in/wps/wcm/connect/d7c7a413-f660-47a9-b185-ee8145358e4d/TranscriptQ2_FY15.pdf?MOD=AJPERES&CACHEID=d7c7a413-f660-47a9-b185-ee8145358e4d

2014 oil and gas M&A snapshots

Figure 8. 2014 oil and gas M&A overview

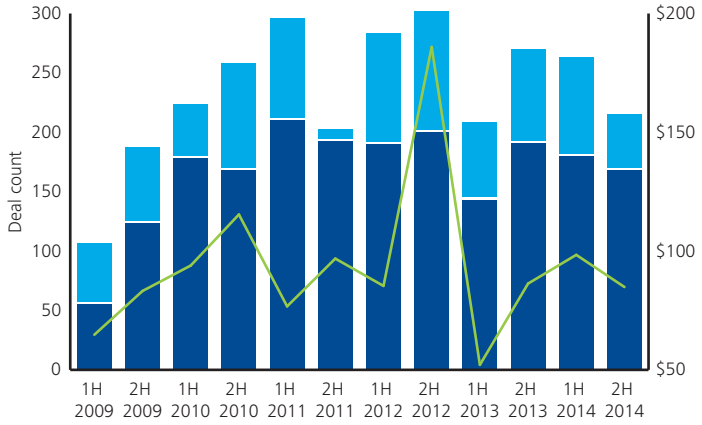
By deal count



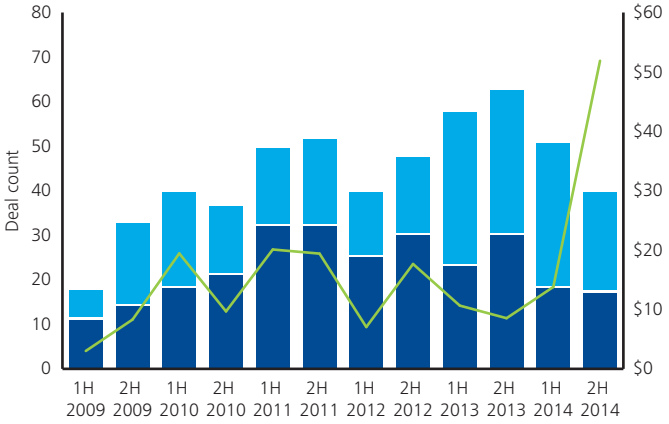
Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2014

Looking across the industry's sectors, E&P transactions continued to make up the majority of M&A activity, comprising 74 percent of total oil and gas transactions in 2014. The decline in global oil prices resonated throughout the oilfield services sector in 2014, depressing deal activity in the second half of the year by nearly 40 percent. Although M&A activity in the midstream sector also slowed in 2014, midstream was the only sector with more deal activity in the second half of 2014 than the first half. Midstream transaction value also surged to nearly $80 billion in 2014, with three transactions ranking among the top 10 M&A transactions for the oil and gas industry in 2014. The refining and marketing sector was the only sector to record more deals in 2014 than 2013, albeit with the lowest number of total transactions of any of the sectors.

