EUROPEAN OIL AND GAS MARKET UPDATE

July 2015

ALVAREZ & MARSAL

OIL PRICE

Three factors have over-shadowed the oil and gas market over the past month:

- The U.S. dollar at one point strengthened versus the Euro by over 5% in reaction to the debt negotiations between European finance ministers and Greece. Furthermore, the Federal Reserve Chairwoman Janet Yellen has signalled a likely rise in U.S. interest rates later in the year, further supporting dollar strength. A stronger U.S. currency tends to cause a downward pressure on dollar denominated crude oil.
- The potential implications if Iran raised its oil exports due to the mid-July nuclear deal. The market barely reacted in June when Iran's Oil Minister Bijan Zanganeh warned that his country had the ability to quickly raise exports by 1 mmbd. The pricing appears set, remaining virtually unchanged since just before the news was announced. Meanwhile, Algeria's Oil Minister Salah Khabri indicated that he may call for an emergency OPEC meeting to discuss how to react to Iran's return.
- The recent collapse in Chinese equities has further spooked the market. The Chinese economy is seen as the engine for global oil demand and any risk to its GDP growth tends to weigh heavily upon price.

Brent has broken out of its recent stable trading range of $60-65/bbl and dropped by over 16% in the past month.

US Rig counts rose (+19) in the past week. As a further positive sign for producers, the Energy Information Administration reported crude stocks had fallen by 4.3 mmbls by 10 July, with demand from U.S. refiners for gasoline seen as the main driver. A note of caution was expressed by Don Morton at HJ Sims "We can't continue to put 2.5 mmbbls of distillate away week after week".

A&M VIEW

"Stretching to believe no impact of Iran"

The International Energy Agency (IEA) and Organization of the Petroleum Exporting Countries (OPEC) appear aligned in the prediction that 2016 oil demand will grow to around 1.2-1.3 mmbd, similar to 2015 (1.3-1.4 mmbd). This growth is likely to be impacted by Iranian exports expected rise of 500-1000 mbd. However this may not hit until early-mid 2016, due to the need for Iran to show compliance with deal conditions. Also impacting growth is the fact that the market is already suffering from significant oversupply. Commentators have indicated a supply/demand imbalance of over 2 mmbbld. It therefore feels a stretch to believe that more Iranian oil can have no impact upon price.

Turning this around, for the incremental oil supply to have no impact, we have to consider the following to be possible:

- Rumours of up to 20 mmbbls of Iranian crude offshore oil are over-stated and what supplies they have will not be released quickly
- Iran brings back production slowly due to the effect on fields during sanctions
- Despite the recent window of opportunity to hedge forward production at higher price levels, U.S. producers will cease raising production in 2016
- Key OPEC players such as Iraq, do not try to counter act their loss in revenues caused by any fall in price by increasing output
- Russian production drops from the current 10.5 mbd
- Crucially, we have to believe that, assuming OPEC does not change its current stance, Iran will regulate its ramp-up in order to control price. However, this feels like a stretched assumption.

All Hail Shale?

It could be argued that in 2015 U.S. shale producers have provided an object lesson in reacting to market forces. They have confounded the doomsayers, adapted to recent price declines and largely retained the confidence of investors (albeit with some notable exceptions). In an industry that has often historically had more of a focus on engineering excellence and less on financial implications; the change required becomes even more notable.

So how has this achieved? We are sure that Business School case studies will be written on this subject for years to come, but key elements have included a laser-focused cost reduction drive supported by tight liquidity management, which has in turn facilitated external capital injections (US$10.6bn raised by US E&P in the first half of this year, albeit there are signs of such injections slowing).

The cost reductions achieved have been in the order of 20% to 25% over the past 6 months according to Sanford C. Bernstein consultants. Some of these reductions have been achieved by insisting on improved pricing down the supply chain, and the balance coming from a focus on operational redesign, greater economies of scale, reduced complexity and tighter management. As price uncertainty continues, this relentless drive to reduce costs will continue to build supply-side options.

