EVALUESERVE

Oil and Gas Industry M&A Update for Q4’2020 and FY’2020

Corporate and Investment Banking Practice

Situation Overview

The COVID-19 pandemic overwhelmed the world in 2020. No one anticipated the social and economic scenarios that unfolded in 2020. However, 2021 started on a positive note, with the rollout of the first phase of COVID-19 vaccination programs across many countries.

Though the effectiveness of these programs may still need some time to reach their full potential, the development of vaccines has improved business sentiment and instilled confidence in global economic recovery.

According to the IMF's Jan 2021 outlook, the global economy will likely grow by 5.5% in 2021 and 4.2% in 2022, from an estimated dip of -3.5% in 2020. The effects of this rebound can be seen in the oil & gas sector, with prices increasing almost daily over the last couple of months. Oil prices have increased by ~33% to USD60 per barrel (/b)* as of February from USD45/b at the beginning of Dec 2020.

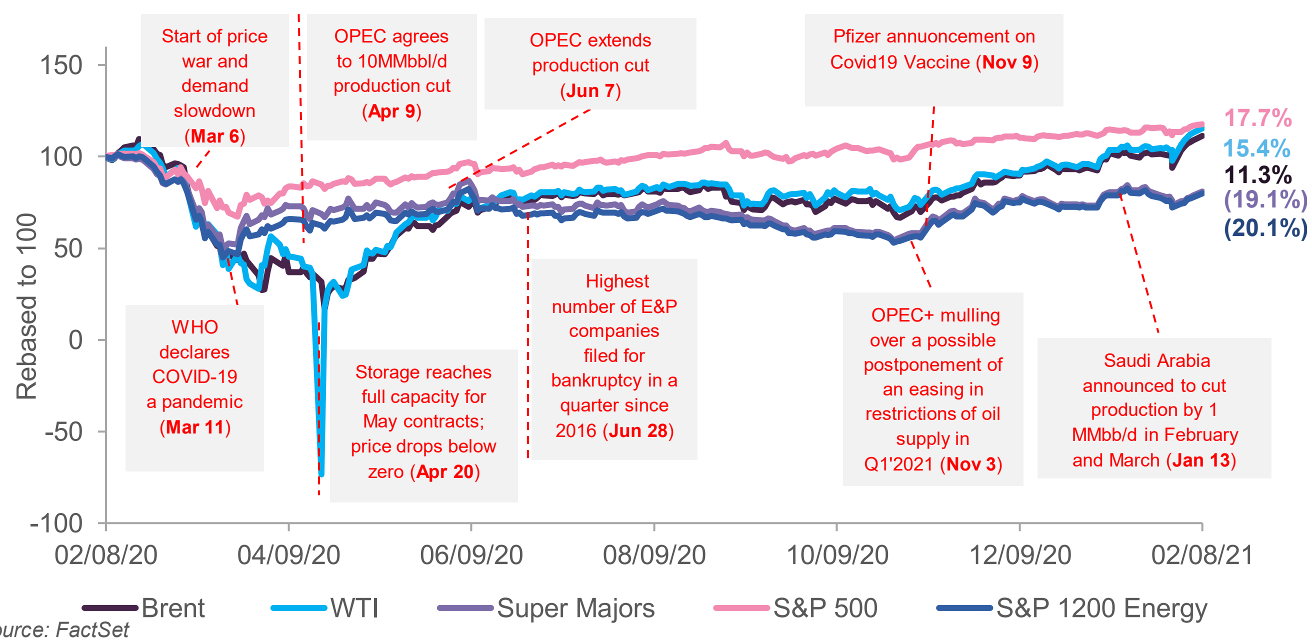
Nevertheless, it is still too early to predict anything. There still is some uncertainty around economic growth, as consumer behavior in response to the vaccination programs will likely dictate the whole scenario. Furthermore, following the emergence of a new strain of the virus, a few countries such as the UK, Belgium, Portugal, Israel, and Denmark have implemented stricter lockdown measures.

According to the Energy Information Administration (EIA), the gap between global consumption and production in December 2020 (1.73 MMbbl/d) was lower than that in October 2020 (3.25 MMbbl/d). The gap decreased due to an increase in production level in response to a rise in oil prices in last two months. However, at the beginning of 2021, OPEC members and Russia agreed to roll over production cuts for the next two months to avoid any excess oil supply amid rising oil prices.

