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Deloitte Oil & Gas Mergers and Acquisitions Report
Year-end 2013
The deal market quiets down

Deloitte Center
for Energy Solutions

Contents

Vice Chairman's introductory comments

For the oil and gas industry, 2013 was a year that focused on the development of existing resources rather than the acqusition of new ones. The prior three years saw a surge in merger and acquisition (M&A) activity as the industry focused on expanding acreage and drilling rights to capitalize on high oil prices, pursuing emerging unconventional shale plays, and evaluating oil sands prospects. In 2013, many producers focused on developing properties acquired in previous years – namely, on streamlining operations and maximizing returns on assets. This emphasis on development and organic growth contributed to a drop in both deal values and the total number of deals completed. Globally, the industry saw a drop of 41 percent in deal values, from $349 billion in 2012 to $205 billion in 2013, and a completion of 119 fewer deals in 2013 than in the previous year.

Commodity prices remained relatively stable, and the differential between West Texas Intermediate and Brent crude prices narrowed as new pipelines came on line, others reversed flows to ease transportation bottlenecks in the United States, and crude transport by rail increased significantly. In spite of improving prospects for liquefied natural gas exports, a revitalization of the U.S. petrochemicals industry, an increasing use of natural gas for transportation and power generation, and a rising demand from domestic manufacturers, producers in the United States seem willing to maintain assets in hopes prices could rise.

The United States and Canada were the center of deal activity in 2013, accounting for 64 percent of all transactions. Many of the largest deals were strategic and enabled companies to increase their exposure to unconventional plays. Foreign investment, on the other hand, seemed to be taking a pause during 2013.

Although Asian oil companies maintained their hunt for assets, seeking to secure supplies for liquefied natural gas shipments and expanding their exposure to North American unconventional plays, their activity was not as robust as it had been in the previous year. These investors, too, seemed to shift their focus from acquisitions to development.

The oilfield services sector continued to be affected by cost containment efforts of producers, as many larger companies began to focus on the efficiency of development costs, including consolidating the number of services and equipment providers they hire, to help drive efficiency and cost competitiveness. In 2013, the oilfield services sector deal values were down, but the number of transactions rose, which could indicate the sector may be ripe for consolidation, especially of smaller companies and those with specific technologies. Private equity also showed an interest in this sector.

While deal activity continues to be dominated by the exploration and production (E&P) sector, the largest deal of 2013 – the $6.7 billion purchase of Repsol's Latin American assets by Shell – came from the midstream sector. As we move into 2014, deal activity could shift from the upstream sector to midstream infrastructure and downstream operations.

John England
Vice Chairman
U.S. Oil & Gas Leader
Deloitte LLP

Industry overview

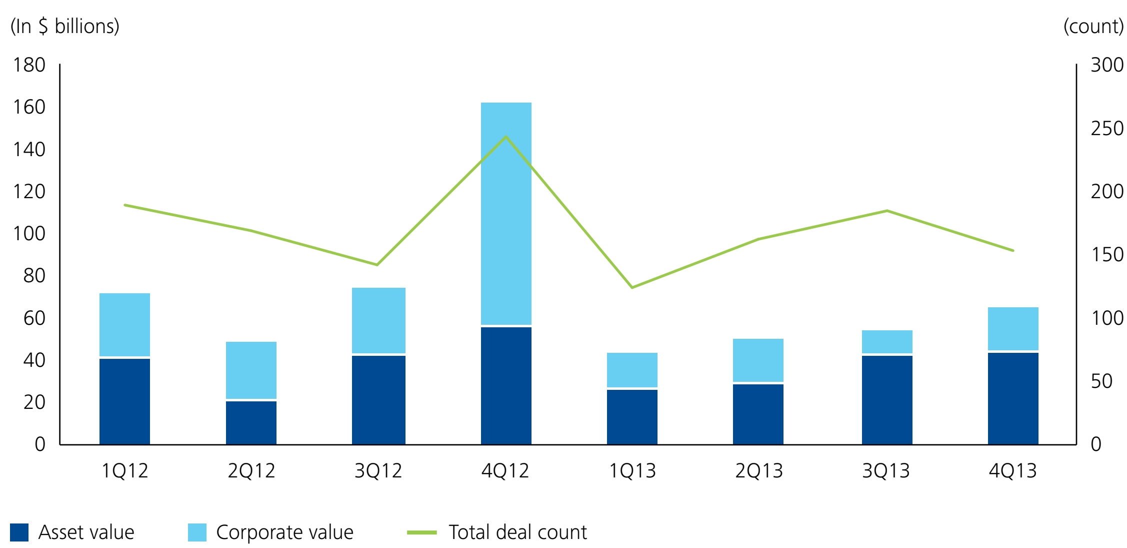
M&A activity eases as producers refocus on existing assets

