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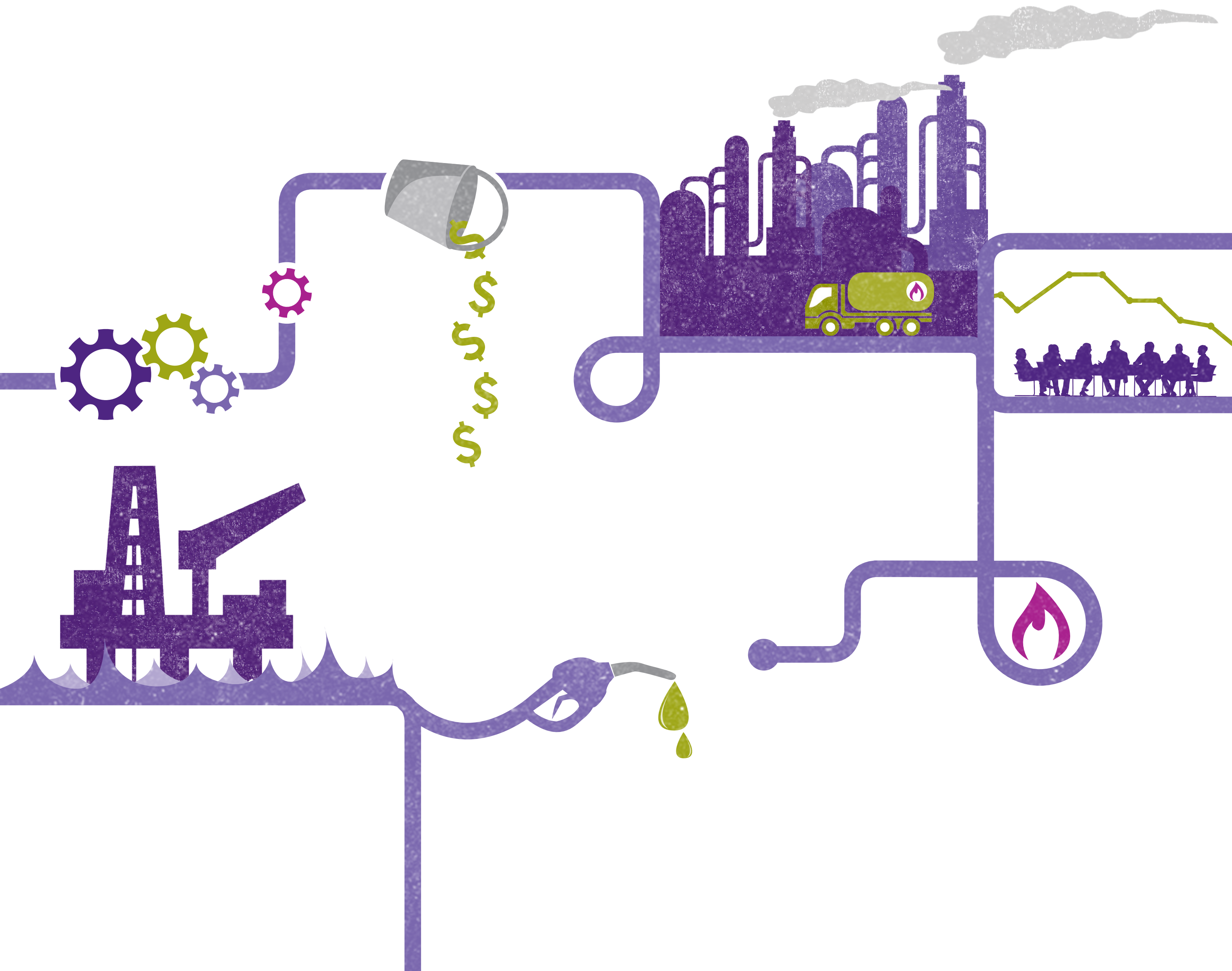
Energy firms rethink strategy in the wake of falling prices

Grant Thornton survey of upstream U.S. oil and gas companies 2015



Impact of lower oil prices on energy company strategy

In "Giant" — the epic film about the Texas oil boom in the early 20th century — a patrician Elizabeth Taylor tries to tell roughneck James Dean that money isn't everything.
"Not when you've got it," he quips.