According to the EIA, US crude oil production fell from 12.2 MMbbl/d in 2019 to 11.3 MMbbl/d in 2020 and will likely dip to 11.1 MMbbl/d in 2021. However, it is expected to increase to 11.5 MMbbl/d in 2022. A steady increase in oil demand has buoyed crude oil prices and narrowed the price performance gap between major oil & gas companies and the S&P 500 in Q4'2020, compared with Q3'2020.

Furthermore, the new presidential regime in the US has fueled price increases with an expectation of fresh stimulus in the sector. We believe the sector is showing signs of recovery and will remain on a steady path in 2021.

LTM Share Price Performance: Super Majors vs. S&P Oil and Gas vs. S&P 500



Source: FactSet

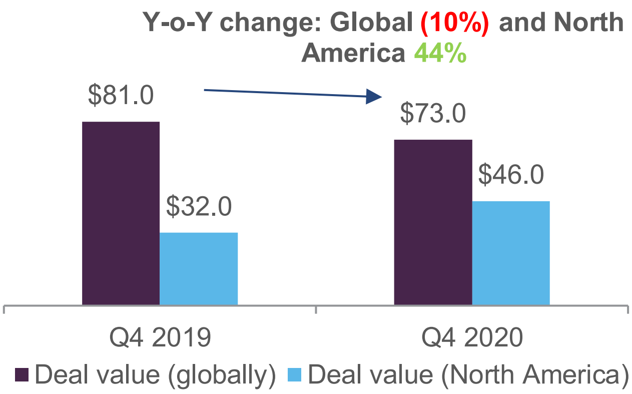
Note: Supermajors include Exxon Mobil, Royal Dutch Shell, Chevron, BP, Total, Eni, and Equinor

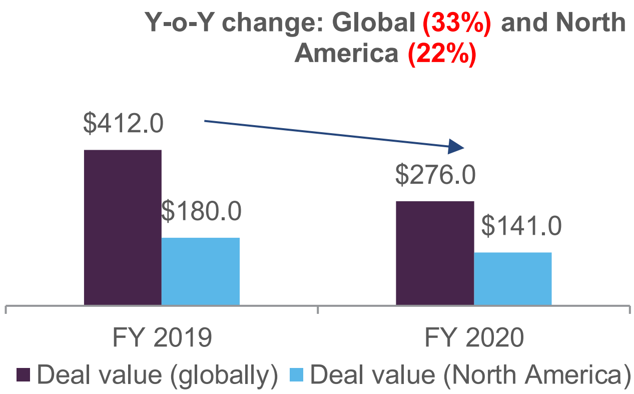
FY2020 M&A Scenario

1. **Deal activity declined in 2020**: According to GlobalData, 535 oil & gas deals (worth USD73bn) were announced globally in Q4'2020, down 53.9% (value terms) vs Q3'2020 and 21.8% vs the average value (USD60.3bn) in the last four quarters. In FY'2020, 1,680 oil & gas M&A deals were announced, down 15.5% from 1,987 deals in FY'2019. Deal value decreased by 33.0% from USD412.0bn in 2019, to USD276.0bn in 2020.

Some of the key deals in Q4'2020 include Conoco's acquisition of Concho Resources for USD13bn; a USD7.8bn merger between Cenovus Energy and Husky Energy; Pioneer Natural Resources' acquisition of Parsley Energy; and China Oil & Gas Pipeline Network's USD6.2bn acquisition of PetroChina Beijing Gas Pipeline and PetroChina Dalian LNG. In Q4'2020, 181 oil & gas deals worth USD46.3bn were announced in North America.

