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Mid-market oil & gas companies barreling along until demand picks up

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OIL PRODUCTION COULD REMAIN LOW AS PRICE CRATERS; MIDDLE-MARKET OIL & GAS COMPANIES FEEL THE PAIN AS COVID-19 CRISIS EVOLVES

In March, two of the largest oil producers in the world, Saudi Arabia and Russia, decided to essentially end their loose coordination of oil production. With the United Arab Emirates joining Saudi Arabia, this effective trade union disintegrated and set off a race for market share in the global oil markets, collapsing prices overnight. By this point the world economy had entered the stark reality of a decline in consumer and commercial energy demand, driven by the COVID-19 crisis. The timing for a return to economic growth remains uncertain. With an oil market awash in growing crude oil production from US shale, demand growth has reversed course to demand shrinkage, and it is uncertain when it will recover. However, as we will discuss later, the major oil-producing nations of the world (led by the US) are now cooperating to bring about a more orderly transition into this new world of lower — perhaps transient — demand.

On 9 March the IEA reported its first decline in demand since 2009, due to the coronavirus outbreak. The Russia-Saudi Arabia-driven supply glut caused prices to drop more than 20% virtually overnight. As demonstrated in the graph below, the world market is well-supplied due to three primary factors: (1) the trade battle between Russia and Saudi Arabia, (2) drastic declines in economic activity due to the COVID-19 pandemic and the social measures taken to slow the infection rate, and (3) seasonal (scheduled or unscheduled) refinery maintenance reducing demand from those that process crude oil into various fuels, such as motor gasoline, jet fuel and diesel.

"In these times of uncertainty in the oil & gas industry, we continuously analyze the supply/demand fundamentals, with consideration to the financial or speculative trends occurring within specific sub-markets. The main driver behind recent large sell-offs has been speculation on top of dislocations between oil & gas producers and oil & gas users. Distinguishing between the physical and the financial, we believe that there will be a faster recovery in the North American energy infrastructure landscape than other parts of the industry."

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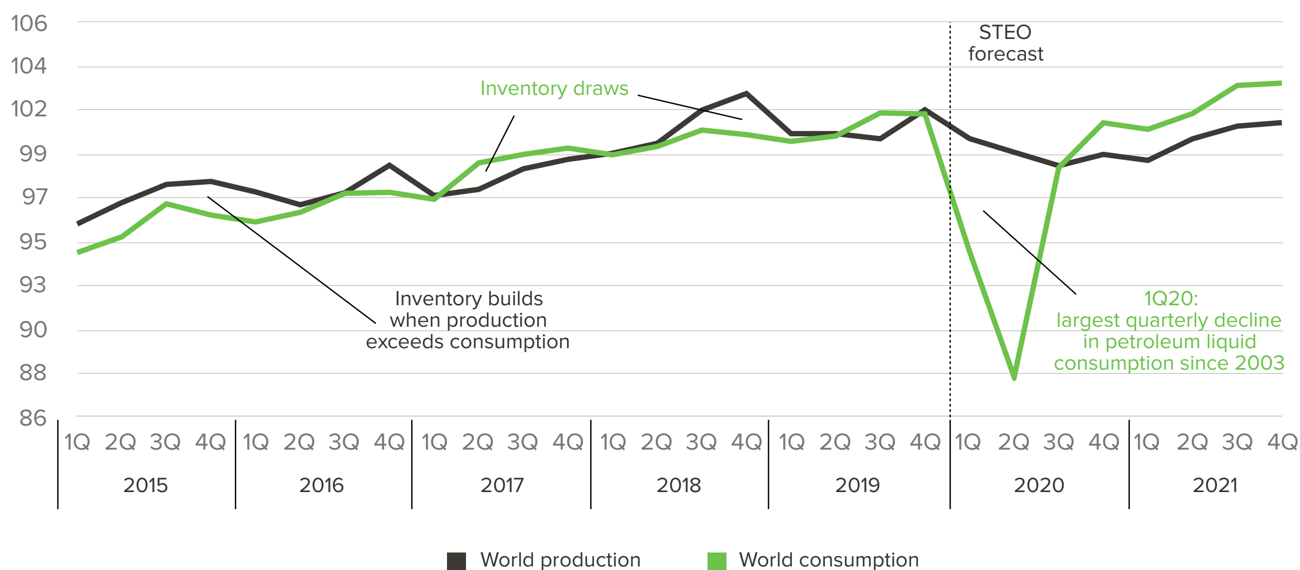
World liquid fuel production and consumption balance, 2015–2021 (million barrels per day)



