

It's hard to imagine a more volatile time for the oil and gas industry. A decrease in U.S. consumption of petroleum products was the first indication of a problem: Consumption in 2008 is projected to decrease 5.4 percent compared to 2007, marking the first annual decline of more than 1 million barrels per day since 1980. Furthermore, the credit crisis has significantly reduced liquidity in the capital markets. The spreads for investment-grade corporate bonds reached a record high of 618 basis points at the end of October. Finally, the global scope of the crisis is having an impact on the dynamics of supply and demand. For example, 67,000 Chinese factories closed during the first half of 2008. At the end of the year, with hydrocarbon prices down nearly 60 percent from the highs reached in July, the combination of decreased demand and reduced liquidity seems to suggest to many observers that the sky is, indeed, falling.

The industry's initial response has been to retrench, restructure, and "live within one's means." Companies have reduced their capital spending budgets: A recent report by IHS Herold suggests that 2009 exploration and production spending in North America will decline at least 10 percent versus 2008 levels. Major projects have been delayed or canceled, with BA Energy, Nexen, Petro-Canada, and Suncor announcing significant project delays or cancellations in the oil sands sector. In some instances, companies are even shutting down production. Chesapeake Energy has curtailed a portion of its natural gas production because natural gas prices are below breakeven levels.

But is the sky really falling? We've been through recessions before. If the 1973 oil crisis, the energy crisis of the 1980s, the economic downturn in 1990, and the bursting of the tech bubble in 2001 have taught us anything, it is that restructuring during a recession is important – but reducing operating costs, managing capital expenditures, and improving working capital should not be a company's only focus.

A second and often ignored part of weathering a recession successfully is about strategic growth, and here, as the following case studies illustrate, opportunities abound for companies to take advantage of market discontinuities. In 1991, for example, Chemical Bank merged with Manufacturers Hanover to become the second-largest banking institution in the U.S. and a powerhouse in the syndicated loan market. The move improved the company's liquidity position, provided a base for significant cost reduction, and established a platform for future consolidation of the industry. In the auto industry, Japanese carmakers including Toyota, Honda, and Nissan established their initial footholds in the North American market by investing in production capacity during periods of economic disruption, including the 1970s oil embargo. The benefits of this strategy are most apparent in the current stock prices of U.S. auto manufacturers. In the airline

industry, an airport management company, reeling like everyone else because of a steep drop in retail sales, introduced brand-name shops, bought a duty-free business, and changed its overall charging structure to a percentage of sales from its tenants – moves that increased the company’s revenues by 6 percent during the recession. Based on these examples, we’d like to highlight three specific growth strategies that oil and gas companies might consider.

Pursue Inorganic Growth

It’s been almost impossible to miss how companies flush with cash have taken advantage of a historic market discontinuity: Barclays Capital purchasing the core business of Lehman Brothers for a song; Warren Buffett swooping in to acquire Constellation Energy or to buy US\$2 billion worth of GE stock at a bargain price. Oil and gas companies have begun to act on similar opportunities: Shell Canada acquired Duvernay Oil for C\$5.9 billion (US\$5.86 billion), StatoilHydro acquired a 32.5 percent interest in Chesapeake Energy’s Marcellus Shale assets for US\$3.375 billion, and BP acquired Chesapeake Energy’s Woodford Shale assets for \$1.7 billion and a 25 percent interest in Chesapeake’s Fayetteville Shale assets for \$1.9 billion.

Of course, the game isn’t only for the “cash rich.” Small players should consider mergers with similar-sized companies or partnerships with other players. Such transactions have the potential to improve capital projects portfolios, increase potential cost synergies, and strengthen balance sheets. Valero Energy, for instance, pursued a consolidation strategy at a time when the refining sector was definitely not in vogue, increasing its capacity from 530,000 barrels per day to 3.3 million barrels per day during a seven-year period. The company later reaped the rewards when refining margins improved. Devon Energy also established a leading competitive position by acquiring several similar-sized competitors – the company has completed 26 acquisitions in its history – and using inorganic moves to expand into new basins such as the Barnett Shale.