Driven by the increase in unconventional reserves onshore in the United States, oil and gas companies focused on buying acreage in emerging resource plays over the last several years. The focus on expansion culminated in a surge of deal activity at the end of 2012. In 2013, the industry shifted gears, focusing on developing the acreage it had acquired and on organic growth rather than acquisitions. As a result, the total number of deals globally in the oil and gas industry declined by 16 percent and the overall value was down 41 percent compared with that of 2012 (Figure 1). E&P companies saw a significant decline in activity, with a 50 percent decrease in deal value and a 23 percent decrease in deal count. "The E&P companies have been very focused on organic growth and developing what they have," said John England, Vice Chairman, U.S. Oil & Gas Leader, Deloitte LLP. "Because of that, there was less focus on going out and doing deals in the market." Onshore drilling programs also underwent a shift to oil and liquids-rich projects and away from gas plays.

Economic and political uncertainty in the United States, including persistent budget battles and the government shutdown, fed uncertainty in the market place and may have weighed on deal activity in 2013. "All the uncertainty we went through had an impact on people's willingness to go out and spend money and do deals," said Jason Spann, partner, M&A Transaction Services, Deloitte Tax LLP. This year's decline was the largest in five years, with the total number of deals for the United States and Canada falling by 21 percent to 398 from 505. The declines extended to the Middle East, Europe, South America, and the Caribbean, while Asia and Africa registered modest increases. Russia saw its deal activity rise by 31 percent for the year.

The total value of global energy deals fell in 2013, to $205 billion from $349 billion, with the bulk of the activity concentrated in North America. The decline in both the number and value of deals reflects the change in producers' strategies for shale plays. The rush to find reserves and acreage leases in the United States, which helped spur deals in years past, slowed in 2013, as E&P companies shifted their focus toward developing those acquisitions. Adding to the drop in global activity, finding costs continued to rise around the world. The higher finding costs crimped company earnings and free cash flow, which, combined with the need to deploy cash to develop existing properties, meant companies had

Figure 1. Global oil and gas M&A deals by value and count



Note: M&A activity examined in this report represents announced mergers and acquisitions involving oil and gas companies between the first quarter 2012 and the fourth quarter 2013, with values greater than $10 million, including transactions with no disclosures on reserves and/or production. Our analysis has excluded several transactions between affiliated companies to provide a more accurate picture of M&A activity in the industry. Deloitte's methodology takes a deeper look into the M&A transaction data.

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

less cash available for acquisitions. The average cost of producing a barrel of oil surpassed $45 a barrel in 2012, up from close to $39 per barrel in 2011, according to a report by Howard Weil.[1] A decrease in profit per barrel also means fewer projects meet the investment appraisals for which buyers are looking.

While E&P companies pulled back on deals during 2013, the need for services and infrastructure kept the deal count steady in the oilfield services and midstream sectors. "There's huge demand for the infrastructure to fuel this North American renaissance," noted Jed Shreve, principal, Deloitte Financial Advisory Services LLP. "Private equity has noticed and continues to look for opportunities to deploy capital in the industry," said Melinda Yee, partner, M&A Transaction Services, Deloitte & Touche LLP. "Energy-focused funds have had strong fund-raising efforts, while other diversified private equity funds continue to look at avenues to enter the oil and gas value chain, such as addressing the backlog of needed energy infrastructure projects in North America and the opportunities in oilfield services and equipment," Ms. Yee added.

"Private equity has noticed and continues to look for opportunities to deploy capital in the industry."

