Expert Insights—M&A Transactions in the Oil and Gas Industry

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We asked Bobby Majumder, a partner in Perkins Coie's Corporate practice resident in the Dallas office, to discuss M&A deal making trends in the oil and gas industry.

What Does the Current Market Look Like in Your Industry?

The domestic oil and gas industry continues to face headwinds. Oil and gas acquisitions in the United States increased moderately in the first half of 2016, though not to the extent expected after a historically challenging 2015. However, the third quarter of 2016 exhibited strong growth in the number of oil and gas acquisitions buoyed by numerous upstream deals in the Permian basin according to a report from industry advisory firm PLS Inc. From 2009 to 2014, deal making centered on stable oil prices between $70–$80 a barrel. In 2015, oil prices fluctuated wildly, leading to uncertainty in deal making. However, oil prices have stabilized, ranging between $42 and $52 a barrel since June 2016, and that stability has led to a moderate increase in oil and gas acquisitions and dispositions. Price stability allows both buyer and seller increased confidence that a deal is not heavily favorable to the counterparty and further suggests a maturation of the cost-cutting measures taken by domestic shale producers. The more stable economics allow typical sellers—generally distressed sellers that are considering selling assets to de-lever their balance sheets—and typical buyers—generally strategic buyers and financial sponsors making bets that the market has reached a level of stability with respect to oil and gas prices—to have comfort that their decisions are not going to be second guessed because of massive fluctuations in price. Notably, while the number of deals increased from 2015, the total value of the deals is substantially lower reflecting fewer blockbuster transactions, which suggests a more measured approach to acquisitions and dispositions. Though it is unclear precisely why deal making has not rebounded as expected, it is likely that instability in the current geopolitical and macroeconomic landscape has counteracted stable oil prices to some degree.

Propelling deal making is the reality that producers remain fearful of decreasing borrowing bases. The oil and gas industry is capital centric, and without proper access to capital, oil and gas companies cannot survive. According to a report compiled by Reuters, in the first quarter of 2016, banks decreased borrowing bases of 12 major oil and gas companies by a combined $3.5 billion because of market uncertainty and decreased valuation of the oil remaining in the ground. The decrease equaled one-fifth of total credit available to those companies. The threat of a decreased borrowing base is often a motivating factor for strategic dispositions.

Low oil prices force creative capital raising methods on oil and gas companies. With the public debt markets substantially closed to oil and gas companies and banks declining to lend to oil and gas companies as a result of underlying uncertainty, producers are seeking alternative capital providers. These alternative providers include private equity funds and mezzanine funds, though these funding sources often come with heavy strings attached, and many private equity funds with substantial available cash are instead content to withhold capital and poach prized assets out of bankruptcy.

Are There Any Prevailing Trends That You Are Seeing?

The oil and gas industry comprises four main sectors:

- Upstream: companies that explore for and produce the oil and gas
- Oil field services: companies that provide services to the exploration and production industry
- Midstream: companies that transport and store oil and gas
- Downstream: companies that refine, process, and distribute oil and gas

Because of the different role each sector plays in the production and distribution of oil and gas, each sector experiences different effects from fluctuations in oil and gas prices. Accordingly, trends in M&A activity are best examined at the sector level.

Upstream Trends

In the upstream sector, deal activity is increasing in low-cost-of-production basins. The Permian basin and Marcellus natural gas basin each have a breakeven point per barrel that is approximately $20 per barrel below that of higher cost-of-production locations. According to the PLS report, as of November 2016, upstream deals in the Permian basin have totaled $23 billion, more than three times the value of deals in the next most active basin. The geology of the Permian basin and the high number of vertical wells lead to lower production costs. Additionally, most of the deal value is derived from the sale of undeveloped acreage—a product of producers being more willing to explore in low-cost basins than acquire producing wells in higher cost basins. The Marcellus natural gas basin resembles the Permian basin in its low production costs. Seven deals in the first half of 2016 have revolved around the Marcellus basin. Buyers possess more confidence when acquiring companies operating in low-cost basins because of the decreased exposure to oil and gas price fluctuations. Conversely, dry gas production basins such as the Bakken or Niobrara have seen fewer acquisitions because of the higher costs of production, combining for only nine significant transactions in 2016. Buyers are content to let operators in high-cost areas enter bankruptcy in order to secure a more attractive deal.

Over 70 producers have entered bankruptcy proceedings in the first half of 2016, according to Deloitte's mid-year oil and gas report. Strategic buyers attempt to take advantage of Section 363 of the U.S. Bankruptcy Code to purchase distressed assets. In most scenarios, Section 363 allows buyers to purchase the debtor's assets without any lien or creditor attaching to the assets. Buyers using Section 363 also forgo several risks of distressed M&A transactions. These risks include fraudulent transfer risk, the distressed seller entering bankruptcy before closing, and a court voiding pre-bankruptcy transfers to the purchaser. Though sales through Section 363 transactions have been relatively rare thus far in 2016—accounting for only four deals to date—the threat of a Section 363 sale has given debtors leverage with their lenders to secure restructuring of their debt load. However, since that leverage is largely a function of a risk analysis based on stable oil prices, the number of Section 363 sales could increase if oil prices destabilize.