M&A Deal Value (USD bn)

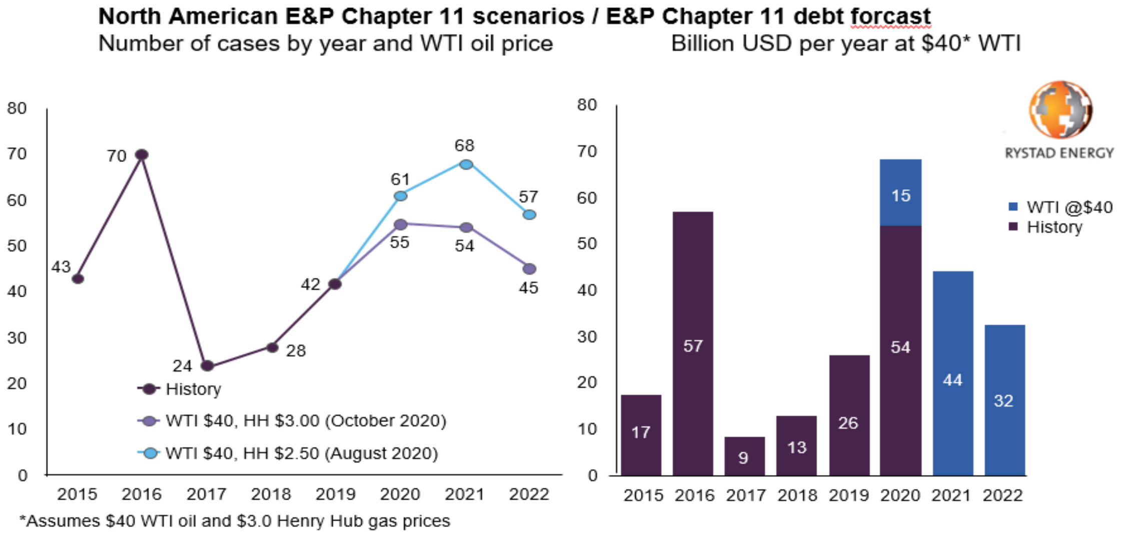




Source: GlobalData

2. **Rise in bankruptcy and restructuring filings in the upstream and services sectors**: According to a survey by Dallas Federal Energy, shale oil producers require to achieve a per barrel breakeven oil price range of USD48–54 to generate a decent bottom line. As per the EIA's Short-term Energy Outlook, January 2021, WTI prices will likely average at USD49.7/b in 2021. This is a positive sign for oil producers. Furthermore, spot prices of Brent crude oil averaged USD50/b in December 2020, up by USD10/b from the average in October 2020. Brent crude oil spot prices are expected to average USD53/b in 2021 and 2022, compared with an average of USD42/b in 2020. The upside in oil prices will likely reduce the number of bankruptcy filings for the time being. Nonetheless, companies must remain cautious and take steps so that they do not reach the 2020 levels. In October 2020, Rystad Energy reported that 84 E&P and OFS companies had filed for Chapter 11 bankruptcy protection, which was lower than the highest number of bankruptcies (142) filed in 2016. Some of the major companies that filed for Chapter 11 bankruptcy in 2020 are Chesapeake (debt: USD11.8bn), California Resource (debt: USD6.3bn), Ultra Petroleum (debt: USD5.6bn), Chaparral Energy (debt: USD3.5bn), Whiting Petroleum (debt: USD3.6bn), Oasis Petroleum (debt: USD2.8bn), and Denbury Resources (debt: USD2.5bn). According to Rystad, if the WTI average remains around USD40/b and Henry Hub price around USD3/MMcf, an additional 55 North American E&P companies may file for bankruptcy protection by the end of 2020.

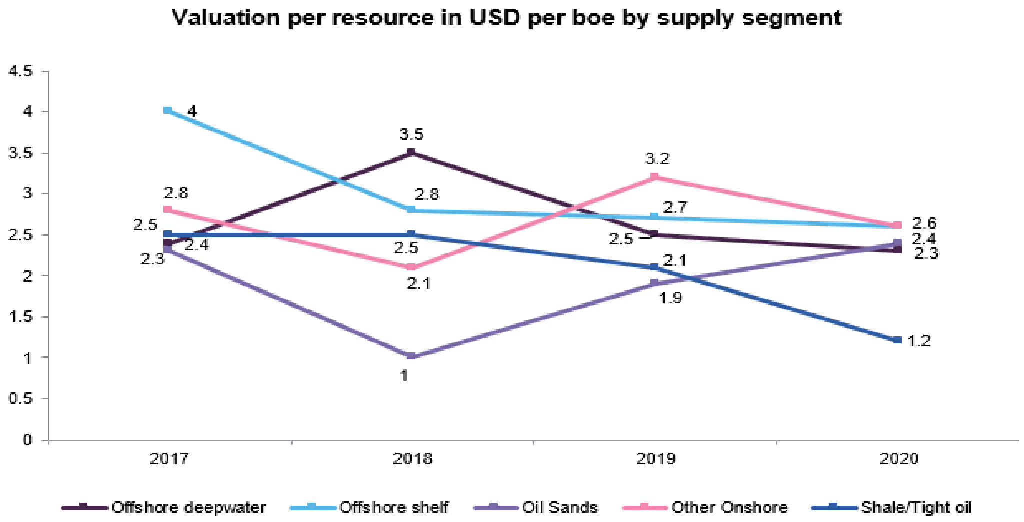
North American E&P Chapter 11 Scenarios, by Year and at Different WTI Oil Prices