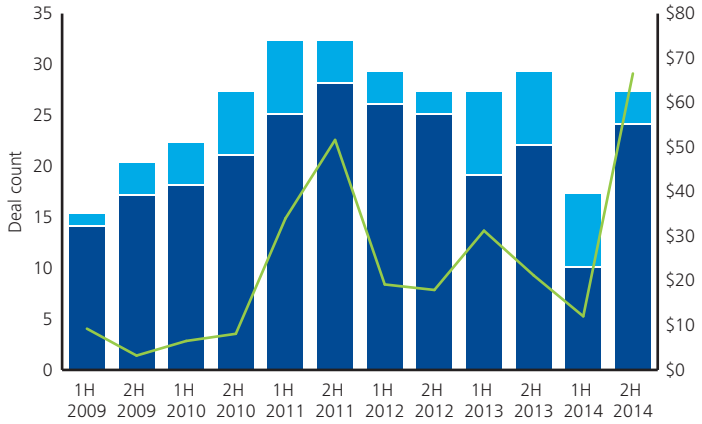
E&P



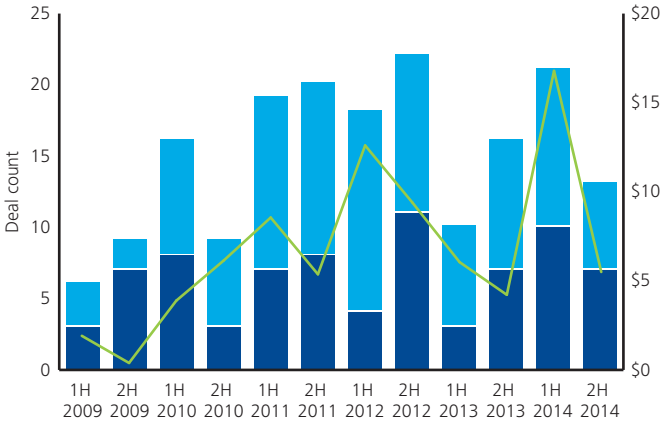
Oilfield services



Midstream



Refining and marketing



Diversified includes globally diversified and non-specified.

North America Rest of the world Deal value (billion USD)

Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

North America remains the largest and most active M&A deal market in the oil and gas industry. The Canadian and US markets captured a larger share of M&A deal value in 2014, a multiyear high of 73 percent of total oil and gas M&A deal value. Overall, other world regions' shares declined or stagnated, with the exception of Asia/Australia, which increased its share of total deal value from six to 10 percent because of E&P deal activity.

Oilfield services

Vulnerability to inspire innovation

2014 oilfield services review

The decline in global oil prices resonated throughout the oilfield services sector in 2014, depressing deal activity in the second half by nearly 40 percent (i.e., 119 deals in 2013 versus 89 deals in 2014). Reduced deal activity most acutely affected drilling, down 67 percent, and support services, down 56 percent, compared to the same period in 2013. Among industry participants, this came as no surprise. A sense of apprehension prevailed throughout the industry in 2014, particularly in oilfield services. This uneasiness was brought on by rising operating costs, as forecast in our 2013 year-end M&A report, amid a flat, and later falling, global oil price environment.

The real M&A story for oilfield services in 2014, however, could be entitled, "A Tale of Two Deals." Two US deals worth a combined $46 billion and comprising 70 percent of total oilfield services deal value dominated the landscape: Halliburton/Baker Hughes and Siemens/Dresser-Rand. The announced $38 billion merger of Halliburton and Baker Hughes is the third largest industry deal in the past 10 years, and it boosted total oilfield services transaction value by 250 percent over 2013. The $7.6 billion acquisition of Dresser-Rand by Siemens is the fourth largest acquisition in the history of the US oil and gas production equipment segment and the largest by a foreign buyer. Both deals perpetuated the ongoing theme of "the rise of unconventional production," as Halliburton strengthened its US shale portfolio and engineering firm Siemens gained key technologies for the hydraulic fracturing market.

However, a two-deal story ignores an important third deal: the announced merger of C&J Energy Services and the completion and production services business in the United States and Canada of Nabors Industries, which is expected to create the third largest oilfield services firm after the announced merger of Halliburton and Baker Hughes. This merger may portend oilfield services dynamics that could play out further in 2015, specifically the emergence of new top players in the oilfield services sector with highly complementary business lines.

