Welcome to Deloitte M&A Views, a Deloitte podcast series exploring the latest trends and topics in mergers and acquisitions (M&A). I’m Greg Jarrett, and today we discuss what’s been happening with M&A transactions in oil and gas in 2017 and whether there are any trends to watch in this sector for 2018. We are joined today by Andrew Slaughter, executive director of the Deloitte Center for Energy Solutions, Deloitte Services LP, and Ray Ballotta, a partner with Deloitte & Touche LLP and Oil & Gas M&A industry leader.

In the past few months we’ve seen the oil industry in its ascendency, and especially with the price of crude continuing to go up. But in order to be able to tell how this might affect mergers and acquisitions moving into 2018, perhaps we should move back several months. So, Ray, can you draw our attention to the most significant trends in transactions for the oil and gas industry for 2017?

Sure. Although 2017 started off strong by continuing the momentum in the second half of 2016, there was a sequential drop in deal activity each quarter in 2017. And if we looked at 2017, how the year played out, there are a couple of macro themes that really stood out. First, investors really demanded more capital discipline. And as a result, there was an acute focus placed on the execution of existing production and the right-sizing of asset portfolios, as opposed to inorganic growth demand. There was a near-term outlook shift from the beginning of the year, when there was more optimism, to a more near-term cautious outlook following some price volatility, particularly in the middle of the year.

But if we peel back the onion a bit, I think there were a few underlying themes. First, there was a slowdown in activity in the Permian. The Permian entered 2017 white hot. The demand for acreage really drove high valuations upward of $60,000 per acre. But as the year progressed, deal activity came to a virtual halt. If you compare deal activity in the Permian from the second half of 2017, it was just 10 percent from a value perspective relative to the second half of 2016. While we did see some increased activities in other plays outside the Permian, like the DJ Basin, it didn’t make up for the short fall of what we saw on the Permian. And for the most part, the land grab that we saw in 2016, essentially ended in 2017.

Instead, upstream companies were really focused on drilling existing acreage, rather than acquiring more acreage. Secondly, we saw companies continue to look for ways to optimize their portfolios by divesting non-core assets, particularly in
high-cost and more mature regions. And lastly, we saw focus on consolidation, both in the upstream and oil field services sector, as companies looked for ways to rationalize capacity or benefit from economies of scale.

**Greg Jarrett:** So we certainly do know there's a lot to the oil and gas industry from the service sector to the exploration people—or upstream as it's called—to downstream—the people who sell the product. Andrew, can you share a little more about that? Which sectors of the oil and gas business, or perhaps even geographical areas, saw the most interest? And why?

**Andrew Slaughter:** Well, of course there were transactions across all the segments of the business right up and down the value chain, as there always are. But the upstream, the exploration and production part of the business, saw about two thirds of the deal value across the whole year of 2017. You know, we started the year, as Ray has mentioned, with fairly strong activity entering the Permian Basin, and that tapered off during the year as value opportunities got scarcer. But we saw some fairly significant exits from the Canadian oil sands, particularly early in the year, and particularly from the large international players as they focused on more central parts of their portfolio.

In oil field services, again, a fairly active year, although lower than in the previous year. Capacity rationalization was a big driver, particularly offshore. The offshore investment in rig market has been down for quite a while now, so a need for rig operators and rig providers to consolidate for efficiency and cost. On the onshore, there was some consolidation in pressure pumping services. And that's more of a preparation for an increase in onshore drilling activity as more wells get drilled and more completions are required. So pressure pumping, I think, is a potential growth area.

In the mid-stream and downstream segments, these are fairly small in comparison to the upstream sector, but private equity finance is increasingly getting into particularly the mid-stream, the pipeline and processing business, as gathering pipes, and long-distance pipes need to be built out from growth areas to provide more takeaway capacity. But also, of course, US exports, both of oil, oil products, and natural gas. They're still increasing and so that all needs new infrastructure. And private equity finance came in to finance the deals in the business to make mid-stream players better positioned for those opportunities. I think that's a newish factor.

