EUROPEAN OIL AND GAS MARKET UPDATE

FEBRUARY 2015

OIL PRICE

Notwithstanding the 30% surge in price since the 29th January, there remains little consensus on near-term direction. Many market watchers point to reduced rig count as a key supporting factor. However, with rig count having reduced week-on-week since November, there is a risk of a story being fitted to the numbers. Record U.S. crude stocks, price contango [1], continued upward trajectory on U.S. crude production and the fact that we are about to enter a low demand season, suggests downward price pressure may come to bear.

The future for oil price continues to attract varying and contrasting opinions:

- Abdalla El-Badri, Secretary-General of OPEC has suggested prices could go up to $*200/bbl* *"If [producers] do not invest there will be no supply, if there is no supply, there will be a shortage in the market after 3 or 4 years and the price will go up and we'll see a repetition of 2008".*
- On 11th January, Goldman Sachs predicted a $43/bbl price for 6 months and a 12 month forecast of $70/bbl.
- BP CEO Bob Dudley compared the situation to 1986, commenting on the 3rd February that it will be *"a long-time"* before oil sells for $100/bbl again.

Winners may emerge from the current malaise. Andrew J Hall (Hedge Fund manager) told investors recently that the massive cuts in oil and gas spend will make the best shale producers attractive targets. His hypothesis appears to be that market leaders are rapidly deploying technology and efficiencies to become sustainable at a lower oil price level.

A&M VIEW

Being robust to a further oil price fall is essential

We think it's fair to say the no one truly knows how and when oil prices will move. Therefore, a scenario based approach to management is essential. We believe there is a credible risk that oil price will continue to be disconnected from the fundamentals with further downside risk, as prices seek lower marginal cash costs. To give an indication of potential price floor, in January 2015, Morgan Stanley indicated that North Sea marginal cash costs (i.e., excluding exploration and return on investment) are around $30/bbl.

The key to surviving (or indeed thriving) during such uncertainty is a strong balance sheet. Companies with weaker balance sheets (high debt, low cash, low reserves, high working capital, etc.) will need to work very hard to maintain their viability, particularly if they should experience the domino effect of low prices and the subsequent squeeze on value in the supply chain.

Companies that have strong balance sheets, good liquidity, access to capital and well-prepared management teams are best placed to gain from the potential long list of assets and businesses that may be forced into play in the near-term.

Being pro-active in reducing cost and strengthening the balance sheet will inevitably pay dividends in a downside oil price scenario, as well as the more benign scenario of oil prices remaining at current levels for 12 - 36 months.

(1) Contango is the situation in which it is possible to buy or sell forward month future contracts at a higher price that the front-month future contract; a sign of a weak market. Backwardation is the opposite effect.

COST CUTS

Reductions in headcount and capital expenditure have become a fixture in daily news-flow. Oil Field services (OFS) continue to be the first impacted by the forced reduction in oil and gas spend. The Big 4 OFS companies are collectively seeking 30,000 job cuts, with smaller competitors following:

- Schlumberger announced 9,000 job cuts (c7%)
- Halliburton indicated 5,200 to 6,400 cuts (c6-8%)
- Baker Hughes announced 7,000 losses (c12%) in Q1
- Weatherford International has plans to cut 5,000 jobs (c9% of the total) in the first quarter

Weatherford commented "for every dollar of revenue we lose due to reduced activity and pricing, we will make up for it in cost, capital expenditure and working capital reductions". Meanwhile, Wood Group announced plans to reduce cost by $30 million, beyond cuts set-out in 2014.

Oil majors also continue to report cuts. Statoil raised spending cuts by 30% to $1.7 billion from 2016 and lowered CapEx to $18 billion from previous $20 billion. These changes occurred despite Statoil announcing cost and headcount reductions and abandoning production-growth targets a year ago.

A&M VIEW

Imperative to drive-down cost and improve liquidity

Given the squeezed margins of the super-majors, national oil companies and other producers, the impact of price concessions is having a domino effect on the oil and gas supply chain, similar to what we saw happen in 2009. Market structure means that participants in certain areas of OFS are most likely to be impacted.

We believe that suppliers need to drive down costs in order to fund these concessions as well as master and improve liquidity. In order to do so, true and timely visibility on working capital, financials and operational data is vital.

Get balance right between E and P

Exploration may lay the foundation for future success, whilst production drives present cash flow and enables the future. Balancing these two activities must be a key focus based on an honest assessment of CapEx and OpEx, the resulting revenues, and how all this translates near-term including the potential impacts on future cash flows.

