Oilfield services: changing dynamics of the sector and implications for the investor and the invested

The outlook for the energy sector in the Middle East is looking strong with changing dynamics designed to create value for the region. Oilfield service businesses that have successfully weathered the downturn are well placed to capitalize on this positive outlook if they have their fundamentals sorted (and a bit of luck).

The sector has, since the 2014 down cycle, rebounded strongly. Utilization is up, due to the US$50 plus oil price that has driven spending on both, capital projects and in maintaining, or even, increasing production from ongoing operations.

As service providers to the oil and gas industry, oilfield service businesses (OFS) are exposed to the roller coaster ride that comes with being associated with the most actively traded, and consequently volatile, commodities on the planet.

The oil and gas sector is at the heart of maintaining the daily flow of some 90 million barrels of oil equivalent. As oil prices fluctuate, so do the fortunes of businesses supporting the industry. The two most recent oil price collapses, in 2008 and 2014, adversely affected the OFS sector, causing:

- A reduction in demand from project owners and operators (mainly national and international oil companies) leading to a fall in utilization;
- Idling of the sector's capacity with retrenchment of staff and significant cost reduction pressures;
- Capital restructuring for some, and insolvency for others, that did not have the right capital structure to sustain the down cycle.

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Upstream expansion

Middle East national oil companies (NOC) have expressed their intention to invest in upstream capacity.

ADNOC (Abu Dhabi National Oil Company) has announced its intention to increase its upstream production capacity to 4 million barrels per day (bpd) by 2020 from a targeted 3.5 million bpd at the end of 2018. Kuwait Petroleum has also announced its intention to increase production capacity to 4 million bpd by 2020 from its current 3.15 million bpd.

Aramco plans to invest in maintaining its production capacity of around 12 million bpd and replace the production decline from ageing fields. Such initiatives would allow these OPEC producers to be more responsive to the expected demand growth from consumer countries.

In addition to oil production expansion, gas self-sufficiency has also been set as a target by Middle East NOCs, led by ADNOC, which would allow expanding exports and provide feedstock to the petrochemical complexes in-country.

Boosted confidence

With this strategic backdrop, the OFS sector in the region is experiencing a resurgence in activities, an increasing order book, and increased near- to mid-term certainty of demand.

The OFS businesses that successfully weathered the last oil price collapse by right sizing their cost base and rationalizing their operations have been well placed to benefit from the upturn since 2016.

An indication of increasing investor confidence is reflected in some of the recent successfully completed transactions in the sector such as the acquisition of Dubai-based National Petroleum Services and Oman-based Gulf Energy Services by NESRCO (National Energy Service Reunited Corp.), for a US$1.1 billion purchase consideration in December 2017, creating the first MENA-focused OFS business listed on the U.S. NASDAQ stock exchange and the Initial Public Offering (IPO) of Dubai-based Shelf Drilling, a shallow water driller, on the

Oslo Stock Exchange that raised US$225 million in June 2018.

The above transactions and additional interest from international and regional investors in the OFS sector are built upon the view that the Middle East will continue to invest in the upstream oil and gas space, given its low cost of production.

Changing landscape and priorities

Doing business with Middle East NOCs will require suppliers and service providers to demonstrate compliance with the in-country value addition requirements that have been introduced by Aramco (IKTVA), ADNOC (ICV) and Oman's Ministry of Oil and Gas (ICV), with Kuwait and other producer nations likely to follow suit.

The agreement signed between Aramco and SNC Lavalin is an example of the initiative to localize the oilfield services and equipment value chain in Saudi Arabia. Equally, the contract between Aramco and Halliburton to increase gas production in the Kingdom's shale fields is a sign of increased upcoming activities for OFS businesses.

The focus for all suppliers and service providers in the region will be to work towards alignment with the stated objectives of the regional NOCs, effecting transfer of knowledge and technology to help develop the local value chain.

Where to, from here?

With this backdrop, strategic players not already in the region are likely to seek joint ventures, investment or outright acquisition of regional OFS businesses that are prequalified with NOCs and that are compliant or working towards achieving compliance with in-country value requirements (ICV).

The regional OFS businesses that will likely fit the bill are those that have:

- A proven management team with a demonstrable track record of managing the business through the down cycle;
- Good quality, well utilized assets and/or capable operational teams;
- A robust order book of work with blue chip customers; and
- The right capital structure and compliance with regional NOC and IOC requirements.

The challenge for OFS business owners and managers will be to time the cycle—which is notoriously hard to do—and balance the longer-term contracts with shorter-term ones, to allow for flexibility and benefit from a potential upturn in rates, all the while mitigating the risk of a reduction due to oil price volatility. What is needed for continued improvement is oil price stability to aid decision making that will facilitate the continued development of this high potential sector. Businesses would do well to be prepared.

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