Source: EIA Short-Term Energy Outlook, April 2020

Three events coinciding to dramatically move both supply and demand in the energy markets is unprecedented; a generational black-swan event, which may have impacts that will persist for decades.

THE PAIN AFFECTS ALL SUPPLIERS

The collapse in the global oil market has long-term implications for the prolific Permian Basin of West Texas and Eastern New Mexico — where shale fracking technology has created efficiencies that lowered extraction costs, and new oil discoveries pushed production to nearly five million barrels a day.

This current situation particularly affects the small-to-middle-market exploration and production companies operating in the Permian and other North American fields, which could feel the pain more acutely as they don't have the diversification of the majors to fall back on.

That said, European majors BP, Shell and Total are among companies with West Texas exposure who are slashing budgets by up to 45%. Analysts have hinted that Chevron and ExxonMobil will need to do the same, as commodity prices remain depressed. There's plenty of pain to go around. Mexico's PEMEX has seen its debt downgraded to junk by both Fitch and Moody's. In the US, Moody's has already downgraded the largest Permian Basin oil producer Occidental Petroleum's debt to junk. We believe more corporate debt downgrades are inevitable and that current borrowers will face a heavy-handed round of credit facility redeterminations by the banks.

DEMAND WILL RETURN, BUT WITH MUTED GROWTH

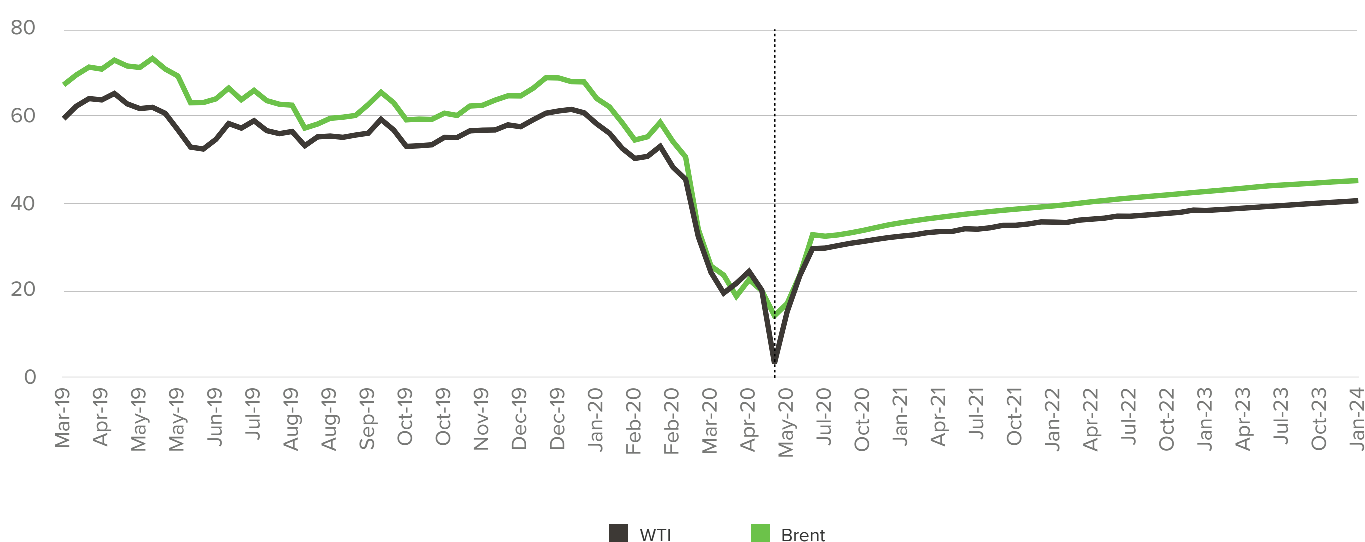
With most of the world's largest economies emerging from shutdown, the worst of the energy commodity price excursion is likely behind us. Governments around the world were quick to address the economic damage and mobilized to combat the virus and its economic impact. The US government has injected close to US$3 trillion in liquidity via multiple rounds of fiscal stimulus, and the Federal Reserve has expanded its balance sheet by an unprecedented amount. The G20 countries have committed to another US$2 trillion in targeted stimulus. It is too early to judge how quickly the global economy will rebound. The debate over health policy in the wake of the crisis, as we have observed elsewhere, remains unresolved until there is a consensus on the actions that nations and trading bloc partners will take to restore cross-border travel and normal economic activity.