– Melinda Yee
Partner, M&A Transaction Services
Deloitte & Touche LLP

1. Bachmann, Joseph. "2012 F&D Cost Study", Howard Weil, Mar. 12, 2013. http://www.howardweil.com/docs/Reports/Conference/2012-FDStudy.pdf

Canada experienced a marked decrease in deal activity in 2013, but deal counts doubled in the second half of the year as companies that needed to sell assets became more motivated and others decided to refocus their businesses. "Companies are repositioning themselves on both sides of the U.S.-Canadian border to divest of noncore properties," said Brian Pyra, Alberta Oil & Gas Tax Leader, partner, Deloitte Canada. The disposition activity may be in part to fund drilling plans in oil and liquids-rich areas.

Oil prices remained stable during the year, which further diminished the appetite for deals, even as the economy improved and demand began to rise. Increased production from U.S. shale plays helped offset the impact of geopolitical upheavals in places such as Libya, Syria, and Iran. Meanwhile, the price differential in the United States between benchmark West Texas Intermediate and international markets eased as more infrastructure came online to address production bottlenecks. While international natural gas prices remain strong, in the U.S., despite record cold temperatures, gas prices improved only slightly, touching $4 per thousand cubic feet for the first time since 2011. "Gas got better, but relative to the returns you get on oil projects, it's not even close," Mr. England said. "The stock market seems to be giving much more value to oil-based companies. The low prices for natural gas, which are likely to persist throughout 2014, even with the recent increase to over $5 per thousand cubic feet in the early weeks of 2014, put a damper on deal-related activity among gas-focused producers."

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

"The stock market seems to be giving much more value to oil-based companies."

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Vice Chairman, U.S. Oil & Gas Leader
Deloitte LLP

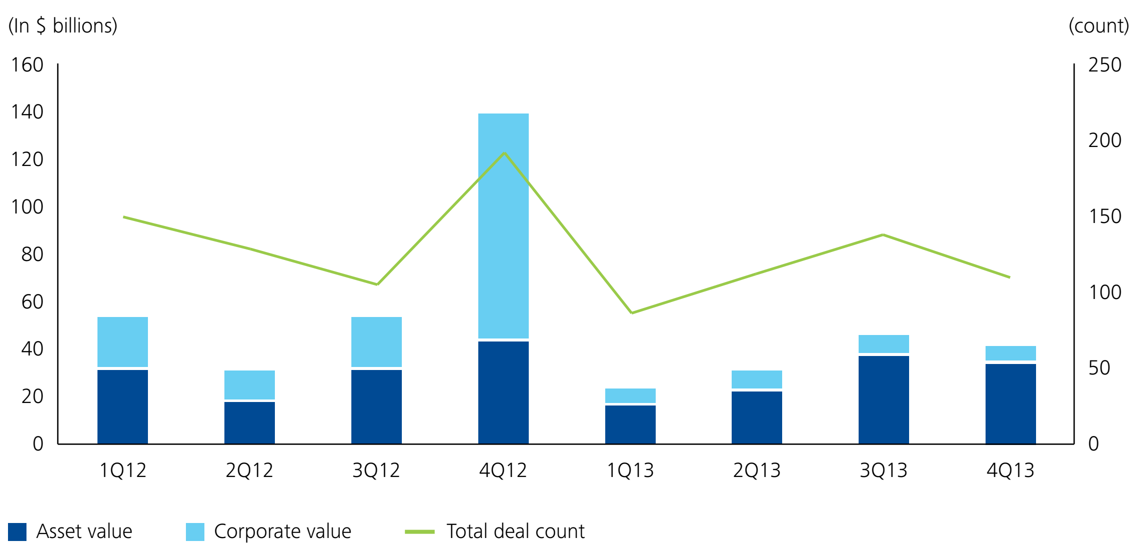
Exploration and production

A more strategic focus

Interest in North American assets continued to drive the transaction market in 2013, with six of the year's ten largest deals focused on E&P assets, led by Devon Energy's acquisition of GeoSouthern Energy's Eagle Ford Shale properties for $6 billion. The volume of deals in the E&P sector outpaced other parts of the oil and gas markets, even though both the pace and value of deals fell. "Upstream is still king in terms of the volume of activity," said Trevear Thomas, principal, M&A Consulting Services, Deloitte Consulting LLP. As is depicted in Figure 2, the decline in deal volume appeared more extreme because it followed a surge in activity in the fourth quarter of 2012. The number of deals fell 23 percent for the year, to 445, compared with 578 in 2012. The value of transactions fell by $135 billion, or 50 percent.