A&M VIEW

"Light, lean and flexible…"

The impressive cost reductions achieved by U.S. shale producers has been a particular point of focus and support for A&M. By being lean, light, flexible, and concentrating on wells where economies of scale can be leveraged, producers have stayed, whilst perhaps not one foot ahead of the game, at least very much in the game. These cost reduction lessons are being adopted throughout the rest of the industry, particularly in the conventional land drilling fleet which shares many similarities with the shale wells. A&M is working closely with clients in ensuring such lessons are learned, including how to achieve improved pricing down the supply chain (easy to talk about, but hard to achieve constructively and sustainably).

A wider focus on cost reduction will serve the industry well, both as volatility continues and, looking ahead, when perhaps the lessons of how to drive production costs down in shale-plays will become a key factor in future European shale production. A subject we will no doubt return to as political and macro-economic factors make European national energy independence an increasingly attractive target.

FPSO's – A tale of two futures

The FPSO (Floating Production Storage and Offloading vessels) market has been under pressure for some time now. Operating cost and oil company liquidity pressures saw a market slowdown even prior to the recent oil price drop, which has now brought additional challenges.

E&P spend reductions, delayed field development and the reassessment of production options have combined to drive down the current tendering level. However, the medium term prospects look more positive with the key FPSO lease companies seeming to have decent backlogs, whilst other offshore service offerings such as seismic and exploration drilling are facing greater short and medium term pressures. Nevertheless, the FPSO industry does need to continue driving cost base reductions as part of a defensive strategy against the current excess capacity leading to falling contract rates on future awards. As and when the oil price recovers, some of those contract rate pressures may subside but the lease companies need to bridge between the current realities and the future prospects.

A&M VIEW

"Helping bridge the gap"

Like any industry based on engineering processes and prowess; standardisation of approach, methodology and equipment can be prime contributors to effective cost management. Such standardisation can be challenging given the different oil field characteristics, hydrocarbon compositions and required treatments. However, it remains a key target for the leading operators given the benefits in cost minimisation throughout the operational cycle, including FEED (Front End Engineering Design) process, construction, mobilisation, production, maintenance and demobilisation. Economies of scale in offshore production have arguably become more elusive for the industry than they expected and A&M has been working with operators to drive improved visibility, capex and opex controls as part of a broader targeting of the unnecessary / excessive complexity that undermines the potential for achieving such economies. There are still plenty of lessons to learn and the industry is increasingly open to learning them.

M&A activity drops further in FY15

The decline in M&A activity in the oil and gas industry that started in the second half of FY14 has continued into the first half of FY15.

Both Europe and the U.S. show a year-on-year drop in deal volume of about 25%[1], while Canada remains the exception with deal numbers staying flat compared to the same period in FY14. The deal value in FY15 was up year-on-year due to the large acquisition of British Gas by Shell in April FY15. Corporates and strategic buyers account for over 90% of the M&A activity in 2015[1], which is a higher proportion than in previous years.

A&M VIEW

"Wave of M&A activity is coming"

The decline in crude prices is attracting a wave of new investments from financial investors and corporates. Generalist funds that never historically invested in energy now recognise the potential opportunity. Additionally, dedicated energy funds have raised billions and are hungry to invest. With record low interest rates and high stock prices, energy assets are one of the few sectors that could offer an attractive upside due to losses of sometimes more than 50% following the drop in commodity prices. However, price expectations and valuations are still high and imply oil prices of over $80 per barrel. Furthermore, companies are still able to obtain cheap financing which allows for further internal restructuring and cost cutting rather than selling assets in order to cope with continued revenue and margin pressure. Should oil prices remain at the current level for a prolonged period, inevitably the expectation gap between buyers and seller will narrow and the wave of new capital may lead to a surge of new M&A activity.

