EUROPEAN OIL AND GAS MARKET UPDATE

October 2015

ALVAREZ & MARSAL

OIL PRICE

Oil price has been bound in the range $40-50/bbl for the past month, with upward direction being taken predominantly from U.S. oil statistics. The impact of the precipitous fall in drilling appears to have finally halted the material rise in production. Output has fallen by over 4% from the June highs of 9.6 mbpd, to the mid-October figure of 9.2 mpbd. This has been compounded by the recent unexpected fall in oil product inventories.

Oil price has been kept in check by factors beyond the U.S. shoreline. OPEC's production continues to rise, reaching 31.54 mbpd in August. The International Energy Agency (IEA) recently warned that OPEC's output rate would continue to be robust throughout 2016, leading to continued rise in global inventories.

On the demand side, China's National Bureau of Statistics indicated that its September measure of Producer Price Index fell for the 43rd consecutive month, with a reduction of 5.9% - the biggest fall since the 2007-2009 financial crisis.

Perhaps ignoring or discounting these worrying demand signals, certain investors have viewed the supply side situation as a driver to take a more bullish view of the market. Net long positions on Brent futures, as reported by Dow Jones, rose by nearly 8% over a week in early October as investors anticipated a rise in oil price – the largest rise since July.

A&M VIEW

Ignore China and Iran at your peril

Contributing 10% to global oil demand and 37% to oil demand growth since 2000 (according to Dow Jones), the health of the Chinese economy is vital to the oil industry. Market participants have no doubt been experiencing a bout of trepidation in recent weeks; not only due to the continuing poor demand side statistics from China, but also due to the recent pressures upon Glencore. With large exposure to the Chinese market, Glencore are a bellwether to the state of the region. Oil industry participants therefore need to ask whether current oil prices adequately reflect the outlook for oil demand.

Having recently signed a nuclear deal with the U.S., Iran is now turning its attention to securing oil income. Minister of Petroleum, Bijan Zangeneh, reports that Iran's oil production will reach 4.2 mbpd by the end of 2016. Oil producers can take some comfort in the fact that Iran cannot ramp-up its oil exports until it has shown compliance with sanctions – expected early-mid 2016. However, commentators have suggested that exports could rise by over 1000 mbpd, swamping the recent 400 mbpd fall in supply from the U.S.

We continue to believe that the industry needs to prepare for a prolonged period of oil price stagnation, with price shocks along the way as markets react to demand factors such as China and supply factors such as Iran.

Hedging & Redetermination

Most oil companies (with the exception of the majors) tend to hedge future production to protect against price movements. Most have benefited from hedges executed in the heady days of mid-2014. These hedges have mostly closed-out. IHS and Fitch both recently commented that hedging for 2016 is far below recent levels. IHS estimate that only 11% of 2016 production is hedged compared to 28% in the first half of 2015. Producers are reticent to 'lock-in' current prices, perhaps in hope of better days.

The market is currently very susceptible to this trend given it is in the second round of its twice yearly redetermination exercise. In order to understand how much a producer can borrow, banks assess what they have hedged, the price level committed to and the extent of reserves and production.

The last redetermination earlier this year, was relatively lenient. Tudor Pickering Holt & Co. commented that banks are less likely to "kick the can" again this time. Bank price forecasts are likely to reflect the prolonged period of low price this year and, worryingly, the additional pressure from regulators upon reserve-based lenders.

A&M VIEW

Entry of the hedge funds

The likely outcome of the current redetermination is that several potentially large E&P companies may need to seek additional funds to shore up depleted balance sheets. Few options exist beyond raising new equity. One route could be to look to exchange at the debt level- previously unsecured investors exchanging debt to a senior level.

Watching on the side-lines have been hedge funds. With more limited distress in other industries, hedge funds have the oil market in their sights and may spot an entry point through the redetermination exercise. Whilst on the one hand being seen as a potential white knight when financing is in short supply, refinanced producers may in future be subject to pressures such as:

- Shareholder activism: Natural territory for hedge funds.
- Loan to own strategies: Hedge funds taking a view that there is a possibility of switching to ownership if company goes into distress i.e. 'loan to own' strategy.

OFS and Decommissioning

With the Baker Hughes Rig Count 59% lower than it was 12 months ago, it's of no surprise that Oil Field Services (OFS) companies are hurting. In October, Schlumberger reported quarterly earnings 33% below 12 months ago, Halliburton earnings similarly dropped 36% over the same time-period, and Baker-Hughes dropped into the red with a $159 million loss. If any explanation were required, Weatherford's CEO Bernard Duroc-Danner, commented that charges in North America for OFS had reduced by 30% and volume by 45% over the past 15 months; outside the U.S. the figures were about half of this.

