Deloitte.

M&A Views

Deloitte M&A Views podcast: Down the value chain: Trends in oil and gas M&A

Transcript

Greg Jarrett: 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're going to discuss what's been happening with M&A transactions in the oil and gas industry in 2018 and whether there are any trends to watch in the sector for 2019.

We're joined today by Andrew Slaughter, executive director of Deloitte's Energy, Resources & Industrial Research and Insights Group, Deloitte Services LP, and Melinda Yee, a partner with Deloitte & Touche LLP. Thank you both for joining us today. Let's get right to it here.

Oil prices remained stronger through most of 2018, but we have seen volatility—and a sharp decline—toward the end of the year. Andrew, what would you say have been the most significant M&A trends in the industry for this past year, and have oil prices had an impact?

Andrew Slaughter: Thank you, Greg. There have certainly been a couple of more positive trends, which we saw in 2018. First of all, the rig counts were up, both globally and in the US, and that's a testament to a little bit of a renewal in investment in the upstream segment. You know, there was positive segment sentiment due to higher oil prices in 2018, at least for most of the year, and of course, many companies were making some progress in shoring up their balance sheets, which were so badly hit during the downturn.

Secondly, following the trends we saw in 2016 and 2017, US onshore shale continues to drive the great majority of transactions. The United States represented over two-thirds of total deal value last year, 2018. Much of that stems from upstream and midstream interests in the Permian Basin, in West Texas and New Mexico, but there were other regions, like the SCOOP/STACK play in Oklahoma and the Eagle Ford play in South Texas, which saw a bit of a revival in 2018 in M&A terms.

But there were some more tempering factors to offset these positive trends. You did mention the oil price decline in the latter part of the year. Brent was $85 a barrel in October, and it dropped back down to $50 in December. It's recovered and stabilized in recent weeks to the high $50 to low $60 level, and that certainly has the potential to blunt near-term growth momentum in the sector.

We did a Deloitte oil and gas, and chemicals industry executive survey, which came out in October, and that indicated more caution than optimism for now in the sector. Price volatility and price uncertainty plays a role in that. In addition, equity markets, particularly for new issuance, remain relatively closed to oil and gas companies, which limit the options to finance new transactions. Shareholders are more and more demanding discipline and focus in developing existing assets, rather than venturing out into new transactions or new plays.

I think in 2018—and looking forward into 2019—portfolio consolidation is still on the table. Not only in upstream, but also in oilfield services, midstream, and the downstream segments as well. There is, I think, and rightly so, renewed emphasis on right-sizing assets for each company's longer-term aspirations and, of course, its core capabilities.

Greg Jarrett: That begs a follow-up, Andrew. Let me ask you this. There've been swings between caution and optimism in oil and gas during recent years. Clearly, oil and natural gas prices can have an impact on the sector, but there are other considerations, am I right?

Andrew Slaughter: Well, oil prices are probably always the most visible indicator of industry sentiment. They drive revenue and cash flow, both from a current and from a forward-looking perspective, and that's the most vital concern for companies. Other indicators, like the rig count are important, particularly in the United States, but there are also strategic drivers for different transactions, which have different potential pitfalls.

You know, last year we saw that deal count was down, the number of transactions was down, but the actual transaction value remained robust. And that's because there were some large deals where companies were pushing to expand operations around their core areas to build on their strengths. Companies interested in transactions should consider how they can best access financing, what are the sensible opportunities for growth that they can pursue, and ways they can close the value spread between the two sides of a transaction, closing the bid-ask spread, as it were.

Oil prices do have a large impact on those questions, but each company's operational, strategic, and financial positioning, they all play a key role as well.

Greg Jarrett: Andrew, that's a lot of factors to consider. So, let's dig a little deeper and see how that played out all across the various oil and gas segments in 2018—from exploration all the way to the gas pump.

Melinda, what insights can you share on that?

Melinda Yee: We recently published our annual report analyzing activity up and down the value chain, from upstream, oilfield services, midstream, and downstream.

In the upstream sector, we saw a lot of focus on the Permian and significant quarterly variance in the type of assets that exchanged hands. That, in many ways, was a lot like 2017, but we have seen the market moving toward other name-brand plays. For example, there were a couple of very large deals with a focus on multiple regions, like BP's acquisition of BHP's onshore shale assets, which span the Permian, Eagle Ford, and Haynesville. Along the same lines, Chesapeake's purchase of Wild Horse Resources increased its Eagle Ford exposure substantially and diversified what has been a natural gas–focused portfolio historically. If we see higher oil prices in 2019, there could be a lot more interest in these other plays, as entry costs in the Permian have become extremely high, relative to elsewhere, and too expensive for smaller players.