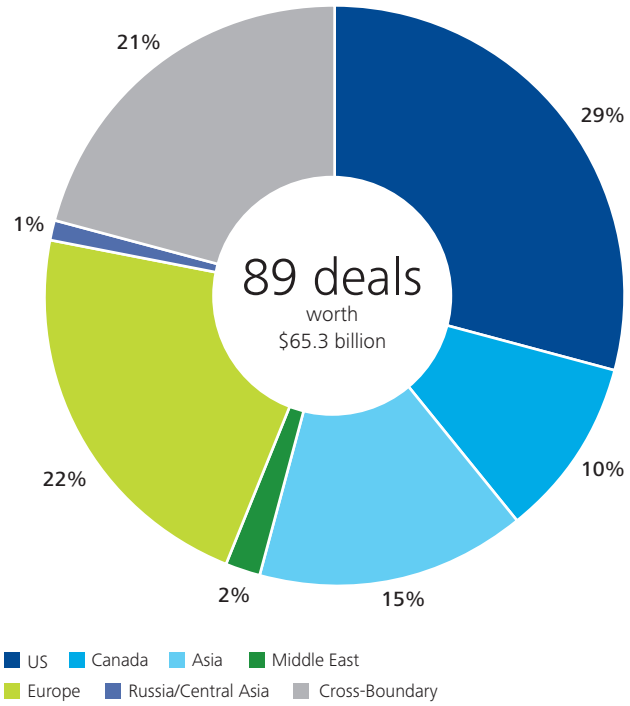
The geographic distribution of oilfield services M&A transactions is also telling, indicating a high degree of responsiveness to industry trends.

Europe and the United States captured 95 percent of total oilfield services deal value in 2014. This dominance is not surprising considering Europe has a legacy of deepwater development in the arduous North Sea environment and the US has posted record-breaking tight oil and shale gas production growth. Europe and the US are also home to oilfield services giants at the forefront of technological innovation for increasingly complex geologic targets, through acquisitions and research and development efforts.

Asia captured a 15 percent share of oilfield services M&A activity by deal count in 2014. Singapore – a strategic base for oilfield services companies supporting the oil and gas industry throughout Southeast Asia – was the dominate deal market within the region. The rise of Singapore represented a market shift from 2013 when Australia's growing energy industry experienced a flurry of corporate transactions.

Figure 9. 2014 oilfield services M&A activity

By deal count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

2015 oilfield services outlook

Early indicators suggest the oilfield services sector's vulnerability to lower E&P expenditures and global oil prices has placed it on track for a resurgence in M&A deal activity in 2015 while also providing companies in this sector with a continuing opportunity to drive innovation in the oil and gas industry.

The oilfield services sector has achieved only marginal, if any, improvements in net contract prices, excluding sand logistics and drilling rigs, since 2011 when global oil prices settled above $100/bbl, putting the sector at a relative disadvantage in comparison to prior industry down-cycles. Even in hydraulic fracturing – the oilfield services segment with the strongest growth from 2013 to 2014 – market saturation has diminished the market share of the largest companies since 2010.[5]

And, another challenge awaits. The speed and steepness of the global oil price decline has catapulted upstream companies into budget revisions that in many instances have yet to translate into project-by-project determinations. Meanwhile, those oilfield services companies that took on debt to expand to meet demand that is now evaporating still have debt payments to service.

Overall, oilfield services is likely to experience some distress earlier than other sectors as producers cutback drilling budgets, seek price concessions or elect not to extend contracts. Oilfield services companies geographically focused or tied to particular upstream operators, in particular, might find themselves facing monthly revenue drops that could prove unsustainable without new capital injections. Adding to this inventory will be corporate divestitures resulting from 2014 M&A deals, as in the announced Halliburton/Baker Hughes merger. This could entice new energy-centric private equity funds with deep pockets, as well as large oilfield services companies seeking inorganic growth. According to executives at National Oilwell Varco, the Halliburton/Baker Hughes deal may result in divestitures, creating opportunities for acquisitions to boost scale and service offerings.[6]

M&A activity in the oilfield services sector has the potential to veer in several new directions. Watch for a potential reversal of the move made by many oil companies in the early 1990s to outsource oilfield services, along with an emergence of new alliances, which could rapidly diversify the portfolios of oilfield services companies. Alliances could also better position upstream producers for rapid capital deployment when global oil prices recover, particularly given the steep competition for contracts among the dwindling number of oilfield services companies capable of supporting frontier projects (e.g., shale, arctic, and ultra-deepwater). Diversified multinational companies – as demonstrated in the Siemens transaction and in recent moves by GE to deepen its energy portfolio – could also seize on depressed asset and corporate valuations to swiftly enhance their energy businesses and competitive position in the oilfield services space.