When we asked a client at a major oil company what he thought the crisis meant for his company’s investment preferences, he said with a smile, “We prefer to invest in the oil and gas industry.” It’s a simple point, but a good reminder to invest in your core business when long-term fundamentals are strong but current valuations are depressed. Indeed, the long-term fundamentals do support a robust outlook for the industry: The International Energy Agency forecasts that the global economy needs 64 million barrels per day of incremental crude supply, the equivalent of almost six times Saudi Arabia’s current capacity, by 2030. Now is the time to double down in those sectors of the value chain where you are positioned to make money in the long term.

Deploy Capital to Create a Long-Term Advantage

While it is prudent to reconsider capital spending in light of reduced liquidity, companies shouldn't miss the opportunity to fund or even accelerate projects that capitalize on future industry trends. For example, in the refining sector, companies may position themselves to profit from future supply and demand trends by accelerating investments that secure access to heavy oil from Canada and increase diesel production capacity. This may coincide with a review of their operating modes, in which they shift from a structure that focuses on maximizing utilization to one that emphasizes getting the most profitable margin per barrel. As another example, oil field-services companies may invest to expand their supply chains in those geographic regions that are expected to see above-average growth in activity, such as the Middle East.

Similar opportunities exist in the upstream sector. Expanding core operations in unconventional basins would be one idea, of course, but also consider investments across the natural gas value chain. In describing its joint venture with Chesapeake Energy in the Marcellus Shale, StatoilHydro said that the investment was "building on our existing capacity rights for the Cove Point LNG terminal, our gas trading and marketing organization, and the gas producing assets in the Gulf of Mexico." A balanced portfolio such as this represents an opportunity to profit from the potential future interplay between domestic and imported sources of natural gas.

We realize that capital budgets will remain under pressure in the near term, given the high degree of uncertainty and the need for companies to live within their cash flow. But don't overlook the fact that as activity decreases, we are likely to see a reduction in the cost of services and raw materials, which will improve the economics of project investments. A recent Booz & Company analysis identified a 12-month lag between crude prices and declines in the IHS cost inflation index. This suggests that now might be the right time to begin planning and negotiating with your suppliers, making key procurement decisions in anticipation of the economy's eventual recovery. After all, when it does improve, you can be sure that there will be supplier and contractor backlogs – but you'll be at the front of the line.

Build New Capabilities

Many companies have exploited a season of market discontinuities to build new capabilities, which means investing in people, processes, technology, and measurement. We believe the current crisis provides opportunities to address all of these elements. An economic downturn and the impact it has on competitors may actually increase the amount and quality of human talent – management and skilled labor – that is available in the market. Many mid-cap natural gas producers with significant shale exposure, for instance, have been obliged to curtail or slow their activities. As a result, experienced technical staff with expertise in particular

basins or specific technologies such as horizontal drilling may now be looking to reenlist with better-positioned companies. That company might be yours. A recession, in effect, represents an excellent time to gain ground in the industry-wide war for talent.

There are many examples in the oil and gas industry of the benefits of improving process capabilities during an economic downturn. For example, during the oil bust of the 1980s, Syncrude and Suncor pursued continuous advancement in the extraction of reserves from oil sands mines. Many of today's production methods, including the truck-and-shovel process (as opposed to bucket-wheel excavators), stem from that work. The output volumes these investments produced allowed these companies to earn significant profits when oil prices did rebound.

The high degree of uncertainty currently plaguing the broad markets and the oil and gas sector is unlikely to end soon. The next 12 months will gradually reveal the impact that the downturn and the credit crisis have had on global economies. Liquidity will return, but not until financial institutions are confident that their lending and investing decisions won't result in a "Lehman-like" catastrophe. But despite this uncertainty, oil and gas sector participants have the opportunity to act boldly – to pursue transactions, invest capital, and build capabilities to help secure a long-term competitive advantage. You can make the most of these opportunities and benefit as a result. After all, as legendary oilman J. Paul Getty said, "Without the element of uncertainty, the bringing off of even the greatest business triumph would be dull, routine, and eminently unsatisfying."

R. Andrew Clyde

Partner

andrew.clyde@booz.com

Andrew Steinhubl

Partner

andrew.steinhubl@booz.com

Eric Spiegel

Senior Partner

eric.spiegel@booz.com