Drilling Down

Exploration and production transactions aim to improve resiliency

In this edition of KPMG Global Energy Institute's Drilling Down, we asked **Andy Steinhubl** and **Chris Click** about the recent merger and acquisition transactions in the exploration and production (E&P) sector.

1. **There have been several merger and acquisition transactions in the E&P industry this summer, including EQT Corporation's proposed acquisition of Rice Energy. What is driving deal flow in this sector?**

Recent E&P transactions represent North American producers' attempt to sustain profitable growth during a period of potentially "lower for longer" commodity prices. Strategic players are focused on establishing and developing core positions—quality assets at scale—allowing them to deploy skill sets and technologies to enhance performance. For example, in commenting on its acquisition of Rice Energy, EQT stated that the integration of complementary positions in the Marcellus and Utica basins would "drive higher capital efficiency through longer laterals and reduce per unit operating costs through operational and G&A synergies."[1]

In fact, Roger Manny, the CFO of Range Resources, another Marcellus player, commented that combinations such as the above would likely lead to "more paced, prudent, and rational development" in the Appalachian area and to a "less frantic boom and bust..." He further stated that a company like Range "with quality assets…for investors who believe in the gas market" would be an attractive party to similar deals.[2]

In addition, some players are utilizing capital to reinforce a specific technical capability. Hence, a "doubling down" on what many already see as a core position or competency can lead to lower costs and a more coherent portfolio story to take to the investment community. The recent reshuffling of oil sands assets from the hands of large independents and majors back to domestic Canadian E&Ps is a great example of this.[3]

Companies such as Shell, Marathon Oil, and ConocoPhillips have exited, while players such as Suncor and Canadian Natural Resources (CNRL) have emerged as buyers. The former has been leveraging advanced technologies such as autonomous (driverless) trucks equipped with GPS to move dirt at a lower cost while still improving safety measures. CNRL indicates an R&D budget of over $1.25B to invest in advanced, cleaner technologies

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such as radio waves—replacing the more conventional choice of steam—to enhance recovery. These players believe that there is opportunity to drive breakeven costs below $40/bbl through focused operations and technology application.[4] It could be argued the assets are being consolidated by their "natural owners" and can be exploited more fully. This will further reinforce fundamental principles of the strategy that the organization is built upon.

The divestiture of noncore assets, such as Encana's sale of Piceance basin properties, often provide capital for acquisitions in core regions, improve liquidity, and, sometimes, reduce a seller's average operating costs.[5] We have seen a large number of companies including ConocoPhillips, Devon Energy, and Marathon Oil employ this tactic, and we expect this portfolio high-grading will continue throughout the year. Such divestitures create opportunities for others, including financial sponsors.

2. **Do you expect private equity and financial sponsors to continue to play an active role in sector E&P activity?**

The private equity and financial sponsor universe has already participated in a significant number of transactions this year and that trend is likely to continue. These players pursue a wide variety of strategies. For example, financial sponsors may partner with an E&P company to accelerate the development of a core region such as what The Carlyle Group's mezzanine fund did with EOG Resources in Oklahoma.[6] An alternative is to fund an E&P company's consolidation of assets within one of the "mature" unconventional basins. An example of this is Blackstone Energy Partners and Sanchez Exploration partnering to purchase $3.2 billion in Eagle Ford assets, complementing Sanchez's existing position in the region.[7] Finally, sponsors may seek value by applying new operating practices and technology to conventional assets. The Carlyle Group and Hilcorp Energy are employing this approach in the San Juan basin.[8]

3. **In addition to portfolio optimization, what other actions are producers taking to secure economics in the current price environment?**

We see four additional levers as being critical to stabilizing and driving improvements in the current price environment. Each can be addressed independently in discrete initiatives, or as part of a more comprehensive review of an organization's operating model:

Capabilities
Building a differentiated capability that aligns elements of the portfolio with technical or functional competencies is one lever that has been particularly valuable as players have shifted their