Consolidation is seen as inevitable, as already evidenced by Schlumberger and Cameron. Halliburton may have to wait longer for its merger with Baker-Hughes. Regulatory reviews are likely to delay the deal until 2016.

Meanwhile, at the recent Offshore Europe Conference, Wood Mackenzie stated that decommissioning spend could increase by 50% by 2019, over-taking development spend.

A&M VIEW

North Sea positioned to lead

The proposed decommissioning of Dunlin and Janice are perhaps the first signals of what could be a re-invention of the North Sea industry and the OFS sector. With various industry commentators indicating a future spend of £30-60 billion, North Sea decommissioning is a large opportunity in an otherwise depressed market.

OFS firms can support in a number of critical areas:

1. Viewing late-life production and decommissioning as seamless rather than consecutive independent steps. Taking cognisance of how steps to prolong production impact decommissioning costs and vice-versa.
2. Habits of acting independently continue to plague the industry in areas such as supply chain. OFS firms can act as integrators or out-sourced supply chain providers to minimise overall industry costs.
3. Pipeline and terminal infrastructure will increasingly fall into independent hands. Service companies have a role in becoming the operator of such infrastructure.

Shell Arctic Drilling – A Postscript

At roughly $7bn historic spend, this could be the most expensive dry hole in history! Contrary to recent robust statements by CEO Ben van Beurden, Shell saw disappointing results from its drilling of the Burger J prospect, as the trigger to exit the region.

Shell is left nursing a write-down of $2.6bn in its third quarter results. The wider industry ramifications are stark. Though a single dry hole should not be taken as a measure of a region's prospects, industry watchers are understandably going to question the 2008 U.S. Geological Survey that estimated 13% of the world's undiscovered oil and 30% of undiscovered gas are in the region. As a spokesman from Bernstein Research commented, "the value of every single oil barrel held by companies just increased".

A&M VIEW

Win-win for Shell

We discussed in our last edition the pressure Shell was under as a result of its Arctic quest. We offered reasons of why Shell would continue – it didn't, so what can be learned?

- Decision costs were negligible as drilling cost was mostly sunk. Shell faced a win-win situation: If oil flowed, they would be set for the next 10 years and leadership in what was said to be a huge region. As it didn't, they could be seen to appease the more vociferous in the City by reducing capex below $3bn.
- Shell has shown the power of supply chain optimisation – many contracts can be re-purposed elsewhere.
- Ultimately, Shell has not rescinded the blocks and with higher oil price, could come back to drill at a later date.

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:

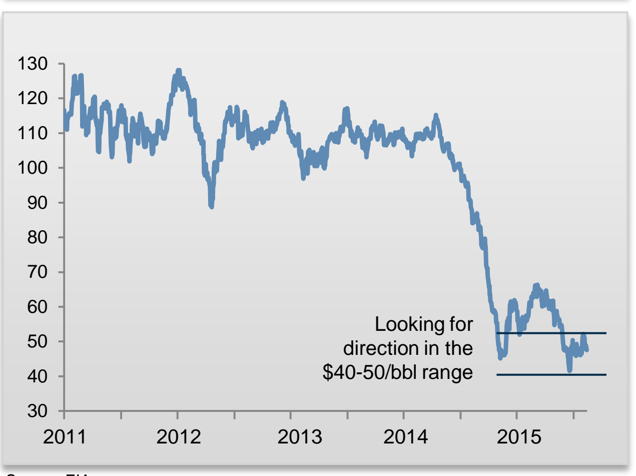
Assisting companies pursue acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.

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".

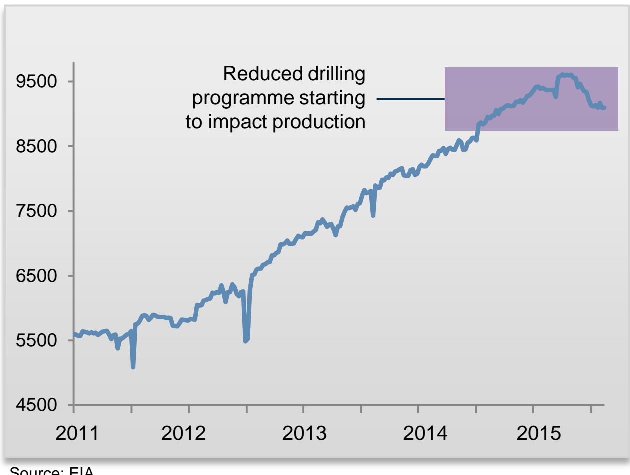
Providing interim management positions as appropriate.