Within the North American market, deal activity was concentrated on "unconventional" production in the Eagle Ford and Permian Basin plays of Texas, in particular. Companies adopted a more strategic focus to their transactions during the year, looking at buying developed, producing properties, rather than making corporate acquisitions. "Valuation multiples have stabilized over the past two years averaging just over $15 per barrel of oil equivalent for deals with a value over $10 million," Mr. Shreve said. The deal activity in North America also reflected a concentration in oil-producing properties rather than natural gas. "Even though gas prices are at historical lows, there's really not anyone buying or selling it. They're just holding acreage and altering their development plans," Mr. Shreve continued.

Figure 2. Global E&P M&A deals by value and count

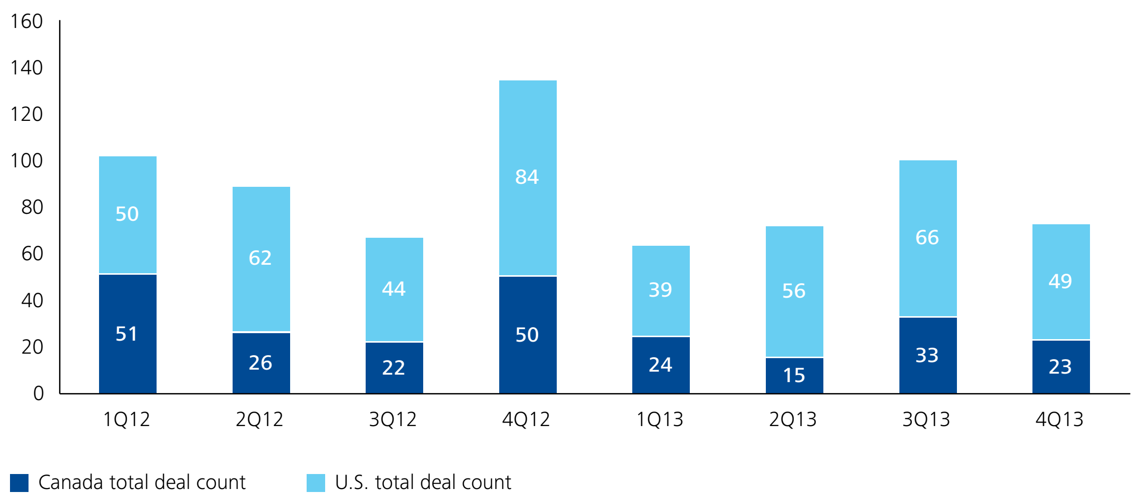


Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

“Even though gas prices are at historical lows, there’s really not anyone buying or selling it.”

– Jed Shreve
Principal
Deloitte Financial Advisory Services LLP

Figure 3. Canada and U.S. E&P M&A deals by count



Some companies that had been buyers in previous years became sellers in 2013 as producers attempted to align their asset mix and maximize their capital investments. "2013 has been characterized as a refocusing of strategies for many Canadian upstream producers in Canada," said Jeff Lyons, director, Deloitte Canada. One of the largest deals in Canada was Suncor's sale of its conventional natural gas business to a partnership between Centrica plc and Qatar Petroleum International. In announcing the deal, Suncor said the transaction is part of a commitment to capital discipline and aligning of assets with strategic objectives.[2]

Inbound investment into North America cooled during the year, as Asian investors who have already invested heavily in the North American supply for liquefied natural gas exports are pausing before securing more. Elsewhere, foreign oil companies that have pumped billions into North American unconventional reserves also retrenched. Like other producers and investors, they chose to focus on developing their existing investments before searching for new acquisitions.

Canadian transactions did pick up significantly in the last quarter of the year as more companies began preparing assets for sale. "If you look across North America, there's a lot of pent-up capital that wants to be in resources," said Robin Mann, partner, Resource Evaluation & Advisory, Deloitte Canada. "They've waited long enough that they're saying, `Hey, it's time for us to pull the trigger.'" As foreign capital investment slowed, other sources have gained prominence in Canada, including pensions, institutions, and private equity firms.