Much has changed in the energy industry since the 1920s, but the difference between the cash-haves and have-nots is as prominent as ever. Cash-strapped companies that managed to stay afloat in the first half of 2015, despite low oil prices, face an additional hurdle this fall when banks conduct the second of their twice-yearly reviews of producer credit lines. Regulators are reportedly concerned about banks' increasing exposures in energy loans; credit lines could well be decreased and terms tightened. If bank financing is cut, struggling firms will need to pursue other avenues for a cash infusion, which will usually require giving up some, if not all, control of their business.

Impact of lower oil prices outside the energy sector

Reduced oil quotes have had a significant effect on even well-diversified companies like Caterpillar, which in September announced layoffs of 10,000 workers — about 10% of its worldwide workforce — partly owing to the downturn in the energy sector. And as indicated earlier, banks that made loans assuming higher oil prices now find themselves with much higher exposures than they had reckoned.

For nonoil companies within the energy industry itself, often the impact has been mixed and the long-term effect difficult to discern. Lower oil prices have hurt the economic argument for solar, wind and other renewable resources. On the other hand, the oil price decline could also lead renewable companies to improve their production methods and technologies to become more economically viable.

Jim Menzies, global leader for the food and beverage sector at Grant Thornton, recently discussed how the slump in oil prices is benefiting food and beverage companies. Manufacturers have locked in lower prices for their own energy needs, as well as benefiting from reduced transportation rates. Declining oil prices also means extra cash for the consumer to spend on the food and beverage industry's products — provided the consumer wasn't laid off by an oil company.

More broadly, the energy industry's downturn has rippled through some local economies. In states relatively new to liquid energy assets like Pennsylvania, where the number of rigs operating in the Marcellus Shale has been about halved, the layoffs have hurt local businesses and government coffers. But areas that have longer exposure to the boom-and-bust energy industry cycles, as well as a more diversified economic base, have coped much better. Notably, unemployment in the oil capital of Houston fell year over year in August from 5.1% to 4.6%. The impact in Colorado seems similarly small.

Globally, even for oil-importing nations like Japan, lower prices can be a mixed blessing. The country is enjoying the reduction in nominal prices (quoted in dollars) that has more than offset the currency-induced increase from a weaker yen. Lower energy costs help Japan cut its trade deficit and boost gross domestic product. On the other hand, they hurt the government's inflation targets in a country that has had persistent deflation for many years.

Meanwhile, those companies that are well-capitalised, did not overpay for assets and have kept costs down are plotting strategy for the next leg-up in the energy price cycle. To be sure,

they're challenged by low oil prices, and some have extended their timetables for meaningful ROI from 18 months to a few years. But in a less frenzied investment environment, they can acquire properties at reasonable prices, hire trained staff from a more plentiful labour pool and focus on projects like introducing new technology infrastructure.

These trends are apparent in the 2015 Grant Thornton LLP survey of U.S. oil and gas companies, conducted in partnership with Hart Energy. Even a cursory comparison of this year's survey with 2014's shows what a difference 12 months can make. In last year's buoyant price setting, government regulations that shackled growth were a major concern; expectations for capital expenditures were surging; and labour shortages bedevilled operations. With oil prices halved, responses to this year's survey reflected the recessionary struggles of many companies, including dealing with budgetary constraints, deciding whether to sell out or merge, and downsizing staff.

"Companies weren't hit as immediately as they were in the downturn of 2008–09 from a creditor standpoint," says Kevin Schroeder, industry managing partner for Grant Thornton's Energy practice. "As prices fell in 2014 and early 2015, managements took the normal steps to deal with a price decline — capital budgets were cut, rigs were idled and operating costs were shaved," said Schroeder. "In the spring, it looked like the industry might stabilise at a new norm of around $60 a barrel. But with prices falling again in the summer and hedges coming off — together with pressures on energy lenders — we're in a period of greater stress. The industry has some real challenges ahead."

