

Finding the Right Opportunities in Energy M&A

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One sure sign that the economy is in recovery mode is the increase in merger and acquisition (M&A) activity, including the USD 60 billion of deals in the energy sector in the first quarter of 2010. The depth and breadth of the M&A rebound in energy has been fueled by optimism that we are emerging from a global financial “funk” and we are at the beginning of a long period of sustained economic growth.

With optimism returning, there are two major reasons we may see an abundance of deals in the energy arena: pent-up demand for deals in the service and equipment space, and the new shale-gas paradigm.

Reordering of Portfolios

In the equipment and service arena, there has been a significant absence of deals over the past 2 years due to uncertain economic conditions. Companies are now in a position to acquire technology and know-how and reorder their portfolios to take advantage of their differential advantage (which is constantly in a state of flux). For example, a company with a strong presence in a particular area that is attracting a lot of investment (i.e., drilling) may seek to expand its product offering in that area to increase the share of the overall service content of the wells. In other instances, particularly in dealing with national oil companies (NOCs), service companies might seek to do a better job bundling services that are relevant to their NOC customers’ changing needs.

Several strategic moves were propelled by what appeared to be (at least at the moment) a recovering stock market, allowing senior executives to see stock-for-stock deals as fair. Thus we have seen several major stock-for-stock transactions in the service space, and (assuming the markets quickly find their way back to a stable footing) there may still be more to come.

Cash-for-stock deals, however, are less prevalent today because they depend on absolute (vs. relative) valuation fairness. Said another way, it is one thing to use my undervalued stock to acquire your undervalued stock. To your shareholders, and mine, it is a fair trade. But for me to use my cash to buy your stock, we both need to know that the valuation is not just fair on a relative scale, it has to be *right*. Until recently, it was difficult for both buyer and seller to see any particular acquisition price as the *right* price because earnings of target companies were declining. As the overall economy improves and sellers report steadily improving quarterly earnings, price expectations between buyer and seller are coming into line. When they are finally aligned, which often happens four to five quarters after the economy begins to recover, then we will see not only corporate cash-for-stock deals become common, but we will also see private equity firms come off the sidelines with a major wave of transactions.

Given the changing economic variables, and some lingering uncertainty in the capital markets, deal-making experience and savvy will be a valuable “commodity.” Our corporate clients are starting to recognize these challenges and are making changes to the way they peruse deals. In fact, we have seen them work hard at getting smarter and in some instances, they are adopting some of the skill sets of petroleum engineering firms to better compete and succeed. Some of those tactics they are implementing include the creation of fully developed deal-management strategies that produce real value for investors, outsourcing all aspects of the diligence team, staffing-deal teams with M&A professionals rather than with

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functional experts, and requiring the seller to cooperate with a vigorous due diligence exercise.

The Shale-Gas Phenomenon

Shale gas is a potential game changer in many ways. Not only does it create the possibility of a dramatic change in the hydrocarbon supply/demand equation, but it has driven and will continue to drive M&A.

Major international oil companies have acquired sizable stakes in shale-gas operations in the US not only to have exposure to a paradigm shift in energy supply in the world's largest economy, but also to acquire the know-how to exploit shale resources in other countries. Many of these deals took the form of joint ventures, or asset acquisitions with a seller's interest carried. Some of the deals have helped independent oil companies meet their lease commitments to maintain their hard-won positions.

Interestingly, the rush to exploit shale gas has also triggered a rush to acquire oil reserves. Although this new "oil rush" surprised many industry observers, it now appears quite logical. With gas prices likely to remain flat (given the tremendous gas supplies found in the shales), there is a new expectation that independent oil companies in particular will be rewarded for oil reserves in their portfolios in the intermediate term. As a result, there have been several recent oil-resource acquisitions and many gas-weighted companies have announced plans to acquire oil reserves and oil-weighted companies.

While acquiring a resource asset (i.e., a producing field or reserves) is a relatively straight forward engineering proposi-


tion, acquiring an entire company can be a much different experience. In the latter case, it is absolutely vital that this process be done carefully, through extensive due diligence to uncover hidden value and risks and proven integration planning to ensure any deal delivers on its promise. Integration can be a particularly sensitive issue when the value in the acquired company is the know-how of the people acquired.

Finally, shale gas is stimulating tremendous new investments in midstream infrastructure. To move new sources of gas to market, there needs to be a major investment in gathering, processing, transportation, storage, compression, and a host of related equipment and services. While the first wave of this overhaul will not necessarily involve M&A (i.e., it will involve massive capital spending by existing companies), history will repeat itself and, in the not-too-distant future, there will be major adjustments of portfolios and perhaps the largest wave of midstream transactions the US has seen.

High-Quality Deals in a Conservative Environment

With nearly 2 years of virtually no deal-making activity, it is understandable that energy players are eager to act on the pent-up demand to do deals. But do not expect quick deals to just be thrown together for the sake of doing a deal. Rather, M&A today will involve quality deals that are a well thought-out, strategic process. Companies are looking to diversify and reorder portfolios, domestic and foreign companies want to acquire a certain technology or know-how, and petroleum engineering firms are seeing opportunities to use their deal-maker expertise in the industry.

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