KPMG

DrillingDOWN

On the cusp of a reinvigorated Oil and Gas M&A environment

Marathon Oil Corporation's recent, substantial asset divestiture appears to have been well-received by the equity markets. Could you describe the components of the transaction?

Marathon announced the divestiture of almost $950 million in assets which management deemed to be "noncore". One of the largest components of the divested package—approximately $870 million in value—consisted of upstream and midstream assets in Wyoming's Big Horn and Wind River basins sold to Dallas-based Merit Energy.[1]

In commenting on the transaction, Marathon said "ongoing portfolio management continues to drive the simplification and concentration of our portfolio to lower-risk, higher-return U.S. resource plays."[2]

Analysts and investors generally reacted favorably to Marathon's announcement—the company's share price rose approximately 15 percent during the week following the announcement. A Deutsche Bank research report summarized the market's perception well in stating that "Marathon has now de-risked the story through at least 2017, positioning itself well into a potential turn in the commodity down the road."[3]

In addition, the deal advances the interests of Merit Energy to further expand its core assets and leverage their specific technical strength in enhanced oil recovery techniques.[4] This is in keeping with Merit Energy's long-standing belief that purchasing high-quality acreage and maintaining its status as owner/operator allows them to extract the most value from their acquisitions, which the company believes clearly differentiates it from their competitors.

Do you expect to see more transactions in the months ahead? Will the types of deals done be similar or different from Marathon's? Will the pace accelerate?

We do expect to see an increase in the number and variety of mergers and acquisition (M&A) transactions in the sector as the year progresses. Asset divestitures, such as Marathon's transaction, provide a means by which companies may not only improve their liquidity position but also accelerate their efforts to focus on specific regions or asset classes where they believe they can effectively compete going forward. In addition, divestitures represent an additional means to enhance financial resilience, for example, to supplement spending reductions or potentially dividend cuts. In February 2016, when Standard & Poor's downgraded the debt rating of 10 investment-grade energy companies, the rating agency said that producers' spending cuts were "for the most part, insufficient to stem meaningful deterioration expected in credit measures over the next few years."5 Several exploration and production (E&P) companies, including Husky Oil and ConocoPhillips, have already publicly expressed their intent to pursue additional divestments.[6]

[1] Source: Oil and Gas Investor, United States (April 11, 2016)
[2] Source: Morningstar, United States (April 11, 2016)
[3] Source: Deutsche Bank, United States, Ryan Todd (April 12, 2016)
[4] Source: Oil and Gas Journal, United States (April 12, 2016)
[5] Standard & Poor's Rating Services, United States (February 2, 2016)
[6] ConocoPhillips Investor Presentation, United States (December 10, 2016)

Welcome to the fifth edition of *Drilling Down,* KPMG Global Energy Institute's monitor of key issues for decision makers in the global oil and gas sector. *Drilling Down* offers insights from KPMG thought leaders on the trends that are driving and shaping oil and gas companies today.

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In addition to divestitures to reinforce focus and improve liquidity, we see other types of M&A deals on the landscape. A recent KPMG survey of executives in the oil and gas industry identified deal priorities as enhancing IP, acquiring new technologies, and entering new basins or asset classes.[6] For example, international player Repsol acquired Talisman Energy, representing a significant step into the unconventional asset realm, which was not a core strategic area until this move. Similarly, the landmark tie-up of BG and Shell marks a decisive scaling of its liquefied natural gas (LNG) business, creating a global LNG leadership position. There are more opportunistic, or perhaps contrarian, deals driven by the current low in commodity prices, such as the purchase of Encana's natural gas assets in Louisiana by the credit arm of a large investment firm.

In terms of pace, investors, both strategic players and financial sponsors such as private equity firms, have earmarked significant capital to put to work in the energy arena. Some estimates suggest nearly $170 billion of capital available for either lending or asset sales.[7] However, to date, the number of transactions in the sector has lagged expectations as uncertainties regarding the duration of the downturn, the potential actions by lenders and bankruptcy proceedings, and other factors have led to significant diversions in buyer and seller value expectations.

As uncertainties begin to subside, including recent revisions to bank regulations that may clarify lenders' potential stance in negotiations, or as crude price outlooks converge and supply/inventory trends stabilize, we do expect the pace of transactions to accelerate.

Given the prevalence of capital expenditure cuts, staff reductions, and asset divestitures, how do E&P companies eventually return to a growth mode?

We believe that the most successful E&P companies will utilize several levers to retain or restore financial liquidity in order to invest in specific areas where they possess a strategic advantage—it is a "shrink-to-grow" strategy in effect. We have seen E&P companies progressively utilize more and more difficult cash preservation techniques starting with supplier price concessions and reductions of nonessential staff, moving on to capital spending cuts, and now reductions in dividend levels and core staffing levels.

However, we have also seen some of these companies then utilize the proceeds from such actions to invest in future growth. For example, when Devon Energy recently announced its $1.9-billion acquisition of resources in Anadarko basin's STACK play from privately held Felix Energy, the company said, "In an effort to focus exclusively on our very best resource plays, strengthen our already-solid financial position, and drive investor value, we are also announcing our intent to divest noncore assets."[8] This deal also included the contingent acquisition of complementary midstream assets from Tall Oak, whose gathering and processing facilities are located strategically within the STACK play itself.

In addition, successful E&P companies have capitalized on their sharpened focus on specific "core" assets to accelerate operating and cost improvement programs. In a recent cross-functional initiative, one large E&P player employed lean manufacturing techniques to further reduce pad-drilling costs by almost 25 percent. In announcing similar returns on its organic improvement programs, EOG Resources stated that "these sustainable improvements uniquely position EOG for long-term success in any commodity price environment."[9]

Those companies that align their cash preservation techniques, acquisition and divestiture posture, and operational improvement programs toward a common objective of realizing a competitive advantage in a specific set of assets, will eventually capture more profitable, sustainable growth going forward.

What is it going to take to be successful in this evolving M&A environment in the oil and gas industry?

Given the above set of market forces, we anticipate upstream companies will need to be highly prepared to participate in M&A. We advocate that upstream company leaders be proactive in shaping their future business model and leverage the following five leading practices to prepare for a period of substantial M&A activity:

- First, leadership across the organization needs to align and clearly define their growth ambitions, and how their approach is competitively advantaged—the means by which the company will create greater value than their competition.
- Second, the company needs to define which markets and business models will help them to achieve their ambition and sources of advantage and then to identify which potential M&A targets align to those markets and models.
- Third, the company will need to evaluate which of the potential targets offer the best opportunity to achieve their strategy and maximize value.
- Fourth, they need to have the capability to execute the deal and do so quickly.
- Last the effective integration of the acquired company is key to realizing the expected value.

A final consideration, in light of potentially pursuing multiple deals, would be to make the above practices repeatable. That is, build both an M&A road map and playbook to appropriately screen, pursue, complete, and effectively integrate opportunities. This last step enables the company to create an enduring M&A capability versus a one-off pursuit.

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[7] Source: KPMG 2016 M&A Outlook Survey, United States (April 2016)

[8] Preqin Data (March 2016)

[9] Business Wire, United States (December 7, 2015)

[10] EOG Resources, United States (February 25, 2016)