Brent Front Month Oil Price ($ / bbl)



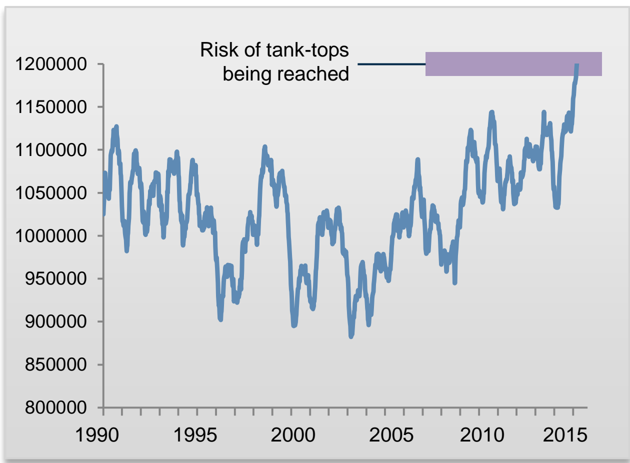
Source: EIA

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



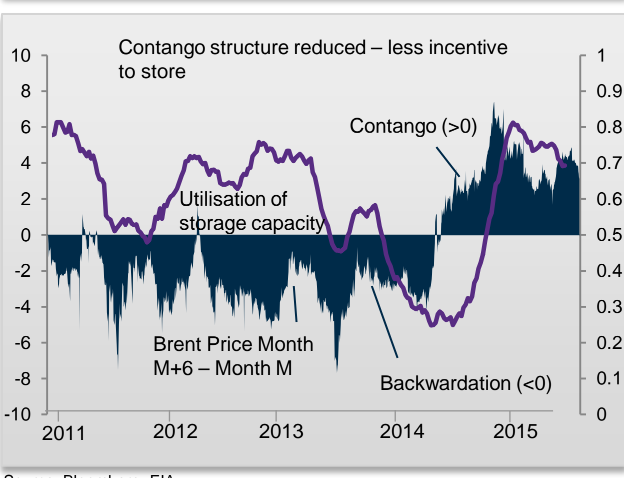
Source: EIA

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



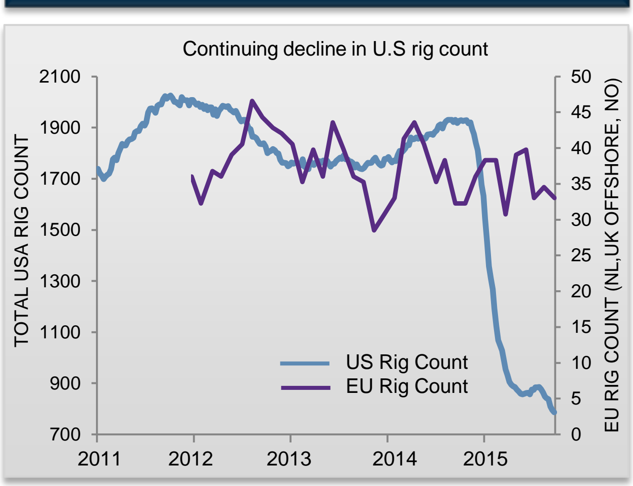
Source: EIA

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



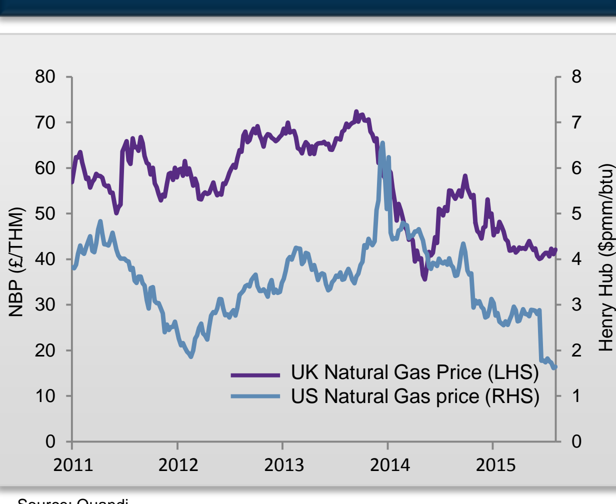
Source: Bloomberg, EIA

Rig Count



Source: Baker Hughes

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

France Key Contact

Tarek S. Hosni
Managing Director
+33 14 45 00 118
thosni@alvarezandmarsal.com

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