Oil and Gas Investor

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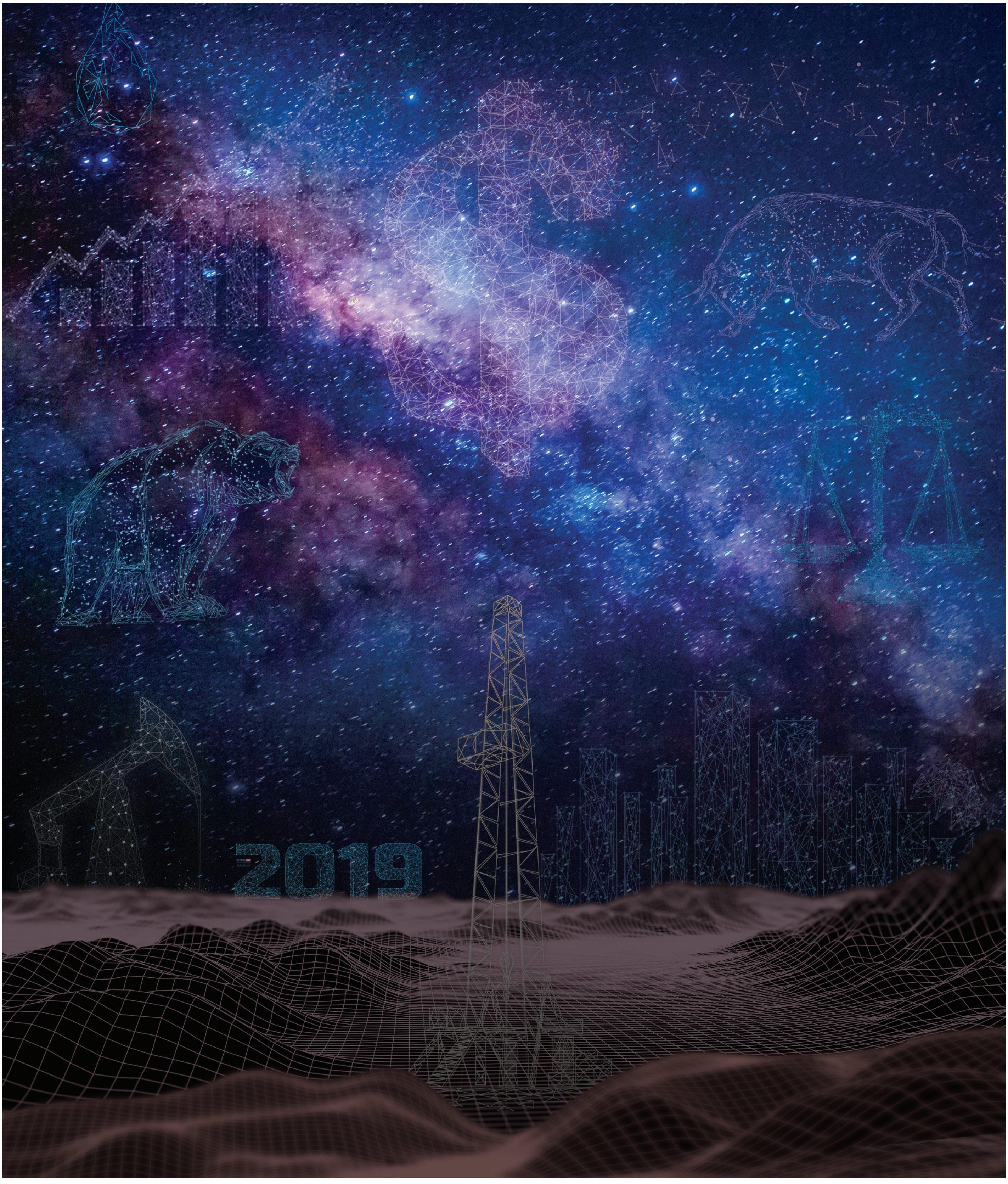

Looking to the stars for the 2019 outlook.

HARTENERGY

STAVING OFF SHAREHOLDER ACTIVISTS

If an activist investor comes calling to urge big changes, here's how to handle the situation.

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Activist investing is surging across almost every industry, and the energy sector has been no exception, especially since the 2014 downturn. In fact, at press time, activist Fir Tree Capital, a major shareholder in Halcón Resources Corp., sent an open letter to the company, urging it to improve returns by exploring various strategies, including a sale.

The steep drop in oil prices that started in late 2014 created a unique confluence of factors that brought with it an uptick in activist interest in the oil and gas industry. As companies saw their cash flow and valuations in free fall, investors quickly adjusted their strategies to seize new opportunities opening at all levels of the capital stack.