Thanks to rising interest rates over the course of the year, deal value for oilfield services ended on a high note, but overall value remains at a five-year low. There was not a lot of deal activity for most of the larger players, but many of the small- and mid-cap oilfield services companies were active, especially in the second half of 2018. Some of the largest deals last year focused on consolidation, particularly for offshore, which still offers competition for multi-million-dollar contracts.

2018 midstream deal activities saw higher cumulative deal value than 2017, but we were still missing the mega deals that drove the segment's transactions in 2014 and 2016. That will likely continue to be the case for the upcoming year. And while pipeline build-out is starting to catch up, there should be plenty of midstream opportunities in 2019 and beyond to meet the growing demand for egress.

Downstream was a different story, recording the largest deal this year. It has typically had a much lower deal count and value than other segments in many places, the United States included. It is a relatively mature market. However, there are opportunities for consolidation, as well as growth, particularly as the US continues to ramp up its exports of oil, natural gas, NGLs, and refined products. US refiners are currently capitalizing on low-cost, domestic supply. It is certainly worth noting, in this context, that the US Energy Information Administration is projecting that the United States will be a net energy exporter by 2020, which is a growth opportunity not only for refiners but also for companies operating pipelines and terminals.

So, we saw a number of different drivers affecting each segment, but I would echo Andrew that overall, oil prices played an outsized role in companies' strategies in deal flow in the latter part of the year, as did closed equity markets throughout the year. Higher oil prices should boost sentiment and generate momentum, but the volatility we have seen lately could make it hard for companies to overcome challenges, like narrowing the bid-ask spread.

Greg Jarrett: And despite the numbers of trends to watch, as you said, oil prices seem to be up front and center in any discussion across the segments. Last year, Andrew, we talked about the impact OPEC and Russia were having on the market. Is that continuing? What's happened recently?

Andrew Slaughter: Yes, Greg. Geopolitics is central in importance to energy markets and most particularly for oil. OPEC and other large producers, led by Russia, are still working together to manage oil supplies from those countries and are partly offsetting the ongoing production growths we see with US onshore shale resources. The most recent extension of the production restraint accord between OPEC and the non-OPEC Vienna agreement countries is expected to reduce the group's production by 1.2 million barrels a day for the first half of 2019 with Saudi Arabia cutting the most. There were reductions in December and January that actually played out, and compliance with that agreement is very high.

There are also continued operational challenges in Venezuela, which are causing their production to drop, and new sanctions on Iran, which mean less oil from Iran is available on international markets. If you add all that up, there's a large number of barrels which have come off the market. Outside those countries, production continues to grow, particularly in the US, and still in the Permian, despite the pipeline bottlenecks that we've seen.

Globally, oil and liquid stocks are expected to still rise modestly in 2019 and even in 2020, but storage levels do remain well within normal historical ranges. So, we don't see the stress on the market from high inventories that we saw in 2014 and early 2015. But it could well mean that the more moderate oil prices we've seen recently may well persist, certainly over the remainder of this year and maybe a little bit longer.

Greg Jarrett: Well, with that price in mind, what do you expect to see in 2019, Melinda?

Melinda Yee: Well, even in a lower-price environment, there's opportunity for deals to be made. Consolidation will likely continue, and portfolio pruning and realignment is still on the table. Moreover, it appears that many companies have used the upturn in prices in 2017 and most of 2018 to shore up their balance sheets, so there are potential green shoots for the oil and gas M&A market.

As Andrew noted though, there are some headwinds in 2019 that companies will face, notably around rising stocks and lower prices. That means 2019 transaction levels could remain muted, more consistent with the past few years than we perhaps saw earlier. We expect to see activity around growth areas like US pipeline and export infrastructure and, secondarily, upstream and OFS companies trying to move beyond the Permian.

There's been a shortfall in investment outside of shale, particularly for international and offshore projects. If we see prices rise in the next 12 to 18 months, a few of the relatively untapped opportunities may come to the fore. That's certainly one thing to watch out for as 2019 unfolds.

And even if traditional sources of capital remain challenging to tap into, there's still active interest from private equity (PE) investors to step in and provide capital to fund investments with opportunities to create value. PE investors are also willing to partner with strategic investors in certain cases, so there's still an opportunity for transactions in the sector to be financed.

Greg Jarrett: Thanks, Melinda. Thanks, Andrew. You've provided a lot for me and our listeners to consider, as we evaluate the oil and gas M&A market for 2019.

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 2018 Report, visit http://www.deloitte.com/us/oandg/ma.