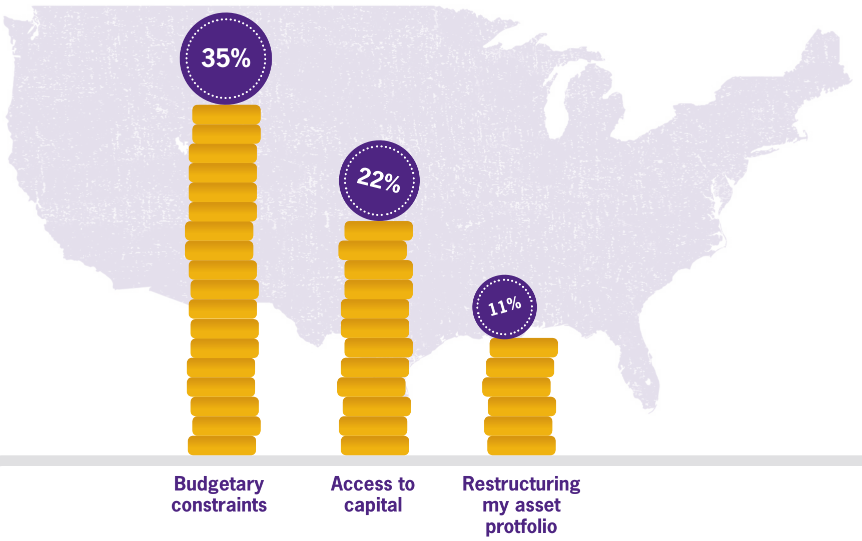
Bryan Benoit, partner in Grant Thornton's Forensic and Valuation Services practice and Advisory Services leader for the Energy practice, agrees: "Over the next 12 months and beyond, both E&P [exploration and production] and service companies will have to deal with the fallout from the steady decline in oil prices over a sustained period of time. There will be companies that will need to refinance or restructure to achieve a level of performance that will appease creditors and shareholders. From an M&A perspective, there were deals that were on but are now off; there are deals that were not contemplated but now will have to happen. All of these are transaction-related activities that in terms of how they are organised and how they are structured look very different from a year ago, and certainly two years ago."

At the same time, the longer-term outlook for the oil and gas industry remains bright. "Driven by advances in technology, since 2009 the U.S. oil industry has basically doubled production," says Schroeder. "This energy revolution has temporarily resulted in an oversupply; but over time, supply and demand will work itself out. The current supply/demand imbalance really isn't much more than a couple of percentage points of the global production. The industry consistently emerges from slumps better-positioned, and well-managed companies with solid balance sheets and good assets come back stronger. The current cycle shouldn't be any different."

Operational barriers and capital spending

Asked about the biggest operational barrier to their business, more than one-half of respondents said either budgetary constraints (35%) or access to capital (22%). Federal, state and local regulatory issues, which in last year's survey were seen as the greatest obstacle in a growth-driven industry, drew only a 10% response.

Top threats to your business

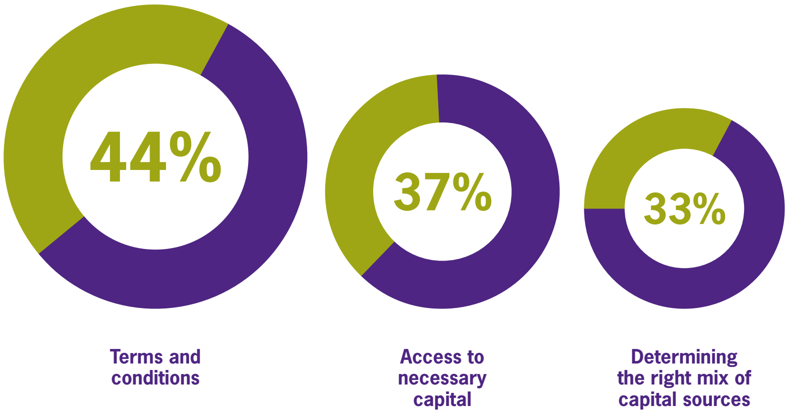


Last year's top barrier, **regulatory issues**, came in fourth (10%)

As one would expect from these results, capital spending is often being put on hold. When asked last year about their plans for U.S. capital spending in 2015, 67% of respondents expected to boost expenditures up to 20% or more year over year. Just 18% forecast no change, and only 5% expected a decrease. This year, 36% expected a year-over-year increase for 2016, while 32% predicted a decline. Nearly half of those who predicted a drop expected it to be more than 20%.