During the past three years, $80 billion of company debt has been swapped for equity, and half of the past 100 bankruptcies have been resolved by debt equitization. The ultimate outcome of those investments has varied, but in 2018 many investors are still searching for a path to a successful exit. In an increasing number of situations, activist investors or activist-like strategies are emerging to create that path.

In 2017, the market saw $11.6 billion deployed in activist campaigns in power and energy. Much of this activism was focused in the U.S. due to its transparent and liquid market for distressed securities. Not surprisingly, Texas and Oklahoma are where most target companies are located, but E&Ps focused in the Bakken, Appalachian and Rockies plays have not escaped attention.

Within the broader energy industry, E&P companies have seen the most activist interest with 13 campaigns in 2017, compared with four in the oilfield service sector and three in the midstream.

Motivations for activism vary. Relative valuations have created enticing circumstances for activists, and if investors think a given company is undervalued, there is a greater impetus to create value beyond what they perceive company management is positioned to achieve. This article includes a useful series of strategies and questions that can help oil and gas companies find the right footing in this new activist environment.

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Why activists push

Looking critically at how activist situations typically arise and how they have impacted the oil business during the past several years, one can identify seven stated motives for an activist: business strategy, board change, governance, M&A, capital return or structure, operational change and management change.

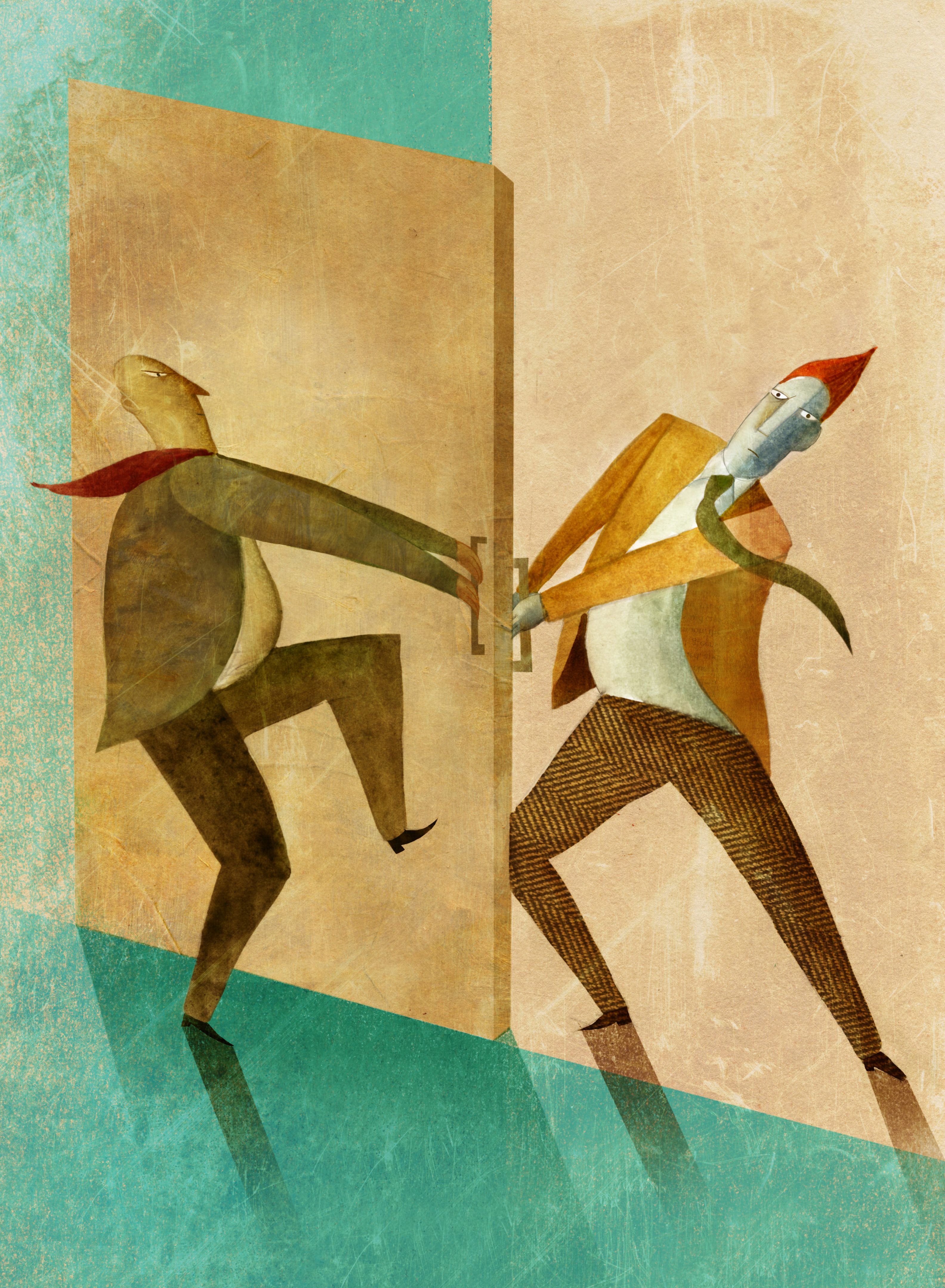
Out of 20 known energy activist campaigns in 2017, the E&P sector saw the most activity, with M&A and business strategy being the most frequently stated motives. This is a bit misleading, however, because even if an activist campaign starts for a different reason, board or management change is often the result.