2. Lewis, Jeff, "Suncor's $1 billion asset sale to Centrica, Qatar company sparks divided chatter", Financial Post, April 1, 2013. http://business.financialpost.com/2013/04/15/suncor-sells-gas-fields-to-centrica-qatar-company-for-1-billion/?__lsa=8c60-99af

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

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Partner, Resource Evaluation & Advisory
Deloitte Canada

Oilfield equipment and services

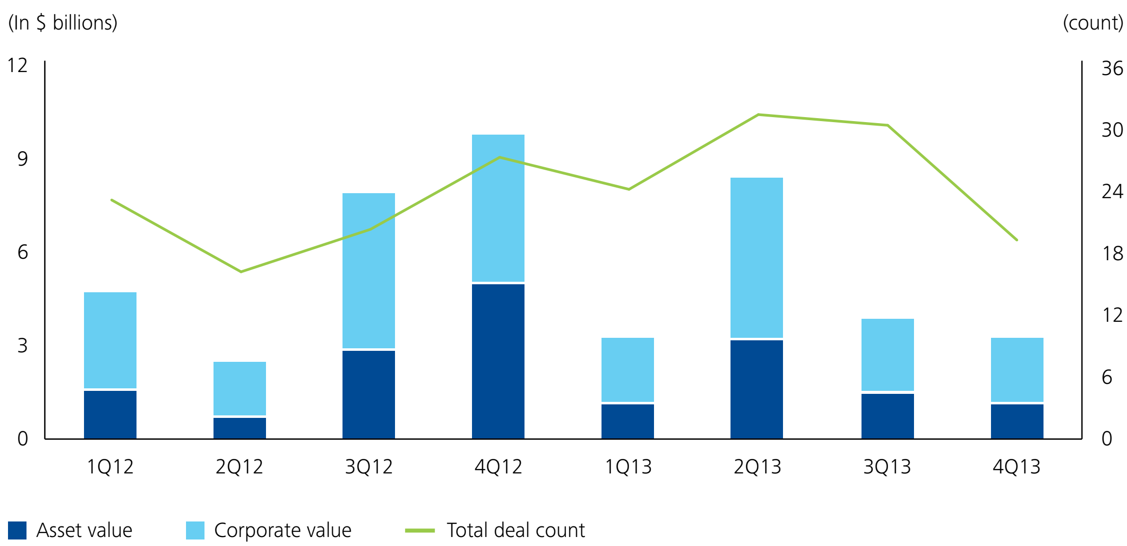
Smaller transactions dominate; consolidation may be coming

The oilfield services sector saw a 21 percent increase in deal activity in 2013, as the emphasis on increased efficient development by the E&P companies put pressure on services companies, which contributed to consolidation efforts. "With the focus shifting to development and production efforts in many of the shale plays, the demand for service and equipment companies is likely to remain high," said Mr. Spann. As producers shift their attention from acquisition to development, many are looking to increase their drilling efficiency, including a reduction in the number of contractors they use, which could continue consolidation efforts in the sector in 2014. The number of deals rose in 2013 – to 104 from 86 – although the total value fell 25 percent, to over $18 billion. The average deal size dropped by 38 percent, from $286 million in 2012 to $177 million in 2013. Increased activity in the first half of the year slowed in the second. See Figure 4 for a breakdown by quarter. "Higher prices for services have skewed the multiples of prospective deals, making it difficult to find buyers at the current levels," Mr. England said.

Service sector activity primarily focused on smaller transactions. Of the 104 deals in 2013, only seven were greater than $500 million. "That trend is likely to continue as large companies seek to acquire the technical expertise of niche players and companies seek increasingly specialized technology for hydraulic fracturing onshore, and drilling in greater depths and harsher environments offshore" Mr. Thomas said. The smaller transactions may also be indicative of private equity interest in the space as a means to capitalize on the energy renaissance that is occurring in the United States. "The level of fragmentation in the service and equipment sector gives private equity a larger field of potential companies or opportunities to invest in," Ms. Yee said.

