IJGlobal
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M&A opportunities pick up amid the oil price collapse

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04/03/2015

Exploration and production companies have begun cutting back on spending plans amid a period of depressed crude oil prices.

Since mid-December 2014, the Brent crude index has stood below $65. For smaller operators with high levels of leverage, the strain on their balance sheets is already starting to tell. Financial distress and the lower valuations attached to reserves make struggling operators and their assets tempting targets for larger oil producers and financial investors. Mergers and acquisitions (M&A) activity is still subdued, but is expected to pick up in the second half of 2015.

As the industry comes to terms with, and adapts to, the new pricing environment, M&A opportunities will increase as distressed assets become available, predicted Jon Clark, a partner and UK & EMEIA leader for oil & gas transactions at EY in London.

“At the moment companies are probably looking at attractive ways to buy into portfolios,” he said. “But unless there is distress, most management teams will say their shares are undervalued, so it requires a certain catalyst to complete a corporate acquisition. There will be lots of people looking to sell assets and rebalance their portfolios and it will be very much a buyers’ market,” he added. “So by volume we will mostly see asset deals, but also corporate deals with an element of distress in them.”

The best-positioned buyers

Smaller companies are likely to focus on shoring up their own capital structures first, before trying to buy up their peers.

The most successful buyers will be those with strong balance sheets that are able to take a long-term view and will be able to take advantage of lower prices to replenish their reserves and add near-term production.

“You’re likely to see financial buyers, sovereign wealth funds, and probably non-traditional parties,” Clark said. “Any established oil & gas company is probably focusing on its own portfolio in the first instance and wouldn’t be well-regarded by shareholders if it was seen to not be focusing on its core activities, whereas the people from a financial background are able to look at this from a longer-term view and try to be opportunistic.”

One reason for the slow pace at which M&A activity has picked up is that a consensus on the prices of reserves has yet to catch up to the fast drop in the price of crude.

“Price determination in M&A is very difficult,” Clark said. “That means in the short term there will be a reduction in activity. But in the medium-term, as soon as next quarter, there will be a rebasing in the value expectations in the M&A market and a rebound in activity.”

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“If prices continue to stay at these levels we will likely see companies that need asset sales in order to raise capital and that’s where you might see a distressed M&A market emerging for players that are financially strong,” said Tom Ellacott, head of corporate analysis for Wood Mackenzie in London.

The oil majors – which have the financial muscle to close quickly on acquisitions – will be at the head of the pack of acquirers. “There are also some financially strong independents that could see opportunity if distressed asset sales or exploration acreage comes up for grabs,” Ellacott added.

Cutting back spending

Cost cutting is the key theme, according to Ellacott, who said that conditions will be tough for oil companies if prices don’t bounce back, because the fall in prices means that some European projects have become unviable.

In February 2015 BP said that it would be bringing forward the closure of some unprofitable UK fields, while Shell has begun decommissioning its Brent Delta platform. Shell is holding its exploration budget at $4 billion for this year – the same level as 2014.

At BP’s fourth quarter results conference, chief executive officer Bob Dudley said that everything in its business is “up for grabs” for cost cutting, bar anything related to safety compliance or ethics obligations.

“We do think there is going to be a considerable uncertainty in the outlook and we have got to reset the whole cost base for a sustained period of lower oil prices,” Dudley said. “We are going to look at all of our activity across the group and that is going to be the intense focus of 2015. It is going to take a year.”

By the beginning of February, oil producers had announced 25% cuts to their budgets over the year before, according to Ellacott, who expected the cuts to gain in severity if low oil prices persist.

“With an oil price around $50 a barrel, cuts will need to go quite a bit deeper in order to achieve cash flow neutrality and that’s quite a key factor in this,” he said, adding that exploration cost cuts are designed to ensure survival rather than enforce capital discipline. “The oil price collapse has really changed the dynamic and a lot of it is about freeing up capital in order to balance the books at these sorts of prices.”

Although producing assets and development-stage assets account for some potential savings, one of the main targets for cuts is discretionary capital spending – which includes expenditure on projects in advance of final investment decisions (FID). Projects that might have received an approval over the next 12 months might now be pushed back.

“Some of that was starting to happen before the price started falling in the middle of last year but it’s just accelerated the process,” Ellacott says.

Projects in all regions, but particularly in the US, have been put on hold because of the fall in oil prices, and this is likely to spread to Europe, notes Ian Cogswell, managing director and head of natural resources in Natixis’ global infrastructure and projects group in London. “A number of the projects that were planned were based on a much higher oil price and they are now unlikely to be developed because they’re no longer economic.”

In particular, upstream unconventional resources are likely to face cuts. Shale, oil, shale gas, ultra-deepwater and Arctic projects are all very expensive to develop, and are quickly becoming uneconomic.

“Due to lower prices, the major international oil companies will be generating less revenue both this year and next,” Cogswell says. “And if they have lower revenues they are less likely to spend it on exploration and production – especially given the lower returns this would generate."

Most of Europe is likely to benefit from the lower prices because the region is a net importer. But Norway – a net exporter – and the UK, which became a net importer of crude in 2005 but has a large oil and gas industry, will suffer in the current environment.

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