Activists may see value—or a different approach to generating value—in areas company leadership is not targeting.

Following a company strategy and serving investor interests can be a delicate balance. Even when management has a credible, clear strategic plan and a timeline that is supported by the board, activists often grow impatient. A simple difference of opinion on the outlook for oil prices could drive a deep disagreement on core pieces of a strategic plan, such as proposed drilling locations, formations targeted and the overall timing and pace of a drilling plan.

In general, energy-focused activists are pushing to increase shareholder value through various monetization strategies. This might mean a request for asset rationalization as opposed to a sale of the entire company or wholesale changes in management. Greater cash flows and different allocation strategies may even have the effect of encouraging further activism. The trends are manageable if a company is well-positioned to confront them.

It's virtually axiomatic in business that every company should have a firm grasp of its strategy and a well-formed view of its own value-drivers. Management should understand what the company is, what it isn't, what it does and does not do well. Executives should be able to communicate these things clearly and consistently to each other, to investors and the public, and as often as necessary, they need to be willing to pull the car over and make sure the roadmap matches the view from the windshield.



Following a company strategy and serving investor interests can be a delicate balance.

In other words, businesses should be proactively planning, measuring results, communicating and gauging stakeholder perception.

Once activist pressure becomes public, the unfolding situation for companies is often painful. Both a realistic self-assessment and an outside-in point of view are good exercises to pursue. They not only help companies gauge the risk of attracting activist investors, but they can also strengthen the business even if the possibility of activism seems remote.

What inspires an activist to get involved? Although motives, timing and strategies vary, it's presumably with the underlying desire to drive change and unlock trapped value that an activist approaches a company. Firms with a history of underperformance can certainly attract attention, but an activist campaign might also follow the announcement of a failed M&A transaction, as turmoil can ensue when a deal falls through on the public stage.

Sudden or even sustained degradations of stock price can also prompt an activist to initiate or increase their holdings. These are just a few scenarios, but a common theme is that the activist pushes for change, and the company is forced to respond.

C-suite responses

Leaders should ask themselves, how does company performance, recent or historical, appear to external audiences? Are there opportunities to correct or clarify situations that may be catalysts for activism?

Although a company's executive management might think its strategy and actions are in perfect harmony, the leadership should still ask, are there structural or other changes the company should consider to increase shareholder value? For example, how does the company determine core vs. noncore assets? Setting realistic and challenging economic thresholds to establish a stronger core footprint is key to sustained success.

Many companies today find it a healthy exercise and a favorable signal to the market to streamline operations to a more core asset base that can optimize efficiency and capture greater synergies, even if that means shedding assets that were once viewed as core.

Motivations for activist investors vary, but most of their demands lead to corporate changes.

The strategic plan should also be dynamic and backed by a realistic and robust process to compare performance to the plan, updating or adding internal and external drivers and testing thresholds and metrics against constantly changing industry and global market conditions. The plan should not pivot on every daily movement in oil prices, but adjustments ranging from minor course corrections to major strategic shifts should always be part of the conversation. Companies often engage independent advisors to help leadership scope, clarify, refine and implement their strategic vision.

It is never too late to start asking, does the company have a clear, actionable strategy? Is it demonstrating value to investors, shareholders and the interested public?

Delivering a healthy return

The most effective way to stave off shareholder unrest is to deliver a healthy return on equity. Oil and gas management teams can achieve this by optimizing a few key areas of operation. First, companies should define and execute a focused operating strategy, which may require exiting noncore assets and regions.

Second, selling, general and administrative (SG&A) costs should be adequately scaled to fit the organization's asset base and operating strategy. Within SG&A, opportunities may reside in corporate headcount, information technology, facilities or real estate.

Additionally, a company must understand and drive toward top-quartile lease operating expenses and production and equipment uptime performance in each area. Management should ask, is there room for performance improvement across any of the firm's functions or assets?

Can capital allocation be more disciplined, and can the selection of capital projects be based on proven returns? Can service provider and supplier agreements be more competitive? By asking these questions and taking action, leadership may be able to streamline operations, optimize costs and improve returns.