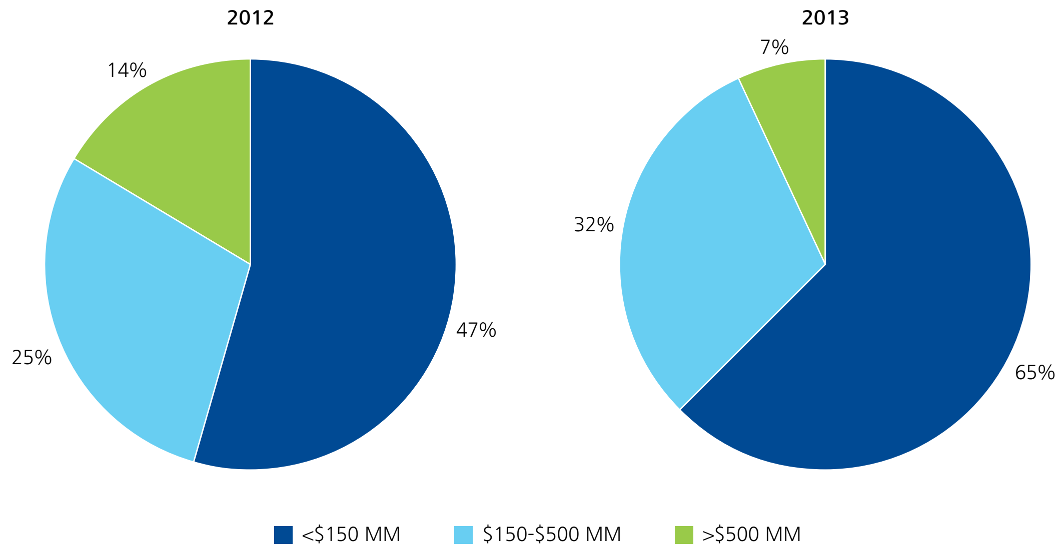
An anticipated rebound in large-cap deal activity among service companies didn't materialize in 2013. "The big players have done the significant transactions, and now it's the second tranche of companies doing deals," Ms. Yee added. "The shale activity in the United States requires bigger players to help satisfy demand." The sector is still recovering from the shift to oil and liquids and away from dry gas, which began several months ago, and the move has left service companies struggling to reposition resources and labor in new areas.

Figure 4. Global oilfield equipment and services M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

Figure 5. Global oilfield equipment and services deal counts by value range



> "The level of fragmentation in the service and equipment sector gives private equity a larger field of potential companies or opportunities to invest in."

– Melinda Yee
Partner
Deloitte & Touche LLP

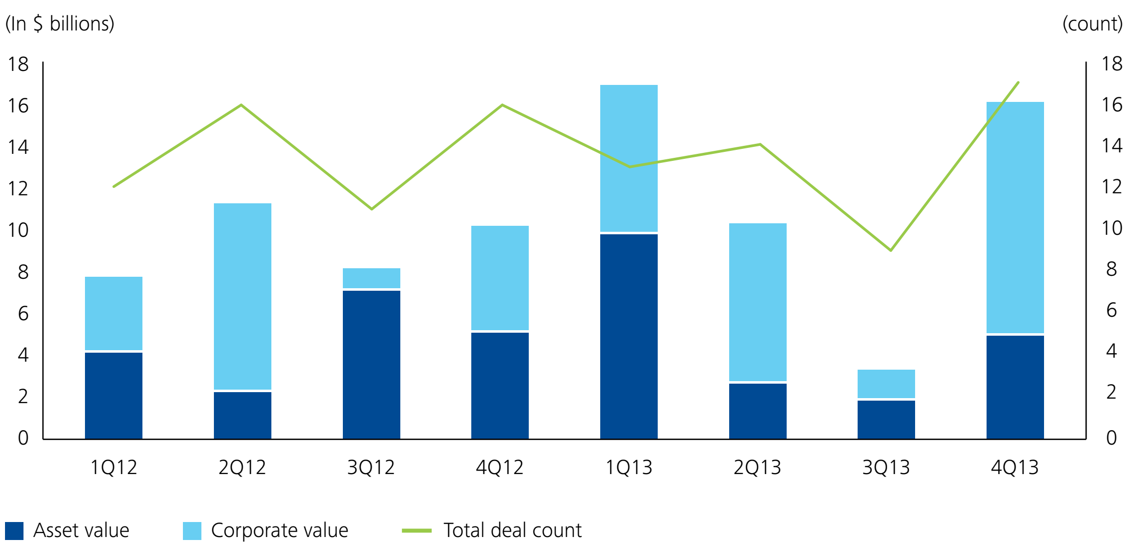
Midstream

The need for infrastructure continues to drive deal activity

The need for infrastructure to transport crude from new unconventional reserves in the United States and the oil sands of western Canada to market continued to drive mergers and acquisitions in 2013. The two countries combined accounted for 75 percent of all midstream transactions. The midstream sector continued expanding to meet demand from fields such as the Eagle Ford Shale in South Texas, where pipelines, gathering systems, and processing plants lag production. "There's huge demand for the infrastructure to fuel this North American renaissance," Mr. England said. Meanwhile, the industry continued to seek alternatives for shipments from Canadian oil sands as the U.S. government's delays in permitting the Keystone XL pipeline stretched into another year.