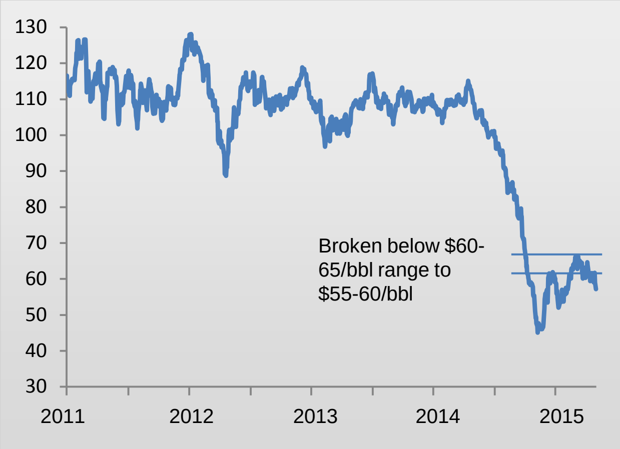
In the current oil and gas environment, many companies need the support of experienced professionals who can work alongside management to deliver solutions to complex problems.

Founded in 1983, Alvarez & Marsal is known for its distinctive restructuring heritage, hands-on approach and relentless focus on execution and results. A&M works with clients across the energy investment life-cycle in the following ways:

- Assisting companies pursue acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.
- Working with management to optimise cost and CapEx, analyse asset performance and portfolio prioritisation, identify divestiture opportunities, and improve the company's planning and financial control processes and systems.
- Support management, legal and financial advisors of distressed companies to stabilise operations and cash flow, thereby extending their "liquidity runway".
- Providing interim management positions as appropriate.

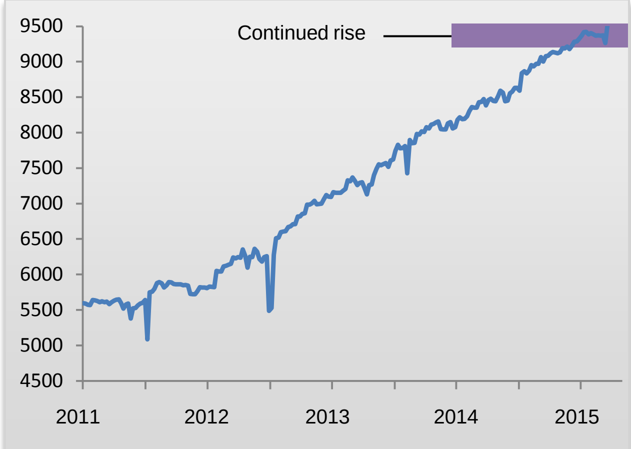
[1] A&M research, based on Mergermarket data

Brent Front Month Oil Price ($ / bbl)



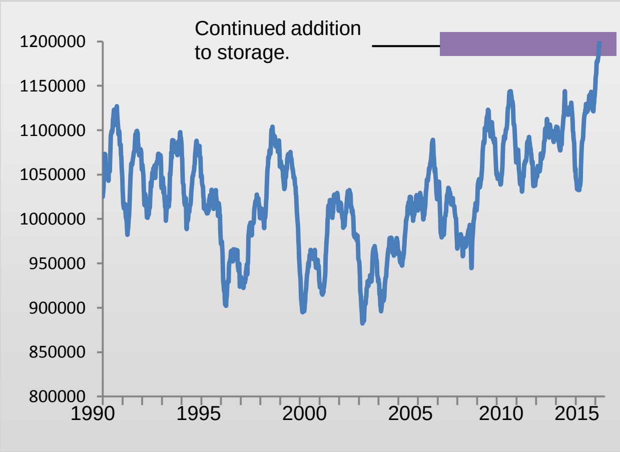
Source: EIA

U.S. Crude Oil Production (kbbl / month)