But low oil prices have also allowed companies to consider drilling programs that were unfeasible during the boom. "There are companies that couldn't get acreage or afford rigs when oil was $100 a barrel," says Rocky Williams, managing director in the Technology Solutions practice. "Now that the acreage is available, and with daily rig rates substantially lower, drilling opportunities have opened. Well-run companies that have kept their costs down [and] who have concentrated on geographic areas they know really well, can succeed in this price environment, just as there were companies that succeeded when oil was at $8."

Capital consdierations that have the greatest impact on strategy



54% **found access to new capital to be the most difficult this year**

Operational infrastructure challenges

Perhaps no single question reveals the changed circumstances of the industry as one about the biggest operational infrastructure challenges companies face. In the 2014 survey, finding and retaining the right people drew the largest response — three times that of the next closest answer. This year, its polar opposite — necessary downsizing of personnel —attracted nearly 30%. The strong response for managing efficient processes internally (37%) may reflect reduced headcounts as well.

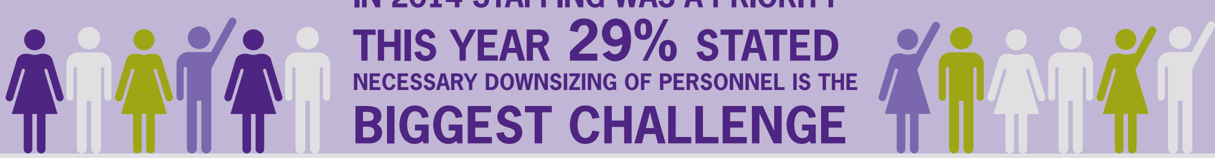
Assessing current employment conditions, Nick Vellani, principal at Grant Thornton's Business Advisory Services, says: "There's little new hiring going out in the field, but you are seeing some hiring in back-office operations. For companies that have cash to spend, the widespread layoffs have greatly expanded the available talent, providing an excellent opportunity to find the right people."

M&A outlook

Asked in 2014 about their main M&A challenges, by a 10-point margin respondents' top choice was high costs driven by competition. This year, some 54% said it was the differences in buyer and seller expectations, outpacing the next highest response of commodity price fluctuations by more than 30 percentage points.

The difference in buyer/seller expectations certainly contributed to the low levels of energy M&A in the first half of the year. By the end of the quarter, however, the number of deals was beginning to creep up.

"When oil hit $40 a barrel in late August, that's when we saw a change of sentiment by some of the industry players, notably the banks," says Kyle Reid, managing director in the Transaction Advisory Services practice. "People are now more willing to talk about consolidation, and we're seeing an



increased appetite for transactions. In the midmarket E&P sector, there's a lot of activity by private-equity-backed portfolio companies that are rolling up distressed companies and boosting valuations through efficiencies like back-office sharing."

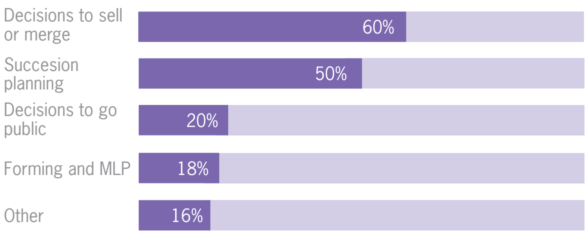
Reid adds, "The decision by the banks this fall on credit lines is becoming crucial. If oil prices remain depressed and the outlook stays dismal, you'll see a lot more activity and arrangements being made by both the banks and private equity."