Despite the challenges, the outlook for the oilfield services sector appears to be positive in some areas, particularly in the US and in relation to liquefied natural gas (LNG) projects. For instance:

- In the near term, sustained lower global oil prices may usher in a new wave of innovation to preserve and build market share. In addition, US methane regulations could spur new business for equipment manufacturers and services providers involved in emissions tracking and containment.
- Upstream capital spending in shale and deepwater Gulf of Mexico will also likely grow and the need for oilfield services along with it. Like some oil regions of the US in decades past, San Joaquin basin, for example, shale deposits will also eventually require increasingly sophisticated oilfield services that only a narrower group of technically-sophisticated companies will be able to provide. As such, US shale basins could present a continuing stream of lucrative opportunities for capable oilfield services companies.
- Growth in LNG and small-scale liquefaction at drilling sites could also generate opportunities for oilfield services companies.

5 Spears, Outlook for the US Upstream Oil and Gas Industry, January 2015.

6 MergerMarket, Baker Hughes sale to spur increased oilfield services dealflow, 20 November 2014.

Midstream

Evolving structure and players

2014 midstream review

Midstream transaction value surged to nearly $80 billion in 2014, a three-year high, compared to about $52.5 billion in 2013. Three midstream transactions, all with master limited partnership (MLP) acquirers, ranked among the top 10 M&A transactions for the oil and gas industry in 2014 and made up roughly 60 percent of total oil and gas deal value. For instance, the $34.4 billion merger of Access Midstream Partners and Williams Partners LP created one of the largest companies in US natural gas pipeline and processing infrastructure.

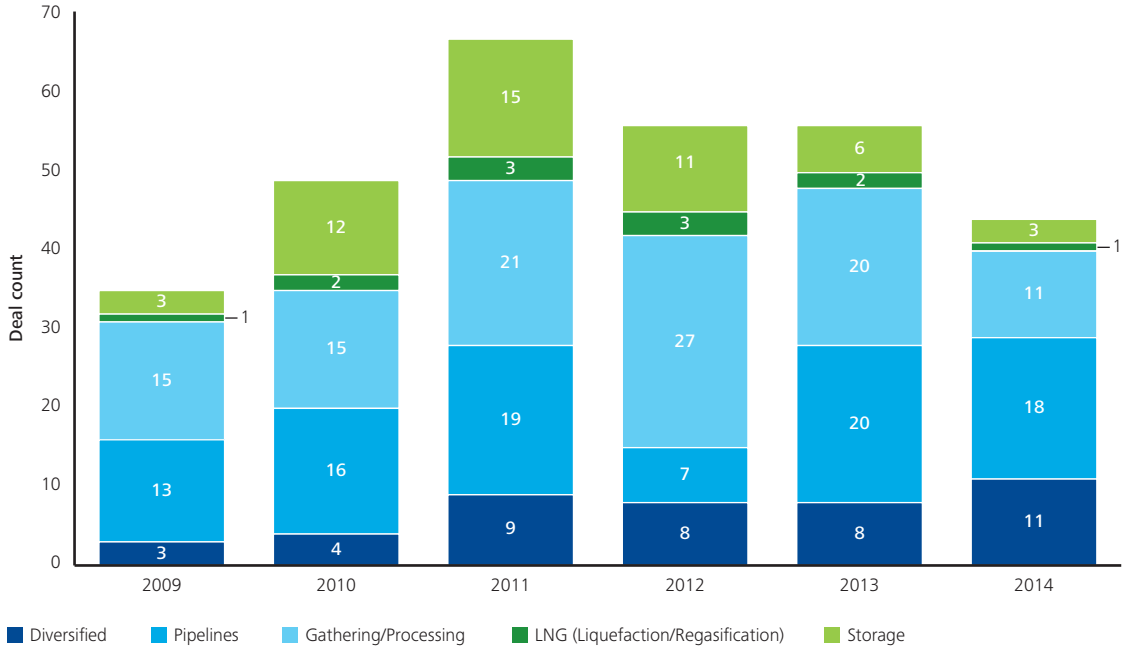
Beyond the top 10 deals, a notable trend emerged: the dominance and consolidation focus of MLPs and infrastructure funds in midstream transactions. This group of buyers accounted for nearly 90 percent of the $65.7 billion in transactions with a minimum value of $1 billion. In addition, all but one of the $1-billion-plus transactions occurred in the US, helping expand its share of overall midstream deal value from 56 percent in 2013 to 86 percent in 2014.