Oil Field Services Trends

In the oil field services sector, cost efficiencies are the first priority. Low energy prices affect the oil field services sector more heavily than other sectors because producer cutbacks negatively affect the demand for equipment, services, and personnel. Yet, only four oil field services companies have entered bankruptcy in the first half of 2016. This is because many oil field services companies have developed creative cost-cutting methods in order to stave off bankruptcy proceedings. One emerging method focuses on a company with existing technology merging with a services company. Most service companies do not produce the hardware necessary for operation, and instead must purchase such hardware from others. The combined entity resulting from the merger of a services company with a company with the hardware technology can operate without entering the hardware marketplace because the surviving entity can produce the hardware. The merger, in essence, removes a previously required step, thereby creating greater efficiencies and lower costs. Services companies completed only 18 deals in the first half of 2016, yet over 20% of the deals involved a technology company merging with a service company, according to Deloitte's mid-year oil and gas report.

The Technip/FMC merger exemplifies this strategy of merging of technology and services to form a vertically integrated company. Technip, Europe's largest services provider, could not operate without the subsea equipment and technology FMC provides. The merger allowed the surviving services company to obtain the necessary operating technology without entering the marketplace. Additionally, the surviving entity can develop new, more efficient technology specifically for itself. The Technip/FMC merger resulted in the largest deal by value in the oil field services sector in the first two quarters of 2016.

Fewer antitrust regulatory difficulties exist in a technology/service merger relative to a service/service merger. A service/service merger may require significant divestitures to appease regulators fearing decreased competition in the market. For example, Baker Hughes and Halliburton abandoned their proposed service/service merger after facing significant regulatory challenges, including an antitrust lawsuit filed by the U.S. Justice Department. A technology/service merger would not culminate in similar fears from regulators, nor would significant divestitures be necessary.

Midstream Trends

Three years of low oil prices have caused decreased deal activity in the midstream sector. Long-term, fixed-price contracts are common in the midstream sector. Fixed-price contracts protect midstream revenue. Industry analysts thought the fixed-price contract structure would protect the midstream sector for a significant amount of time. However, the first half of 2016 has shown that even deal activity in the midstream sector is susceptible to a prolonged downturn in oil prices. Midstream companies completed only 22 deals in the first half of 2016—the second-lowest pace for deal activity in the last five years. Also, the total number of deals in the first half of 2016 decreased almost 30% compared to the first half of 2015 according to Deloitte's mid-year oil and gas report.

Master limited partnership (MLP)-backed deals are slowing down in the midstream sector. Historically, midstream contracts guaranteed revenues for the MLP buyer. However, a recent U.S. Bankruptcy Court decision in the Sabine Oil & Gas Corporation bankruptcy cast uncertainty on guaranteed revenues. The court in Sabine Oil allowed Sabine Oil to reject four midstream contracts because the contracts were not in the best interest of Sabine's bankruptcy estate. See In re Sabine Oil & Gas Corp., 547 B.R. 66 (Bankr. S.D.N.Y. 2016). With guaranteed revenue from midstream contracts in doubt, MLP buyers will be hesitant to purchase midstream assets.

Downstream Trends

The downstream sector has seen fewer deals in the first half of 2016 compared to previous years. Because the downstream energy sector is more insulated from the effect of lower oil prices, a majority of deals in the downstream sector center around growth rather than cost cutting, with downstream market participants seeking to opportunistically grow market share through acquisitions. Notably, deals in the first half of 2016 did not involve refinery companies. Low oil prices spurred refining companies to ratchet up the amount of fuel they produced. The refiners increased production to an extent greater than the global marketplace demanded, therefore many refiners possess borderline full inventory. Full inventories initiate reduced margins if oil prices begin to recover, therefore many buyers bullish on oil prices are neglecting refining companies. Instead, deals centered on logistics and distribution assets.

What Are the Most Common Deal Structuring Issues That You Encounter?

Deal structuring issues tend to turn upon two factors: first, the involvement, if any, the sellers will have in the ongoing assets or enterprise; and second, the tax ramifications of the deal in question. In terms of post-transaction involvement, management of the selling entity will seek to retain some form of upside. A royalty spin-off and earn-outs are two attractive methods sellers use to protect upside.

What Are the Due Diligence Topics and Transactional Issues Specific to an Energy Industry Acquisition / Merger?

First and foremost is cost of production. A low oil price environment demands an accurate cost of production picture. Due diligence must therefore be precise and complete. Engaging reputable industry consultants who are independent and not incentivized to close helps dealmakers gain a more accurate rendering of the cost of production. Additionally, due diligence concerning title issues, environmental liabilities, third-party processing and transportation agreements, and storage facilities continue to be necessary when conducting oil and gas due diligence.

Is There a Particular Aspect of This Industry's M&A Activity That a Typical M&A Practitioner Would Be Unaware of or Would Be Surprised to Learn?

Many practitioners would be unaware of the need to get approval from the Bureau of Land Management (BLM) (a part of the U.S. Department of the Interior) for transactions involving production or leases on Native American reservations. The BLM is an inherently convoluted and cumbersome area of regulation, therefore the help of a BLM specialist is important when constructing deals that require BLM approval. For instance, the Dakota Access Pipeline—currently in the news due to Native American protests—had to receive permission from the BLM in order to develop the pipeline.

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