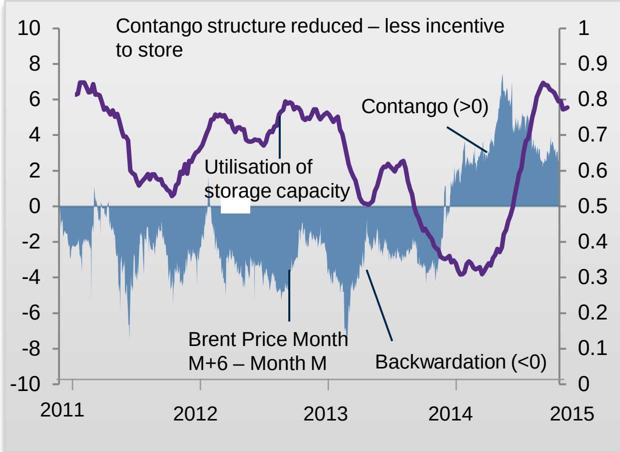
Source: EIA

U.S. Crude Oil Stocks (Exc SPR) (kbbl)



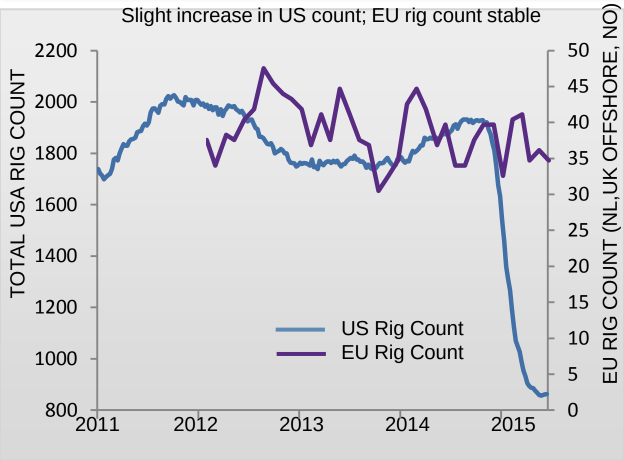
Source: EIA

Brent Month M+6 – M ($ / bbl) (LHS) and Cushing* Utilisation (%) (RHS)



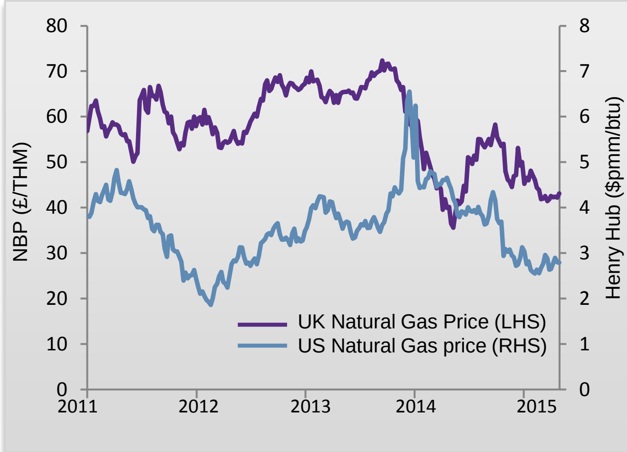
Source: Bloomberg, EIA

Rig Count



Source: Baker Hughes

UK Gas Price



Source: Quandi

* Cushing OK is a key independent crude oil storage location.
Current capacity around 71 mmbbls

CONTACT US

To discuss how A&M might provide assistance with Transaction Services, Operational Performance Improvement, Restructuring or Interim Management please contact any of the following:

UK Key Contacts

Colie Spink
Managing Director, Private Equity Services
+44 207 715 5221
sspink@alvarezandmarsal.com

Paul Kinrade
Managing Director, Restructuring
+44 207 663 0446
Pkinrade@alvarezandmarsal.com

Senthil Alagar
Managing Director, Restructuring
+44 207 663 0441
salagar@alvarezandmarsal.com

David Jones
Director, Private Equity Services and Energy Specialist
+44 207 663 0786
djones@alvarezandmarsal.com

Benelux Key Contact

Casper de Bruyn
Senior Director, Transaction Advisory Services
+31 20 76 71 130
cdebruyn@alvarezandmarsal.com

When action matters, find us at **http://www.alvarezandmarsal.com**

Follow us on:

ALVAREZ & MARSAL

www.alvarezandmarsal.com