In 2014, Latin America was the most active midstream M&A region outside the US, accounting for 16 percent of deals. During the first quarter, gas pipeline operators and local engineering and construction companies announced $1.9 billion in equity acquisitions in Peruvian natural gas pipeline assets. Peruvian upstream operator, PlusPetrol, anticipates the country will lead the region in electricity demand growth, which is expected to be met through increased gas supply that will require infrastructure expansion.[7]

The pipeline business segment continued to increase its share of deals even though the number of deals declined from a peak of 20 in 2013 to 18 in 2014. Gathering and processing deal activity declined much more steeply, falling 45 percent year-on-year, although signs of interest in the segment remain.

Read more – The rise of the midstream: Shale reinvigorates midstream growth

Figure 10. 2014 midstream M&A activity



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

7 PlusPetrol, Building on the success of Camisea, May 2014.

2015 midstream outlook

Midstream's near-term growth prospects, while susceptible to the broader oil and gas industry dynamics, appear to be brighter than the upstream sector and may be poised for growth through M&A in 2015. The fee-based contracts and relatively stable, long-lived cash flows associated with midstream assets naturally appeal to many investors. In addition, numerous developments worldwide should help sustain positive midstream momentum – even if at a somewhat slower pace than anticipated one year ago.

Commodity prices. With some upstream activity being suspended going into 2015 in response to oil market conditions, pricing on midstream assets may relax. Risk-averse investors may seek out lower-risk equity investments, such as long-haul natural gas pipelines, particularly while interest rates remain relatively low.

Liquefied Natural Gas. Encouraged by international trade dynamics and the regulatory environment, natural gas appears to be well positioned to sustain modest global demand growth through the end of the decade. Infrastructure build outs to support LNG projects in the latter stages of development and that are already contracted, primarily in North America and Australia, will likely have the momentum to withstand the current commodity price slump; however, LNG projects in earlier stages of development may be delayed or cancelled outright.

Storage. Here, two conditions could potentially encourage opportunistic investment: an increase in oil purchases for onshore commercial storage, particularly in China where independent operators are permitted to operate oil storage facilities and have been aggressively increasing capacity; and, the prospect of higher than usual global oil price volatility, as demonstrated through crude oil futures.

The North American midstream M&A outlook is positive, being further strengthened by the potential for the expansion of pipeline systems to support growing demand for natural gas as a transportation fuel and as a cleaner energy feedstock for industrial production and power generation – particularly in light of the growing movement to retire aging coal-fired power plants. Residential demand is also outgrowing infrastructure capacity, especially during cold snaps in the Northeast and mid-Atlantic regions. Additional factors include:

- In the absence of the approval and completion of the Keystone XL pipeline, any growth in Canadian oil exports handled through US terminals would heighten demand for barges and rail infrastructure. This in turn could stimulate deal interest in the US midstream segment.
- Likewise, in Canada, the Energy East project, if approved, will require heavy capital injections to support the buildout of the pipeline and related infrastructure, such as pump stations and tank facilities that could attract investors.
- Looking more broadly within the Western Hemisphere, Mexico's energy reform is generating demand for investment and support on a range of projects, including natural gas transport. At least some of these efforts should catch the eye of institutional lenders as well as traditional oil and gas companies. Projects in Mexico, as well as those scattered throughout Latin America, raise an interesting prospect for the internationalization of US midstream companies.