While the number of midstream deals worldwide slipped slightly to 53 in 2013 from 55 a year earlier, the value of the transactions rose by 25 percent, to $46 billion. "Midstream is playing catch-up to upstream to build out the infrastructure that's needed," Mr. Spann said. The year's largest deal came from the midstream sector – Shell's $6.7 billion purchase of liquefied natural gas assets in South and Central America from Repsol with two other midstream transactions in the top five deals for the year, including Regency Energy Partners' $5.6 billion acquisition of PVR Partners and Kinder Morgan's purchase of Copano Energy for $5 billion.

Figure 6. Global midstream M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

In the wake of the larger deals completed in 2013, Mr. Thomas expects smaller companies in the U.S. will begin either building critical mass organically or get acquired by larger companies that are looking to expand their networks. Private equity continues to play a key role in the midstream sector in providing capital for ongoing investments to build out gathering systems and consolidating among smaller master limited partnerships (MLPs). "Private equity is filling a demand for capital from oil and gas producers who need the money to build out gathering and processing systems on their acreage positions, and the MLPs structurally can't fill this void due to the lag time from required capital expenditures to construct and the steady cash flows MLPs need," noted Mr. Spann. "Additionally, the infrastructure fund market is also interested in investing in the midstream space, as it can offer steady returns," Mr. Lyons said.

"Midstream is playing catch-up to upstream to build out the infrastructure that's needed."

– Jason Spann
Partner, M&A Transaction Services
Deloitte Tax LLP

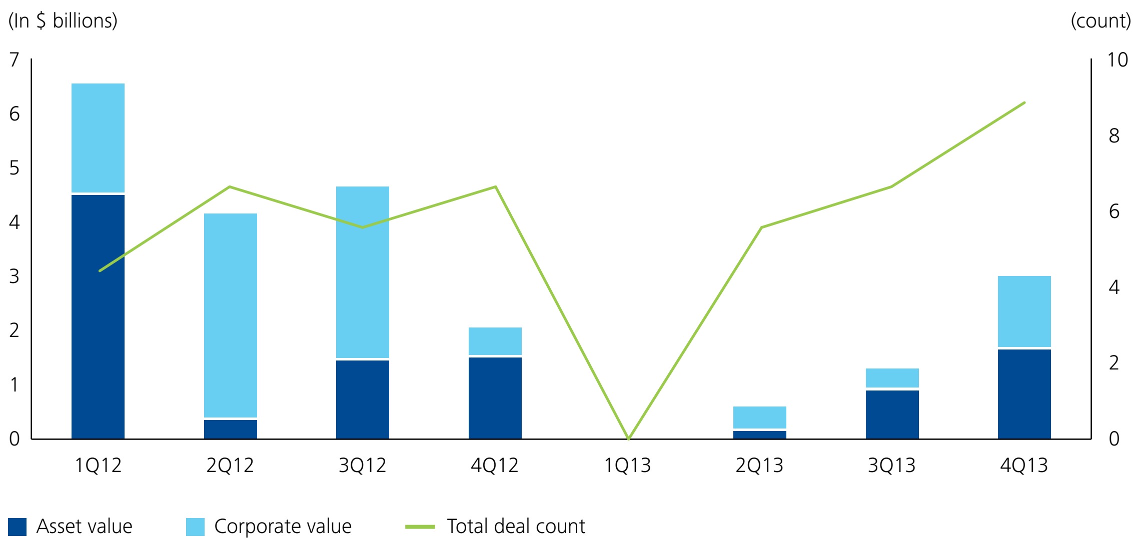
Refining and marketing

Another quiet year as refiners adapt to new crude supplies

The refining and marketing sector had another quiet year in 2013. Downstream deal activity has been limited for the past few years, and 2013 continued the trend with only 19 transactions announced. The total deal value fell by 72 percent, to almost $5 billion, as no deals in 2013 were greater than $1 billion, whereas four were announced in 2012.