REDUCED DRILLING ACTIVITY

IHS analysis of rig day rates over the past six months shows a general reduction. Drill-ships rates are down c25%, Harsh water European JackUps down c15% and South East Asian Jack Ups down c10%. However Semisubmersibles, having fallen by c20% by September 2014, have recovered to only a 3% reduction.

In North America, Baker-Hughes reports in-land rig counts at ever-decreasing levels, now over 25% below the average of 2014. The steepness of fall is beyond that of 2008-09 and should be welcomed by those that see North America as key to stemming short-term supply growth. In Europe, the key offshore sectors of the North Sea, Norway and Netherlands have also collectively seen declines in drilling rates – an 18% decline in January versus the average of 2014. As well as being somewhat less dramatic than the North American cut-back, the rig count is still above the low point for the 2011-2015 period; likely indicating the difference in ability for operators to react between inland and offshore drill segments.

A&M VIEW

Beware of generalisations

The relative strength of semisubmersible day rates illustrates the point that for oil and gas there will always be differences across different markets, geographies, customers and politics.

The very best businesses will be those nimble enough to find and exploit these differences. To do this, operators need to:

- Have real-time tracking of the relative strengths of distinct market segments and be able to react quickly in times of distress or in redeploying resources to new opportunities.
- Quickly act to close-down or divest activities that are a drag on resources or cash flow.

Acquisition or merger opportunities will exist for operators with knowledge of how oil price decline impacts different segments of the drilling and wider oil field services market.

POLITICS AND REGULATION

Industry leaders have reacted positively to George Osborne's expected budget announcement of a North Sea investment allowance that could lower the effective tax rate for new projects to 45 – 50%. Industry voices have also asked for the basic rate of tax to be lowered to c45%.

A new UK O&G Industry Regulator (the Oil & Gas Authority "OGA") will take over industry supervision from 1 April 2015. The new OGA CEO (Andy Samuel) has been asked by the Government to provide recommendations of how the Government should react to the current low oil price. Recommendations are expected this week.

A&M VIEW

Intervention may bring both winners and losers

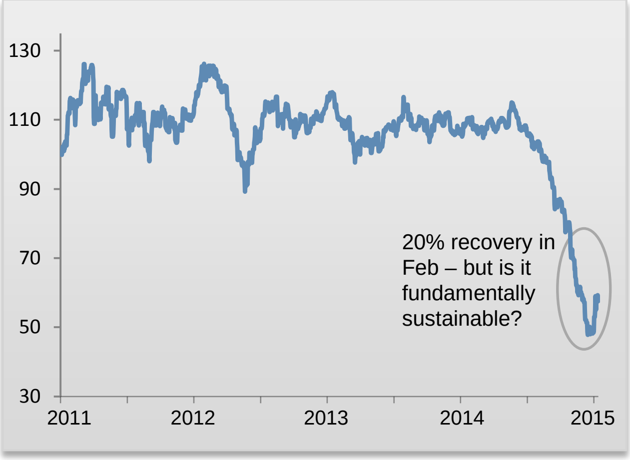
Any changes introduced by either the new OGA or the Government is likely to bring a combination of risks and opportunities for various players in the industry. Any fiscal breaks will be generally welcomed whilst changes to the decommissioning regime (should there be any) may result in both winners and losers within the OFS market.

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:

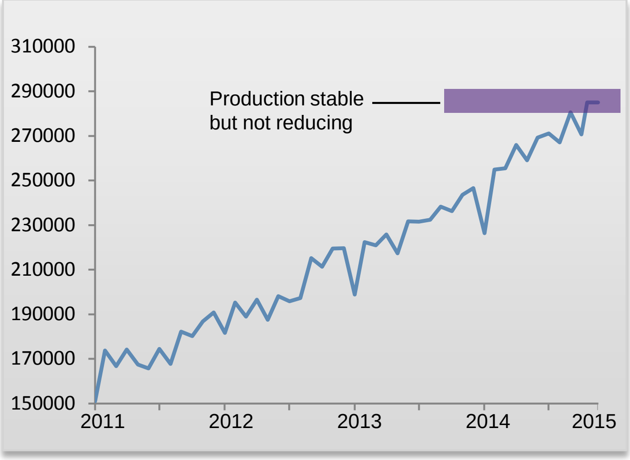
- Assisting companies pursue acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.
- Working with management to optimise cost and CapEx, analyse asset performance and portfolio prioritisation, 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)