**Greg Jarrett:** As prices were pushed down back in 2014, down in the $20 range, the industry responded with new technologies, new efficiencies, all in order to be able to make money at those lower prices. So, Ray, how does the evolving oil price context, the upward momentum, influence how deals are getting done today?

**Ray Ballotta:** Recently prices have increased over the $60 mark. And if prices do continue at this level, that is a positive sign for M&A activity. It's when prices fluctuate and there's less confidence around prices where we really see muted M&A activity levels. Over the last three and a half years in this “lower for longer” mantra, we really see the muted effect on M&A activities just because there's been less confidence around pricing, and less capital and less liquidity in the debt markets, and those have all really hindered M&A activity. But if we continue to see upward momentum in pricing, particularly over the $60 mark, that is certainly a positive sign for M&A activity in 2018.

**Greg Jarrett:** Andrew, we've been closely monitoring OPEC and Russia, and non-OPEC countries that are participating along with OPEC in production restraint. How closely should
we be watching that situation to determine which direction M&A is going to go in the coming year?

**Andrew Slaughter:** I think that has been one of the key drivers in driving down global inventories, firming up prices, and obviously making a more attractive and confident environment in which M&A can happen. It's been a remarkably successful OPEC/non-OPEC production constraint program. All the signs are that it's being carried forward until certain inventories would get back into historical levels. So I've got a lot of confidence. I think that that's yielding the results that were expected and that it does significantly contribute to more confidence around the industry, which leads to more openness to deals.

**Greg Jarrett:** Andrew, if you could get out your crystal ball for me. Are there any other factors that we should be really paying close attention to for M&A in the oil and gas industry this year?

**Andrew Slaughter:** Yes. I mean, this somewhat firmer price environment that we've been in for the past few weeks, it does open up a bigger window for financing deals, financing transactions, both through improved cash flow for operators who want to make portfolio moves and for ability to access outside finance from non-industry sources. So that confidence I think will drive a level of transactions maybe higher than 2017. On the flip side of that, we have quite a number of the major oil companies and the large independents who basically looked at their portfolio during the downturn and decided to focus in certain areas, certain play types, certain geographies, and divest assets, which were non-core.

Well now, in an improved financial environment, the ability of smaller companies and more focused companies to get into those plays and pick up those divested assets improves. So I think that's going to drive quite a bit of transaction activity over the next 12 to 18 months or so. The improved price environment also brings more basins, more regions into play. So I think we're likely to see more deals in other areas apart from the Permian, like for example a return to North Dakota, the Bakken, or the Oklahoma plays, or the mid-continent plays. I think they'll be a greater diversity of transactions than we've seen in the last 12 to 18 months.

And if we move down the value chain toward mid-stream and downstream, I still take a good hard look at the continued rise in US exports and the need to actually put infrastructure in place, which will increase capacity to take hydrocarbons, whether it's oil, whether it's refined products or natural gas, into export markets, international markets. And some of that is done through transactions and building out for existing player's infrastructure. So I expect that to be quite a big driver in the mid-stream and downstream this year. Although typically these macro changes in the price environment, in the business confidence, they do affect the upstream more than the downstream. But we shall see. One of the interesting things is looking at what happens. There's always something you never thought of, and we'll be waiting with great anticipation to see what the real numbers in deal flow tell us as we go forward.

**Greg Jarrett:** I'm Greg Jarrett. Thanks for listening to Deloitte M&A Views, sponsored by Deloitte's M&A Institute. If you'd like to read the full Oil & Gas M&A year-end report, visit www.deloitte.com/us/oandg/ma. This podcast is provided by Deloitte and is intended to provide general information only. This podcast is not intended to constitute advice or services of any kind. For additional information about Deloitte, go to deloitte.com/about. We also release new podcasts regularly, and if you subscribe, you won't miss a single one.
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