Fitch said it expects the crude oil markets to be "massively oversupplied" in 2020 and forecasts a gradual rebalancing over the next two to three years. The impact on the US is particularly acute, with the loss of many oil & gas industry jobs.

There is supply-side mitigation in energy policies adopted in mid-April. The US, OPEC+ leaders and G20 energy ministers agreed immediate cuts of approximately 10 million barrels per day. Additional cuts in supply will almost certainly take place, primarily caused by rapid shale oil well declines and the drop in capital spending for replacement production. Many North American producers have announced heavy capital budget reductions for at least the remainder of 2020. In total, as much as 20% of the world's supply may be taken off the market. Announcements by producers are not always in line with outcomes, however, so the supply side of the crude oil market is impossible to predict with confidence. Even if the agreed/expected production cuts materialize, the world may still be oversupplied by as much as 10 million barrels per day.

For now, traders and strategic users of oil & petroleum are finding any way possible to purchase and store cheap oil for future use or trading gains — a scenario which the industry defines as a "contango" market. An interesting phenomenon occurred for a single trading day on 20 April, where the US oil benchmark West Texas Intermediate (WTI) cash contract waded deep into negative territory (close to negative US$40 per barrel). While momentary negative WTI pricing created big headlines, most traders and market participants viewed this as a market technicality, with expectations of reaching the upper limits of storage capacity. In fact, storage capacity, though tight, remains available. Since 20 April, prices have staged a bumpy recovery. Both Brent and WTI are trading in the US$30 per barrel range as of late May.

Historical and future crude oil prices (US$/Bbl)



Source: NYMEX and ICE pricing as of 15 May 2020

IMPACT ON M&A: MIDSTREAM OPPORTUNITIES

In the mergers and acquisitions (M&A) market, we expect capitalization efforts to be the main focus, while traditional M&A grinds to a halt amid valuation uncertainty. Distressed upstream operators may be forced into deals, which should lead to significant consolidation as creditors dictate restructuring plans and debt capacity. Companies needing capital may need to turn to alternative ways of raising cash, since the traditional capital markets have largely frozen up. The US Federal Reserve threw the proverbial kitchen sink full of monetary stimulus at the financial industry to keep the market liquid, but its impact, so far, seems muted.

At Oaklins, we continue to believe that the energy infrastructure space, in particular, has the ability to raise capital through asset divestitures.