[1] Source: *Rice Energy Investor Relations*, United States (June 19, 2017)
[2] Source: *SNL Financial*, United States (August 2, 2017)
[3] Source: *Forbes*, United States (May 1, 2017)
[4] Source: *Bloomberg BusinessWeek*, United States (August 24, 2017)
[5] Source: *World Oil*, United States (June 9, 2017)
[6] Source: *Oil and Gas Journal*, United States (May 23, 2017)
[7] Source: *Blackstone Investor Relations*, United States (January 12, 2017)
[8] Source: *Bloomberg*, United States (April 13, 2017)

portfolios. Occidental's recent choice to divest almost $600M of nonstrategic Permian acreage while acquiring $600M of assets in its Enhanced Oil Recovery (EOR) business unit represents this type of choice.[9] Operating and financial results from the EOR unit have been extremely competitive, and harnessing the carbon dioxide already produced during oil extraction will be lucrative and satisfy a key concern of environmentalists who are wary of potential impacts from CO2 release.

Cost base
Reevaluating the cost base and ensuring that widely used metrics take into account everything necessary to make the right types of decisions at both the executive and operational level is another key lever. This is well-understood by ConocoPhillips, which has recently undertaken an initiative to develop a "fully burdened cost of supply (everything including the kitchen sink)" to better understand its costs. This new view includes all direct and indirect costs, infrastructure, G&A, and inflation to get a clearer understanding of what is required to make money in an increasingly competitive industry with increasingly difficult portfolio questions.[10]

Technology
Though technology has long been understood as a driver of value, in many cases it is only now being integrated into day-to-day workflows in ways that are meaningful. For example, Rice Institute's Center for Energy studies reported on how Shell has instituted an "iShale" initiative, centered on new technology and ways of working to address environmental and operational opportunities in shale drilling, completions, and production. Shell's initiative seeks to set a standard (overcoming industry and service company fragmentation) for deploying state of the art technology (e.g., data and analytics, sensors, cloud computing) to the shale asset class as a whole.[11]

As another example, Chevron—spurred in part by attacks on critical automation infrastructure by the Stuxnet worm in 2012—has recently been trying to bring "emerging technologies into [daily] operations."[12] This simplifies basic (but time-consuming) work such as ensuring the correct time stamps on log data to automating preliminary interpretation work. The major outcome is that senior geologists and reservoir engineers can focus their attention on only the most critical analyses that impact the design and productivity of wells.

Organization and culture
Though one of the most difficult to capture and quantify, organizational issues still contribute a significant amount of value to any company. EOG—while recognized throughout the industry for impressive well results and significant innovation—owes much of its success to the fact that it has been able to propagate abstract values, such as accountability, using very tangible measures. This is encapsulated most within the use of return on capital as a significant determinant of executive pay.[13] EOG has also geared both its management processes and organization to reinforce this fundamental objective. Instituting such a clear linkage between financial incentives and strategy is not necessarily rare, but its implementation mirrors the lens through which many members of the investment and analyst community view E&P performance.

[9] Source: *Occidental Investor Relations*, United States (June 19, 2017)

[10] Source: *ConocoPhillips Investor Relations*, United States (May 9, 2017)

[11] Source: *Energy Dialogues*, United States (June 2017)

[12] Source: *ITNews*, United States (February 16, 2017)

[13] Source: *Oil & Gas 360*, United States (April 22, 2016)

Key considerations
Consistent with the lower-for-longer commodity price environment, we anticipate the industry will continue to adjust. Consolidation is one form of merger that can bring immediate synergies by establishing greater scale, multiplying the rewards of new technology investments, or leveraging existing operating or management advantages. Being successful in such transactions starts with absolute clarity of a company's ambition and business model. Knowing what capabilities and positions are needed to create competitive advantage lead to earning back premiums paid for assets or companies, with line of sight into what combinations of levers – capabilities, costs, technology, organization, and culture—will need to be pulled to create the most value.

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