The pace of U.S. transactions picked up in the second half of the year to six, after only one took place in the first six months of 2013. "Activity could pick up if some of the newly independent refiners decide they need to increase their size to remain competitive," Mr. Thomas said. In addition, potential regulatory changes could cause banks with commodity trading operations to scale back, which may lead to dispositions of physical commodity assets and storage facilities and opportunities for physical players.

Figure 7. Global refining and marketing M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

“Activity could pick up if some of the newly independent refiners decide they need to increase their size to remain competitive.”

– Trevear Thomas
Principal
Deloitte Consulting LLP

U.S. refiners continue to struggle with the grades and location of their crude supplies. Excess supplies of light crude from U.S. shale plays have narrowed differentials which have resulted in refineries processing the less complex light crudes, which does not maximize the value of the refinery. Heavy crudes from Venezuela, Mexico, and Brazil go to other global markets where heavy oils can command better prices than in the United States. As a result, Gulf Coast refineries, which are calibrated to process heavy crude, are grappling with investing in refinery overhauls or waiting on pipelines that can transport heavy crude from Canadian oil sands. There has been a call by some industry players to allow U.S. exports of oil to help address some of these imbalances in the supply and refinery complexity levels. Persistent uncertainty over the Keystone XL pipeline continues to weigh on these decisions, as does the growing political debate in the United States over the so-called ethanol mandate, which requires refiners to blend a certain amount of biofuels into gasoline. “Rising ethanol prices and stable crude supplies, however, have made the mandate costly for refiners. Without a change in the law, the economics of the mandate may make the sector unattractive to nontraditional buyers,” Mr. Shreve said.

Conclusion

Economics, new opportunities, and needed capital... could spur deals in 2014

Despite the slowdown in deal activity in 2013, the market shows signs of a rebound heading into 2014. Cold weather is expected to give a boost to natural gas prices, which have seen a recent uptick in the United States and crossed $5.50/mmbtu in late January 2014, the highest levels since February 2010.[3] Foreign investors also continue to focus on securing North American supplies. Renewed discussion of reforms, especially as they relate to oil industry provisions, such as the treatment of intangible drilling costs, could spur more activity in 2014. At the same time, the Federal Reserve's announcement that it will end its economic stimulus program could cause interest rates to rise, thereby creating an incentive to complete deals before borrowing costs increase. "With the Fed's comment, perhaps that gives the market more clarity," Mr. Shreve said.

Private equity firms have invested heavily in energy as an asset class, riding the wave of activity that began with the shale boom. As the three- to five-year horizon many firms seek for a return comes into focus and funds see favorable pricing opportunities, more may look to monetize their investments in 2014. Recent fund-raising efforts for energy-focused funds will continue to drive private equity investment in the space.

Canada will continue to be an attractive investment, especially for majors and large integrated companies looking for lower-risk investments. "Canada continues to be seen as a relatively stable environment in terms of making an investment versus other global opportunities," Mr. Lyons said. While investments north of the border may garner more attention in 2014, large U.S. companies will be looking southward as well. Recent reforms in Mexico are opening up that potentially lucrative market to foreign investment for the first time since the industry was nationalized in 1938. That could encourage joint venture and acquisitions on both sides of the border, as Mexico's national oil company, Petróleos Mexicanos, or Pemex, may look to update its expertise. "I think that will have a positive effect in terms of deal flow," Mr. Thomas said. "I'm seeing a positive uptick in terms of interest."

Deal flow may increase in 2014 as companies are challenged to seek more capital to find resources, complete projects, and maintain reserve replacement ratios above 100 percent. In the long term, the level of investment in North America needed to maintain current levels of output and meet projected future long-term demand is expected to drive a tremendous level of well activity and oil sands development, which will continue down the value chain.

3. Energy Information Administration, Natural Gas Spot and Futures Prices (NYMEX) http://www.eia.gov/dnav/ng/ng_pri_fut_s1_d.htm

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

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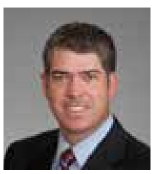

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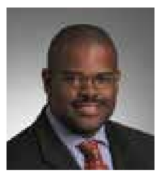

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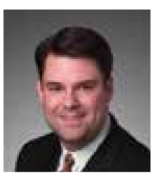

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Deloitte Center
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