The midstream sector will not be immune to the broader struggles of the energy industry. In particular, gathering and processing volumes could shrink and infrastructure buildout requirements could decrease if global oil prices stay low for the next few years. Private equity, infrastructure funds, and other investors that have facilitated the expansion of gathering, processing and pipeline systems will soon need to discern which capacity enhancements will need to be postponed or canceled as upstream producers reprioritize projects with output destined for the infrastructure. In addition, upstream producers could seek to reduce their costs by renegotiating take-or-pay contracts. Particularly vulnerable are companies that aggressively acquired pipeline assets and now face project delays and reduced throughput extending beyond 2015.

Refining and marketing

Systemic issues inspiring deals

2014 refining and marketing review

During the last five years, deal value and volume in the refining and marketing sector have outstripped the previous five-year average from 2006 to 2010 by 65 and 70 percent, respectively, with retailing and marketing and cross-segment transactions comprising the bulk of activity. 2014 was no different. The sector reached a multi-year high of nearly $23 billion in transactions, a 110 percent increase from 2013 for deal value, driven by robust global activity in the retailing and marketing segment.

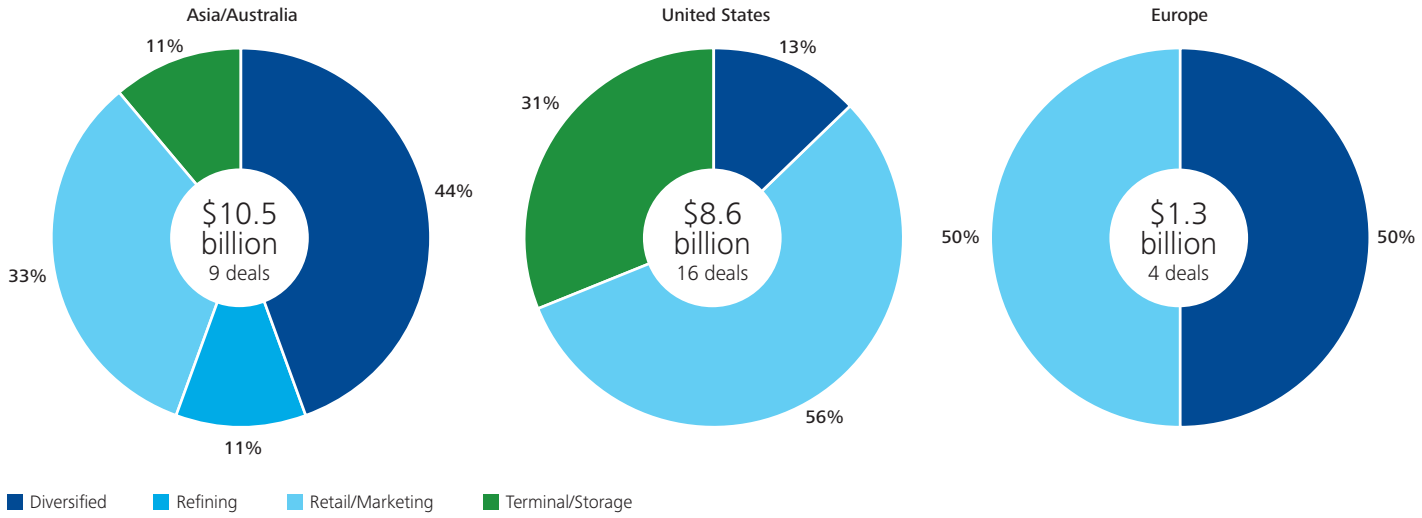
The M&A targets, by region, in the refining and marketing sector illuminate persistent systemic challenges that will continue to shape the sector's M&A activity outlook.

Asia/Australia. The Asia/Australia market dominated the sector by deal value, capturing $10.5 billion in deals (see Figure 11). National oil companies – ONGC, Petronas, and Saudi Aramco – were the exclusive buyers in Asia, with the exception of Prosperity Gas Holdings, a privately held US company operating in China. Saudi Aramco executives said the company's corporate acquisition of Korean refiner S-Oil, which was the only refining deal of 2014, is indicative of its confidence in the South Korean economy and interest in increasing its footprint in Asian markets.[8]

United States. More than half of the $8.6 billion in US deals were in retailing and marketing with seven of the nine transactions in retail trading and marketing operations. Two of these deals each exceeded $2 billion – Hess/Marathon and Susser/Energy Transfer Partners – bolstering the companies' stand-alone retail businesses. Terminals and storage made up another 30 percent of US deals, deepening the buyers' strategic infrastructure inventories.