Thus far, the largest M&A deals have been in the service sector. Halliburton announced a $35 billion takeover of Baker Hughes in November 2014 (although there is still concern that the deal will fall through).1 In August, Schlumberger, the world's largest oilfield contractor, agreed to buy Cameron International in a deal valued at about $15 billion.2 In the production area, the most noteworthy transaction has been Noble Energy's takeover of Rosetta Resources in July; valued at a little over $2 billion, the deal enhances Noble's Eagle Ford and Permian positions.

Organisational strategies

The survey also asked about companies' structuring strategies:

Which organisational structuring strategies from legal and tax perspectives are most important for your organisation today?

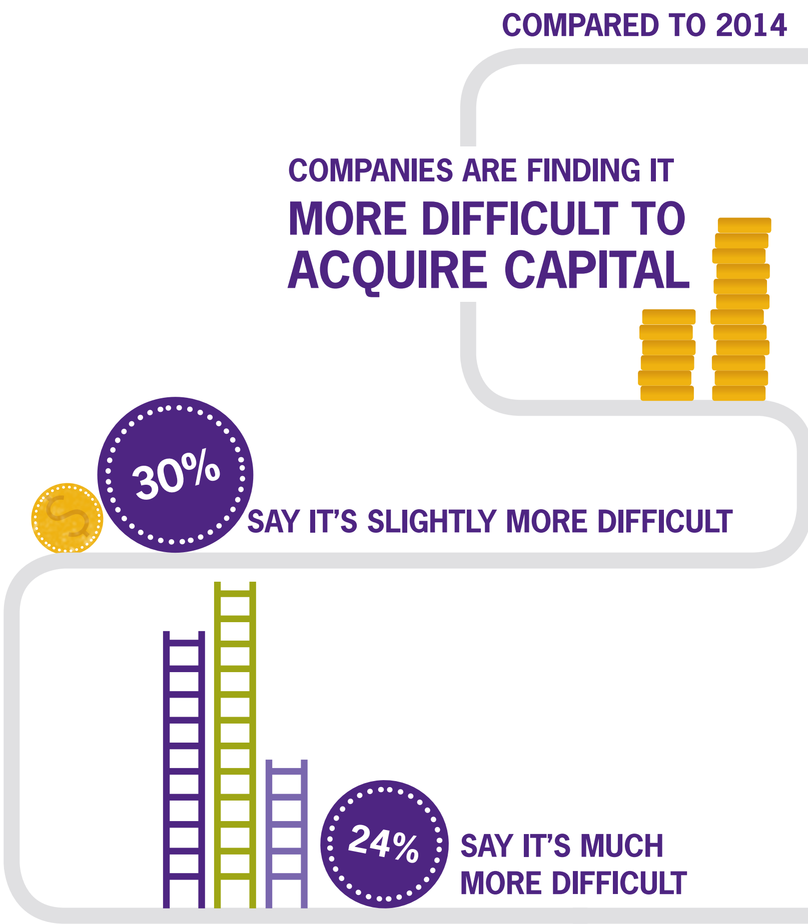


Decisions to sell or merge, as well as succession planning, both received more than 50% of respondents' votes. "Such a high response for succession planning may at first seem surprising," says Benoit. "But both public and private companies are consistently challenged on this issue by investors for whom who's going to lead the company and create shareholder value, both now and in the future, is top of mind."

Securing capital

As expected, compared with 2014, companies are finding it more difficult to acquire capital. Some 30% of respondents said it was slightly more difficult, and 24% said it was much more difficult. In the first half of this year, U.S. shale producers raised about $44 billion in high-yield debt and equity. Falling oil prices have hurt producers' ability to access capital markets at those levels. But current market conditions are proving attractive to private equity (PE), even in the face of large losses from earlier stakes. PE has as much as $115 billion ready for energy investments and is willing to wait a few years for returns.

PE firms won't necessarily fulfil the capital needs of struggling producers. "Private equity may pick up a portion of the investment slack," says Vellani. "But PE has learned from experience — it will now be smart money going after smart companies. PE won't be the saviour for businesses that weren't run well and for companies whose operations could only be sustained at much higher prices."