Source: Rystad Energy's research and analysis

3. **Leading financial institutions exiting the O&G sector**: In 2020, some of the leading financial institutions had announced their exit or planned to exit the oil & gas sector due to the current scenario. The Central Bank of France has announced to limit its exposure to the sector by 2024. In December 2020, the Bank of Montreal announced to exit its oil & gas investment banking business in the US and would divert its resources towards assets in Canada. According to the Institute for Energy Economics & Financial Analysis, in October 2020, ~50 global financial institutions were identified to have restricted the financing of oil sands and / or Arctic drilling projects. Some of these institutions are HSBC, Banco Santander, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Citigroup, Wells Fargo, and Morgan Stanley.

4. **Plummeting shale oil valuation in 2020:** According to a report by Rystad Energy, the global deal value of upstream M&A activity in 2020 dropped to USD87.9bn, the lowest in over a decade, largely due to the pandemic. The valuation of the shale industry's acreage was the worst hit. It was valued at USD1.2 per barrel of oil equivalent (boe)* – a historical low – and was cheaper than any other resource type. The number of field acquisitions declined from 349 in 2019, to 188 in 2020. The number of license acquisitions remained stable, with 92 deals in 2020, compared with 98 in 2019.



Source: Rystad Energy's research and analysis

Factors affecting M&A Situation

In terms of deal focus, nothing much has changed since Q3'2020. Although oil prices have somewhat revived, oil & gas companies are only focusing on M&A deals that can add value to their business in the long run without stretching their balance sheet. Given the volatile nature of the sector, the following are a few factors that could affect M&A activity in the future:

1. **Selective M&A focus amid operational cost-reduction pressure**: Many large oil & gas firms are cautiously choosing their targets, keeping in mind long-term growth strategy but without compromising on operational efficiencies that reduce costs.
2. **Though tough to raise capital for deals amid working capital needs, ultra-low interest rates can provide a push for M&A**: COVID-19-induced uncertainties and considerable variations in capital needs across various sectors have compelled investors and capital providers to focus on their investment sectors. Furthermore, lockdown measures across the globe since Q2'2020 have led to a liquidity crisis, as companies / individuals started saving cash to meet their future capital needs. All these factors have strained capital markets, which were already declining over the past few years (as shown in the chart below). The IPO market has dried up in the last five years, and there is limited availability of other financing routes (equity and debt). Nonetheless, the current economic recession has forced global banks to maintain ultra-low interest rates in 2021, e.g., bank rates in developed countries such as the US, the UK, and Canada, range from 0.1% to 0.25%, while that in developing nations such China, India, and Russia range from 3.75% to 4.25%. This situation will likely be advantageous for the sector. Smaller players are likely to have access to cheap capital, while larger players with strong leverage management backed by proven reserves and yielding assets can focus on M&A using debt capital. In fact, many large companies raised a considerable amount of debt in April 2020 and continued to do so till now. For example, Exxon raised USD9.5bn in April and USD5.1bn in June 2020, Equinor raised USD5.0bn in April and USD1.5bn in May 2020, Shell raised USD7.1bn in April and USD2.5bn in September 2020, and BP raised USD12.5bn to date since April. Traditionally, the key objective behind raising funds was to ensure liquidity for operational needs; however, it is now also being used for M&A activity.