Europe. Deal activity contracted for the third consecutive year in Europe. Refiners struggled against declining consumption of refined product within the EU – approximately 18 percent since 2005 – and competition from US exports of refined products and from greenfield refineries, such as those that have come online in the Middle East and are designed to produce fuels that meet Euro-5 emissions standards. By some estimates, the EU has shut down approximately 1.2 million barrels per day (b/d) of refinery capacity between 2008 and 2013, with more likely to come.[9]

Figure 11. 2014 top three most active refining and marketing M&A markets



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 9 January 2015

8 Petro Global News, Aramco buying S-Oil stake from Hanjin, 6 July 2014. http://petroglobalnews.com/2014/07/aramco-buying-s-oil-stake-from-hanjin/

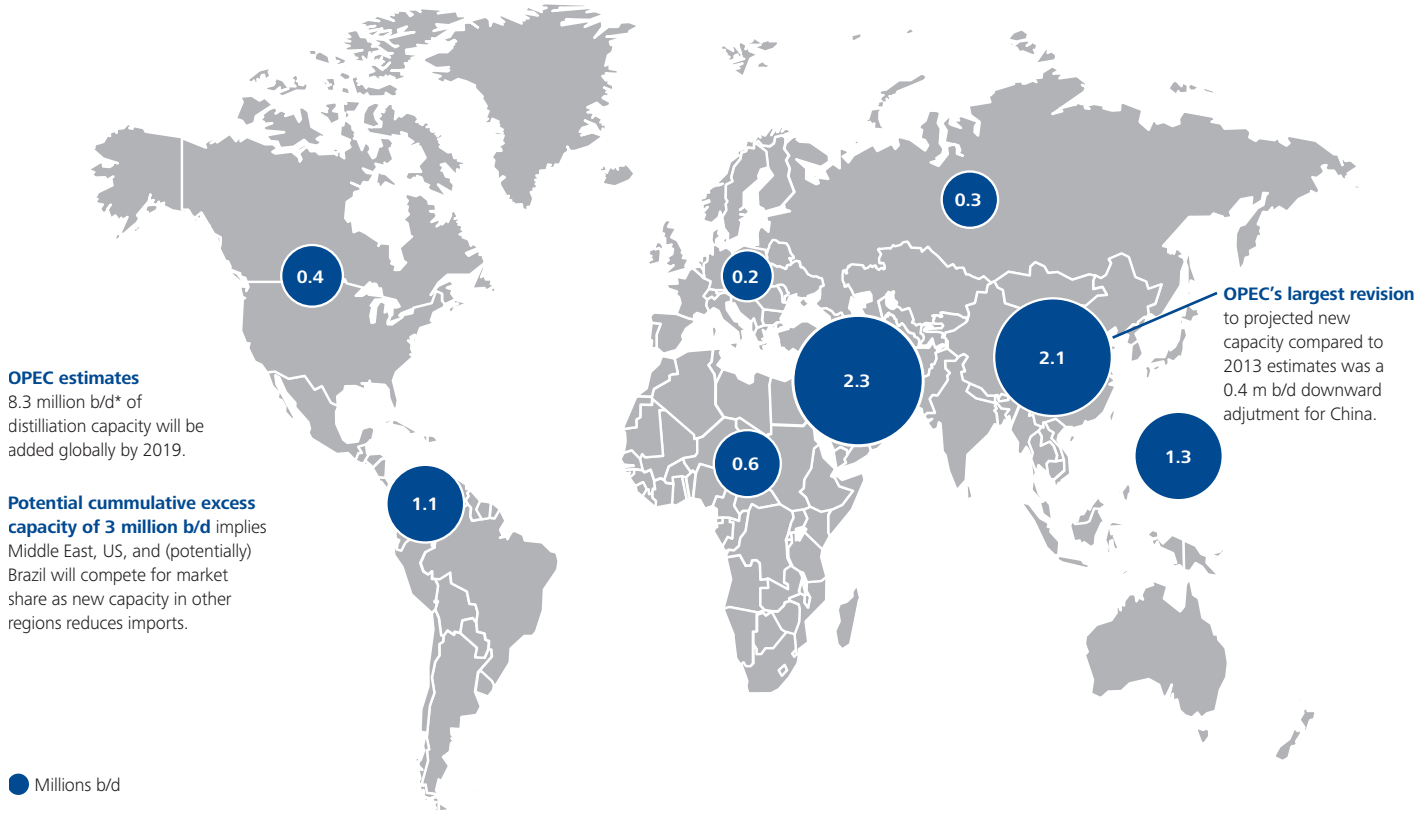
9 Enerdata, Middle East to compensate EU refining capacity decline, 2 October 2014. http://www.enerdata.net/enerdatauk/press-and-publication/energy-news-001/middle-east-oil-refined-consumption-increase_30188.html

