Perspective

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M&A Strategies in the North American Oil & Gas Sector

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EXECUTIVE SUMMARY

M&A activity in the oil and gas sector is on the upswing, and we expect sell-side pressures to result in even more activity in the months to come. We see primarily three types of deals taking place: major oil companies pursuing growth options; independents divesting assets in order to focus capital spending on core assets; and companies combining for survival. This Perspective examines each deal type and presents six key questions senior energy leaders who are evaluating their M&A options should be asking: How well positioned is our current portfolio vis-à-vis different market scenarios? What internal actions can we take to improve our portfolio position? If internal actions aren't enough, does our liquidity situation, in both the short and long terms, position us as a buyer or a seller? How should we decide whether to deal now or wait? What is the right deal size for us? How can we make sure we capture the incremental value of an acquisition?

RENEWED M&A ACTIVITY IN OIL AND GAS SECTOR

Although Suncor Energy's $20 billion stock-for-stock merger with Petro-Canada is the only "big" mergers and acquisitions (M&A) deal in the North American oil and gas industry since the economic downturn began, we believe a string of smaller asset and corporate deals announced in recent weeks signals an important upturn in M&A activity in the sector. What is driving that activity, and what kinds of deals will ensue? More important, how should senior managers determine whether and how to participate in this renewed activity?

Historically, M&A activity moves in cycles, often correlated to commodity price or financial market cycles. Even before the downturn began, high commodity prices boosted the cash flow of the major oil companies, even as they occasionally struggled to build up their upstream reserves and production. These companies now find themselves in a strong position to make acquisitions, since most of them still have lots of cash on hand or access to external capital. That allows them to make strategic acquisitions—perhaps entering or expanding in areas such as unconventional natural gas and oil sands—to improve their long-term growth prospects.

At the same time, many independent exploration and production (E&P) companies grew rapidly during the boom years through the discovery and development of unconventional natural gas basins. In many cases, these growth programs were funded by external financing and backstopped through aggressive hedging programs. But then came the collapse in commodity prices, combined with the economic downturn and the sudden constriction of credit. This situation has put pressure on the large independents to more carefully define their core operations and allocate capital to them, and it has forced smaller and more heavily leveraged producers to consider whether they can survive a prolonged downturn in their current form.

We expect these sell-side pressures to continue to build in the coming months, spurring an increased amount of deal activity. If commodity prices, especially natural gas prices, have not rebounded by the time companies reach their fall planning cycles, the interest in transactions that realize value for shareholders will likely increase. Small and mid-cap producers that may not have the liquidity needed to ensure their viability will feel this pressure sooner, as they renew borrowing plans with their lenders at the higher rates now prevailing and progressively lose the cash flow protection their current hedges offer. In addition, as commodity prices "settle" into an observable range, the valuation expectations of buyers and sellers will more closely align, allowing more deals, including some that have likely stalled during the past few months, to be completed.

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CURRENT DEAL TYPES

Given the current macro conditions in the oil and gas sector, what kinds of M&A transactions are getting done? We see three primary deal types:

Pursuing Growth Options
A number of major oil companies, in search of long-term growth, have been looking to expand their interests in a variety of new areas. These deals often involve nonoperating interests in independent outfits and have been concentrating on unconventional natural gas basins. Eni's purchase of a 27.5 percent interest in Quicksilver Resources's Barnett Shale assets is the most recent example of this type of deal; other examples include BP and Statoil's joint ventures with Chesapeake Energy. Other well-positioned players may pursue similar strategies, either acquiring assets with an eye on the industry's long-term fundamentals or building relevant operational capabilities for sustainable advantage.

Focusing on the Core
Independent E&P companies have been looking to divest noncore assets in order to focus their capital on core growth areas. That's why Marathon sold its assets in the Permian Basin to Apache. Other leading independents have completed or announced divestitures of onshore properties in both conventional and unconventional areas, as well as offshore assets such as their deepwater Gulf of Mexico positions—usually with the goal of redeploying capital to their most attractive core assets. We expect more large independents to make similar moves—selling noncore assets and reinvesting the proceeds in core assets, including basins where they have significant leasehold interests and a large number of attractive drilling prospects—as they seek to maintain their competitive advantage.