Management and the board of directors often become aware of activist intentions at the same time, and activist pressure often focuses on changing that management or board. Activists may initially express their views in private conversations with board members or management, and pressure further escalates when there isn't an open channel of communication between leadership and the board to share activist concerns.

Internal alignment is the first step toward handling activist pressure with strength and competence. Close, frequent conversations about shareholder interests are essential. Leaders need to ask, in terms of company strategy, what areas of alignment could be improved between management and the board?

Stated Motivations For Activist Campaigns In 2017

Oil & Gas Industry Subsector	Business Strategy	Board Change	Governance	M&A	Capital Return/ Structure	Operational	Management Change
Drilling		1		1			
Equipment and Services	1	1				1	
Exploration and Production	6	5	1	8	2	4	2
Storage and Transportation	1				1	1	
Industry Total	8	7	1	9	3	6	2

Source: Alvarez & Marsal LLC

Proactive communication

Once an E&P or service company has a strong strategy and its board and leadership are fully aligned, they must implement a communications plan to inform shareholders, investors and the media. The impact of a strong business strategy can still be weak or negligible if shareholders aren't apprised. Leaders should ask, does the company have a clear communications plan and an appointed spokesperson to manage engagement with all key audience groups?

An effective plan is not a one-way street. Should an activist investor come knocking, acknowledging and addressing, rather than ignoring or deflecting, the activist's concerns is critical to getting ahead of the situation.

The management team doesn't have to agree with the points an activist makes publicly, but it is important to address those concerns through effective communications and, if appropriate, model proposed changes through the strategic plan.

Being open to suggestions and opportunities in the market defines the proactive stance. It's important for investors, media members and others following the firm to understand and respect a company's stance in the market, and there must be an effective communications practice in place for this to happen.

There is no doubt the oil and gas industry has weathered a rough storm the last few years. Although the oil price has increased since the 2014 slump, some companies have not seen their stock prices rebound as quickly, leaving them vulnerable to shareholder activism.

Companies can get ahead of this pressure by being proactive, making sure to update, refine and strengthen their strategic plans, develop robust analytics and prepare for anything that comes.

It's important to know their significant shareholders and whether they support the current corporate leadership and strategy. In addition, they should have a well-rounded, proactive strategy that promotes open lines of communication with the entire investor community. It's always better to ask and answer hard questions privately—before they are raised publicly. □

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Most of the E&P targets shown here have made changes in response to activist demands. Penn Virginia Corp. and SandRidge Energy Corp. were targeted by more than one investor group.

Oil And Gas Companies Targeted By Activists

Campaign Announce Date	Company	Mkt Cap	Activist	Business Strategy	Board Change	Governance	M&A	Capital Return/ Structure	Operational	Management Change
12/18/2017	Penn Virginia Corp.	$527	Contrarian Capital Mgmt.	X	X	X			X	X
12/14/2017	Hess Corp.	$13,559	Elliott Mgmt.				X	X		X
11/22/2017	SandRidge Energy	$595	Icahn Associates				X			
11/20/2017	SandRidge Energy	$593	Fir Tree				X			
11/20/2017	Obsidian Energy	$628	FrontFour Capital	X	X					
11/14/2017	Midstates Petroleum	$436	Avenue Capital	X			X	X		
9/29/2017	Ocean Rig UDW	$2,155	BlueMountain Capital/ Elliott Mgmt./Avenue Capital		X					
9/18/2017	Ultra Petroleum	$1,752	Fir Tree						X	
9/14/2017	EQT Corp.	$10,949	D.E. Shaw		X		X		X	
9/13/2017	Penn Virginia Corp.	$ 585	Strategic Value Partners		X					
9/6/2017	Matrix Service Co.	$323	Engine Capital Mgmt.		X					
9/1/2017	Penn Virginia Corp.	$ 577	Mangrove Partners		X					
8/3/2017	Ensco plc	$2,313	Arrowgrass Capital Partners				X			
7/3/2017	EQT Corp.	$10,396	JANA Partners/Chapter IV	X			X		X	
7/3/2017	Basic Energy Services	$647	Silver Point Capital	X					X	
5/30/2017	Energen Corp.	$5,412	Corvex Mgmt.	X			X			
5/22/2017	Cheniere Energy Partners	$6,153	Zimmer Partners					X	X	
2/9/2017	Columbia Pipeline Partners	$1,726	Whetstone Capital Advisors	X						
1/4/2017	Columbia Pipeline Partners	$1,721	GAMCO Asset Mgmt.							
1/3/2017	EQT Corp.	$11,298	Chapter IV Investors	X			X			

Source: Lazard and Alvarez & Marsal LLC