2015 refining and marketing outlook

The M&A outlook for refining and marketing is complicated by systemic issues that will persist beyond the stabilization of global oil prices, however, areas of growth may attract strategic investors. A similar situation occurred in the chemical sector in 2014 as it struggled to rationalize production when demand growth in emerging markets fell short of industry expectations. Today, an oversupply outlook on global refining capacity through 2019 (see Figure 12) suggests rationalization may also be necessary in refining and marketing, which could contribute to a low level of M&A activity.

The exit of some refiners could be accelerated by competition from growing US petroleum product exports – exports through November 2014 averaged 3.8 million b/d, a 65 percent increase since 2010 – and impending reductions in global refinery utilization rates as new refineries start up. Watch for upstream companies with heavy exposure to potentially divest higher-margin refining assets, and potentially shutdown others, outside the US as global oil prices test the financial capacity of even the largest upstream companies to endure downstream losses.

Figure 12. Distillation capacity additions from existing projects, 2014-2019



Source: World Oil Outlook 2014, Organization of the Petroleum Exporting Countries.
*Estimates does not account for potential capacity closures or capacity improvements through debottlenecking.

M&A activity in the US refining and marketing sector in 2015 will be nuanced. The US, however, is not expected to experience a marked increase in M&A in refining since the segment presently enjoys structural advantages, such as ample access to domestic supplies of light crude feedstocks and low-cost natural gas to run its facilities. US refiners, however, potentially could see their margins pressured depending on where global oil prices settle and if the US ban on crude oil exports is lifted.

Two groups of potential buyers with more diversified risk in the oil and gas industry could potentially become more active in the refining and marketing sector. Real estate investment trusts and infrastructure funds may be interested in building upon their 2014 efforts to develop larger market presences. In addition, oil traders and commodity merchants have grown as owners of physical assets, such as pipelines, oil fields, and condensate splitters, among others, suggesting they may have the desire and investment flexibility to move strategically into refining and marketing to capture greater supply chain value and capitalize on arbitrage opportunities.

Outlook

Primed for a rebound, in time

If the rapid and steep decline in global oil prices during the second half of 2014 stifled global M&A in the oil and gas industry, it will be the opportunities to reactivate the deal market that define the industry in 2015. With more certainty, investors are likely to respond to "the new normal" – a more volatile global oil market, a state of efficiency never before tested in the US shale industry, and consolidation, even of some of the industry's larger companies, forging sustainable cost-saving synergies. Billions of dollars are sitting on the sidelines as companies and investors assess how to best capitalize on the current oil price environment and put the industry's rebound into motion.

Based on early indicators in 2015 and the analyses presented throughout this report, by yearend 2015 oil and gas industry M&A activity could regain momentum with the potential to redesign the US upstream sector, forge strong synergies among global oilfield services companies, broaden the scope and scale of the midstream worldwide, and even carve out space for refining and marketing to better align with broader global economic growth trends.

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