Combining for Survival
Some companies are joining forces to create larger, better-capitalized entities that can benefit from operating synergies and leading positions in key geographic areas or asset types. Suncor and Petro-Canada, for instance, expect to save C$300 million (US$269 million) in annual operating costs and to realize C$1 billion (US$898 million) in annual capital efficiencies through project high-grading. While this is the only example of this kind of deal so far, a number of smaller independents are under pressure to find long-term solutions to capital structure issues, and such mergers represent a good way to accomplish this objective while improving their long-term growth prospects.

SIX QUESTIONS FOR SENIOR LEADERS

No participant can have all the information needed to make perfect decisions about the opportunities and risks of making M&A deals in the current market. As you consider your options, we suggest that you ask yourself and your management team the following questions:

How well positioned is our current portfolio vis-à-vis different market scenarios?

Asset portfolios will respond to future increases in commodity prices and M&A activity levels in different ways. We believe, for example, that this year's market conditions will demonstrate that not all unconventional gas basins are created equal, and that even within a basin, the breakeven economics will vary significantly from player to player. Are you the most economic producer in your basin? Are your gas assets competitive with the landed cost of LNG? Ask yourself similar questions with regard to your oil assets.

What internal actions can we take to improve our portfolio position?

Some players have enhanced their cost competitiveness by improving their lease and deal identification and screening process, thus increasing the likelihood that they can secure a first-mover advantage in attractive basins. Others have turned to lean manufacturing and other techniques to improve cycle times and drive down costs, and have leveraged new technology to increase the efficiency of production operations. Can you employ similar techniques?

If internal actions aren't enough, does our liquidity situation, in both the short and long terms, position us as a buyer or a seller?

Your current liquidity position is just a starting point: If necessary, you can take a number of steps to improve your balance sheet, through capital markets activity, capital allocation, and working capital management. In addition, you should consider alternative deal structures. We have already seen stock-for-stock deals, cash deals, and joint ventures, and there will likely continue to be a market for different deal structures.

How should we decide whether to deal now or wait?

Companies have turned to several "traditional" methods when considering the appropriate timing of a transaction—including historical exchange ratio comparisons, accretion/dilution analysis, and the like. We suggest, however, that management teams start with more fundamental questions: Can your company add value above and beyond the current market valuation of the target asset, based on your specific capabilities? Does your operating model allow you to manage the asset at a lower cost structure? Would your subsurface expertise and drilling efficiency unlock additional production potential? In the current market environment, we believe the benefits associated with acting quickly on fundamentally sound deals that create competitive advantage outweigh the potential gain of waiting in hopes that transaction prices will decline further.

What is the right deal size for us?

Every transaction involves risk. The key is to take risks that actually increase your "option value." Evaluate the options a potential transaction might generate (such as future production growth or increased exposure to a particular commodity or play type). Then weigh those options against the transaction's potential to reduce the flexibility of your current portfolio, because of insufficient capital to drill attractive inventory, for instance, or a higher probability of default. Some transactions—particularly large ones—may create new portfolio options but inappropriately curtail your current flexibility.

How can we make sure we capture the incremental value of an acquisition?

Historical analysis indicates that most deals fail to add significant value for the shareholders of the acquiring company, usually because of poor planning for postmerger integration prior to the transaction. What is your integration strategy? How will you integrate and retain the capabilities of the acquired company? Will you be able to lock in value—through hedges, for instance—and realize the potential synergies the transaction offers?

A number of leading participants in the North American oil and gas sector employed an M&A strategy during previous downturns to establish the foundation for future success. We believe the current environment offers similar opportunities. The key to success lies in knowing where you have or can create competitive advantage, using a disciplined process to review the available inorganic opportunities and risks (including timing), weighing them against other growth alternatives (both inorganic and organic), and then executing your strategy with a conscious view toward value creation.

Reference

Merge Ahead: Mastering the Five Enduring Trends of Artful M&A, by Gerald Adolph and Justin Pettit, McGraw-Hill, 2009.

About the Authors

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