Technology infrastructure

When asked about their biggest technology challenges, the two top responses were cost of implementing a new technology platform and access to relevant data for decision-making — each mentioned by about 30% of respondents. Vellani believes the two responses are related. “When senior managers ask their staff how they can get the data they need for a decision, they’re often told they need a new system to do that. So the issue becomes whether there’s money for it in the capital budget. Often the feeling is that the project is too costly now, and we’ll put in the money when things pick up. In my view, that gets things backwards, because now is the time to make the IT investment so the company is positioned to proceed when there is a turnaround.”

Another popular response was systems integration and compatibility. According to Williams, systems integration is a long-running and continuing challenge for the industry. “Most oil and gas IT systems are not self-integrated at all. Reserves, production, supply chain, inventory … all of the sub mechanisms of operations do not talk well to the general ledger, to the reporting system, to budgeting and forecasting applications. What companies need to do is to get better integration of the data into an analytical platform. The best-managed companies are taking a longer, five-year outlook, rather than 18 months, toward their IT systems and data management.”

THE TWO GREATEST TECH CHALLENGES: IMPLEMENTING A NEW TECHNOLOGY PLATFORM AND ACCESS TO RELEVANT DATA FOR DECISION-MAKING

Only 1/3 of respondents use big-data analytics to inform their organisations.

Information needs

Asked about what information they need to run their business, but have difficulty getting, the most popular response was play/basin analytics. When asked in a separate question whether they were using big-data analytics to inform their organisation, only one-third of respondents said they were.

Benoit comments, “There’s such an abundance of information today about plays and oil and gas formations, and a tremendous amount of data about historical prices. The high response for play/basin analytics demonstrates that companies are recognising that data analytics could be extremely valuable to them as they pursue exploration opportunities.”

How important are the following issues to your company strategy and decision-making? (1-Not important through 5-Very important)

	Rating average
ISIS and unrest in the Middle East	2.75
2016 presidential primaries	2.66
Approaching peak demand	2.51
U.S. exporting of oil and gas	2.14
OPEC/Saudi Arabia’s next moves	2.13
U.S. local/state/federal regulations	2.19

Important issues for decision-making

We asked respondents about their opinion on the importance of a number of issues on their decision making. Unrest in the Middle East, 2016 presidential race and the fear of approaching peak demand took the top three slots. It seems that in 2015 broad geopolitical issues supersede domestic challenges such as U.S. oil and gas exports, as well as taxes and regulations.

Pricing outlook

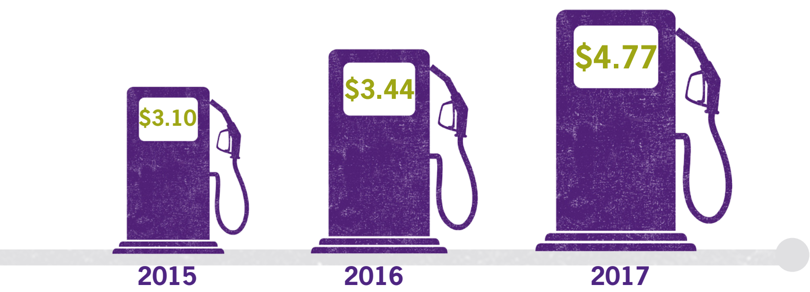
As in previous years' surveys, respondents were asked to give their forecasts for energy prices. Given that last year not a single respondent saw oil dipping below $75 a barrel in 2015, the ability of even industry players to foretell oil prices must be considered questionable at best. Still, as a gauge of industry sentiment and what price assumptions companies may be using for decision-making, the exercise has utility.

Surveyed in July 2015, one-half of respondents saw West Texas Intermediate selling at year-end 2015 at between $50 to $60 per barrel, and another 41% estimated prices in the $60 to $70 range. For 2016, 48% predicted $60 to $70, and 28% believed prices would be in the $70 to $80 range. For 2017, the forecasts were $60 to $70, 30%; $70 to $80, 36%; and $80 to $90, 23%. Essentially, respondents saw oil prices gradually rising each year, with responses for 2017 averaging in the $70 to $80 range.