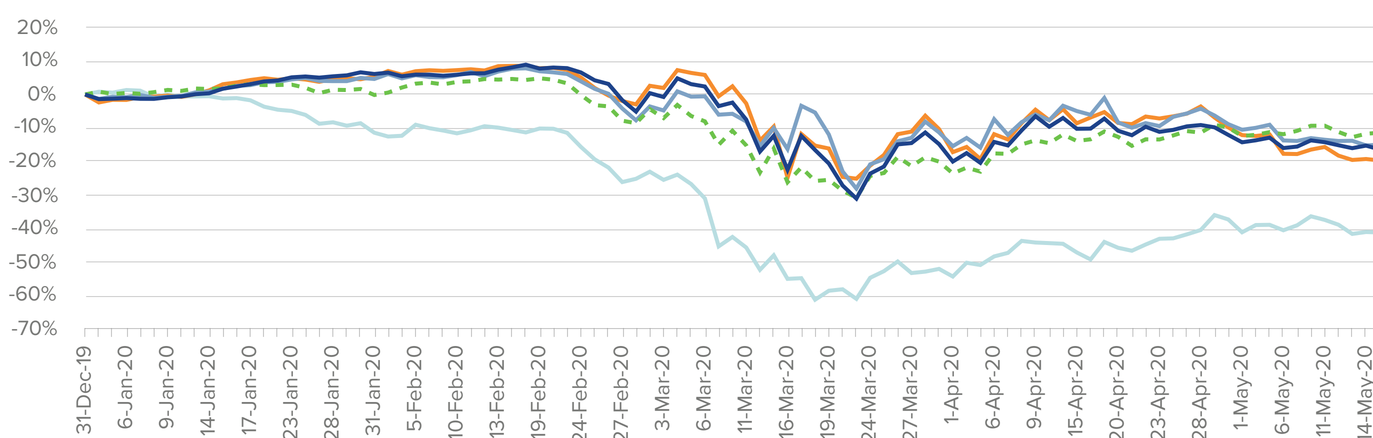
As midstream companies begin to rationalize their capital programs and streamline their operations, there will be a significant portion of their assets deemed non-core to their overall operations. While not as valuable to the current owner, these assets can be highly attractive to the right type of investor with a different capitalization profile. With the unique ability to aggregate multiple, unique sources of low-cost capital through its global reach in the relatively underserved middle markets, Oaklins is in touch with sources of capital that have an appetite for investments in energy infrastructure, particularly with attractive and stable cash yields.

So far, a recent S&P Global Market Intelligence analysis of the 42 largest midstream companies in North America has indicated only a modest drop-off in their capital expenditures in 2020 versus 2019, while their market capitalization has dropped significantly. We certainly anticipate more public announcements regarding reduced capital spending and restructuring plans in this group. Furthermore, most of these companies are thinly capitalized — their practice has been to distribute most of the free cash flow — and they are experiencing strain on their balance sheets. When the dust settles, they will look to explore all possibilities to improve their financial posture. In the meantime, the stronger companies are looking to preserve cash in order to maintain expected and relatively healthy dividends/distributions.

COUNTERCYCLICAL INDUSTRIAL THEMES

Like oil, other energy commodity prices, such as natural gas, are in for a long period of weak growth. Consider the massive natural gas utility industry. Natural gas utility equities are passing this market stress test — a sell-off was inevitable due to the broader market and overall energy industry shock. But the indexed share price graph below demonstrates a year to date (YTD) equity outperformance by the broader utilities index, as well as that of two natural gas utility pure-play companies. The energy companies further upstream — including the larger integrated oil companies (i.e., Exxon, Chevron, BP, Shell, Oxy, etc.) — have done far worse during the crisis.

Utility share price performance versus S&P 500



	YTD price performance (as of 15 May 2020)	Alpha (versus S&P 500)
S&P 500	(11.4%)	-
Dow Jones Oil & Gas Index	(41.1%)	(29.7%)
Dow Jones US Utilities Index	(16.4%)	(5.0%)
Atmos Energy Corporation	(15.0%)	(3.6%)
NiSource	(19.7%)	(8.3%)