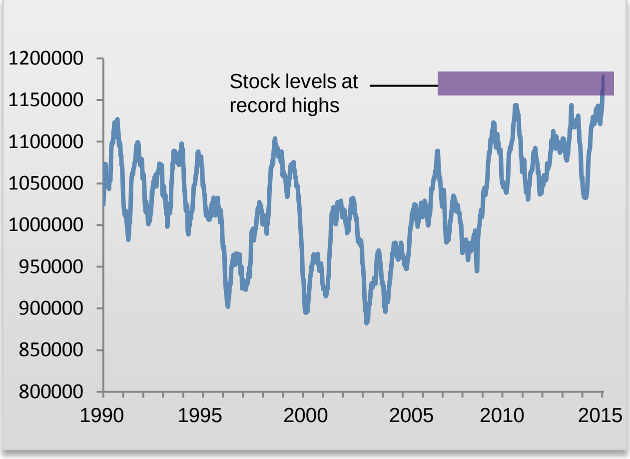
Source: EIA

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



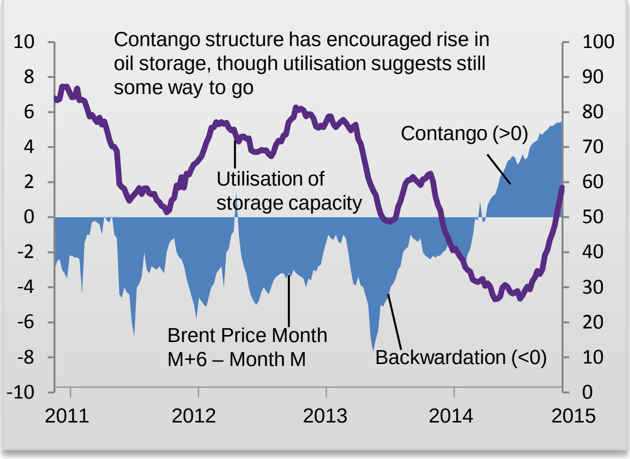
Source: EIA

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



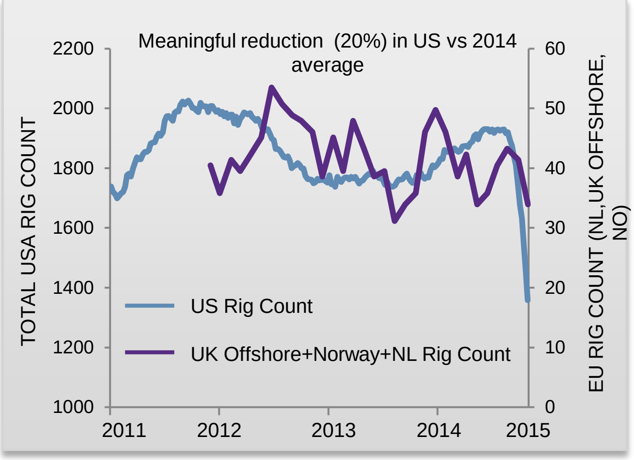
Source: EIA

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



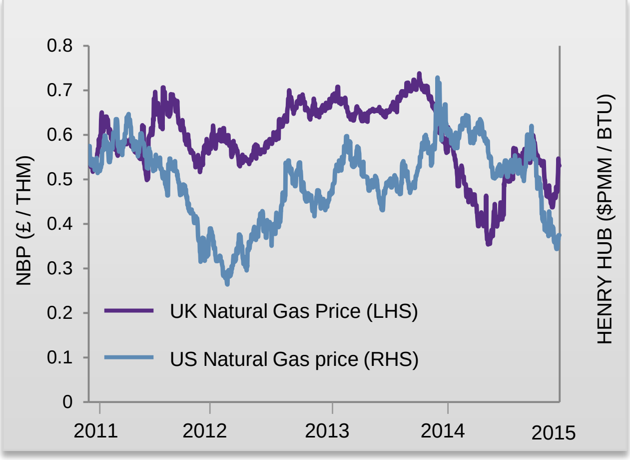
Source: Bloomberg, EIA

Rig Count U.S. (LHS) and Offshore Europe (RHS)



Source: Baker Hughes

UK Gas Price (£/therm) (LHS) and U.S. Gas Price ($/mmbtu) (RHS)



Source: CapitalIQ. EIA

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