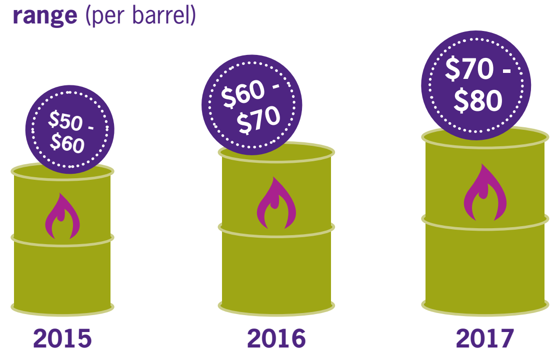
"Industry participants are surprised by the current price levels," says Benoit. "They were very surprised by the decline — it was completely unexpected. For most people in the industry, the recovery in prices is not a matter of if, but of when. But people are talking less about a price recovery by the end of this year or next, and more about a recovery into 2017 or2018."

Looking forward: Respondents' price and capital spending projections

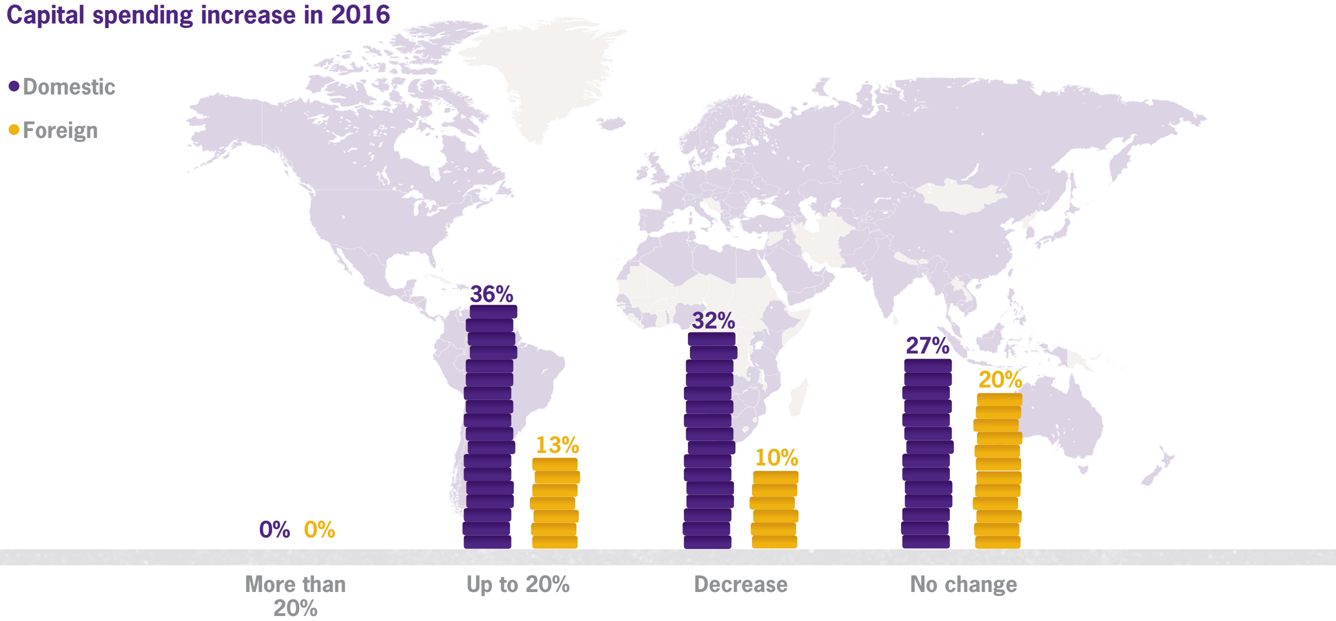
Henry Hub average natural gas price (per 1,000 cubic feet)



West Texas Intermediate crude oil price range (per barrel)



Capital spending increase in 2016



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