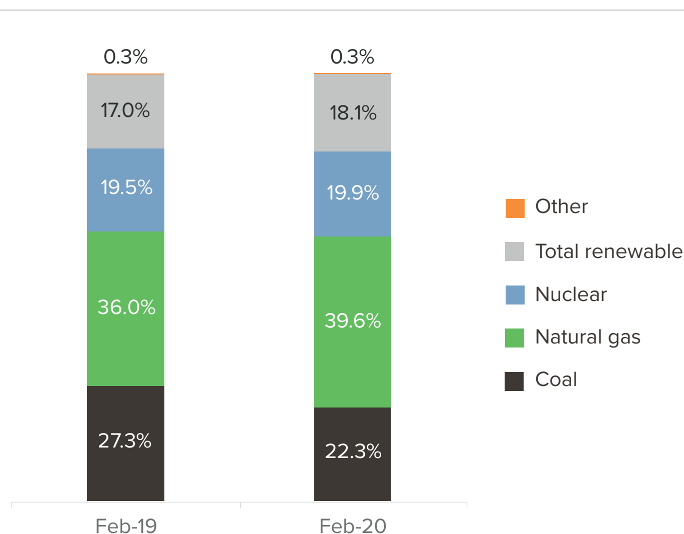
Source: Capital IQ

Utilities are considered defensive, value investments, due to the regulated and stable nature of their cash flows. Furthermore, the lower price of the underlying commodity that utilities deliver to customers may spur incremental volume demand from various types of users, increasing tariff- or fee-based revenue to these companies.

A similar situation prevails in Europe, even as a much more aggressive embrace of renewables, including an ambitious offshore wind development program, has unfolded over the last decade. Social and political pressure continues for renewables to increase their contribution to the global generation fuel mix, but natural gas remains the primary benefactor of the generational shift away from coal.

Natural gas utilities, and the transportation and processing asset base that they control, are a vital part of the global energy economy, and we believe that the value they represent is overlooked.

US generation fuel mix (%)



Source: US Energy Information Administration

CONCLUSION

We believe that fundamentals, the most important of which is global energy demand, will reassert themselves and create a navigable market landscape sooner than most expect. The speed with which demand was crushed is unprecedented, as is the fact that the overnight removal of demand from the market was completely artificial.

The speed and depth of recovery is extremely difficult to predict, considering the impact of government mitigation on an enormous scale. Here are some questions that we are looking to have answered in coming weeks, and which should provide clear indications of how energy markets will develop into 2021:

1. Will the build-up in natural gas takeaway capacity from US shale plays continue, or are transportation and terminaling CAPEX, including liquefied natural gas (LNG) infrastructure, winding down?

2. How sustained is the current bumpy recovery in WTI and Brent prices?

3. What are the implications of early distressed deal announcements?

4. How sticky are the production curtailment agreements announced in April, and what is the trend in global supply and demand?

Oaklins' Energy Infrastructure Team bankers and analysts welcome opportunities to exchange our thoughts on the unfolding recovery with operators and investors. Our global team has advisory and deal completion experience that informs our point of view, and we look forward to sharing our observations and insights as the energy industry faces the challenges ahead.

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OAKLINS OFFERS A COMPREHENSIVE RANGE OF SERVICES

- M&A advisory (buy- and sell-side)
- Growth equity and equity capital markets advisory
- Debt advisory
- Corporate finance services

Energy infrastructure is one of our focus areas. Combining comprehensive sector knowledge with global execution has led Oaklins to become the most experienced M&A advisor in the energy infrastructure sector, with a large contact network of the most relevant market players worldwide. This results in the best possible merger, acquisition and divestment opportunities for energy infrastructure companies.

If mergers, acquisitions or divestitures of businesses or business units are part of your strategy, we would welcome the opportunity to exchange ideas with you.

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Neal leads Oaklins' energy infrastructure team. He is also managing director at Capital Alliance, Oaklins' member firm in Dallas. He has advised multiple clients across the industry and has successfully participated in transactions involving the spin-out of Spectra Energy from Duke Energy, TC Energy (f.k.a. TransCanada) for the acquisition of a large natural gas pipeline asset, multiple acquisition targets and corporate initiatives for Plains All American, and equity capital markets for multiple midstream-focused companies.

Oaklins is the world's most experienced mid-market M&A advisor, with over 850 professionals globally and dedicated industry teams in more than 45 countries. We have closed 1,700 transactions in the past five years.

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