EUROPEAN OIL AND GAS MARKET UPDATE

June 2015

A & M

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OIL PRICE

Oil price has recently appeared to have reached a degree of stability in the range of $60-65/bbl. News-flow has provided little momentum with OPEC's long anticipated decision in early June to maintain output at 30 mm b/d and little change in Middle East conflict. A degree of confidence has, perhaps prematurely, returned. An expectation of $75-80/bbl oil price by the end of the year was expressed by Iraqi Oil Minister Abdul-Mahdi before the recent OPEC meeting, also reflecting the views of the representatives of Angola and Venezuela.

Providing some support to price is the continuing fall of the US rig count. However, the ambition of US shale producers continues to hold, reflected recently by Ryan Lance of ConocoPhillips on Oilpro: “This business will survive at $100 Brent oil pricing and it will survive at $60-70 Brent pricing”.

On the demand side, refinery margins have had a welcome revival, though several market commentators, one being Morgan Stanley, have warned that these levels may not be sustainable. Another key support to demand has been China with record imports of 7.4 mmbd in April. Regarding the basis for Chinese demand, the sale of SUVs in China soared by 48% year-on-year in Q1 2015, however a more impactful trend may be the fact that the major demand appears to be from China's strategic reserve. China has taken advantage of lower oil price to build towards a storage target of 500 mmbbls (US has c700 mmbbls). Worryingly, May's imports were down 23% versus April, demonstrating the fickle nature of such demand.

A&M VIEW

Supply side risks are abundant

Contrary to the optimistic tone expressed by some, supply side fundamentals fail to show support for further price-rises and continue to suggest a weak outlook. The past 6 weeks have been marked by a number of key mile stones:

- US production of 9.57 mmbd is the highest since 1983
- With 10.7 mmbd production, Russia is now said to be pumping more oil than Saudi Arabia (10.2 mmbd)
- OPEC pumped 31.2 mmbd in April, the highest level since September 2012 and above its target of 30.0 mmbd
- In May, US stocks reached their highest since 1990
- Cushing storage at 85% utilisation is effectively full

Signals of weakness are appearing. There are reports of unsold cargoes in the North Sea and West Africa; and Nigeria’s Forcados crude grade, normally trading at a $4-5/bbl premium to Brent is now trading at less than $1/bbl above.

Another key market change has been the reduction in crude contango. The 6 month forward quote has dropped from a contango level of $7/bbl at the start of the year, to a mere $2.5/bbl in early June. The incentive to store oil is greatly reduced at these levels suggesting both a market belief in oil price strength, as well as the risk of de-stocking.

Conflicting market signals emphasise the need for a scenario based approach to planning, with continued need to be robust to the downside.

North Sea Costs

North Sea operating costs are reported to be around $40/bbl. It is therefore of no surprise to see the flood of job reductions (c1500) at North Sea operators and service providers over 2015. Cost reductions are thought to be around 20% in 2014, however Oonagh Werngren, Operations Director at Oil & Gas UK sees the need for more, recently claiming that "The goal is to achieve a more internationally competitive oil and gas province and attract the fresh investment needed to unlock the North Sea's remaining potential. Achieving this will require a 40% reduction in the industry's cost base".

Oil & Gas UK consider 'standardisation and simplification' to be the key focus for operators in the province, a move away from the 'gold-plating' standard that elsewhere has become the norm.

Operators are also seeking to change resource practices. Shell, BP and Enquest have all announced intentions to move towards three weeks on / three weeks off, as opposed to the current 'two on two off' practice. So far, unions have been resisting such change, with industrial action threatened in both the UK and Norwegian sectors.

A&M VIEW

Essential to learn from other industries

A 40% reduction in cost sounds remarkable, until you consider that they have increased by 50% between 2011 and 2014. The challenging nature of the mature North Sea industry has been contributing to this trend and it now appears that market participants have been acting independently for too long. An emphasis, supported by Oil & Gas UK, is the need for greater collaboration and a more 'fit-for-purpose' approach. Unfortunately, remembering that other regions can subsequently mimic these practices, it's unlikely this alone will be sufficient to reduce costs.

Many other industries have faced almost fatal experiences in the past decade, but survived. One example is the UK car industry. It would appear that the North Sea oil industry still has a lot to learn from analogous industries in the areas of procurement, supply chain optimisation, equipment standards and resource planning.

A&M has in-depth experience supporting the oil industry with our cross-sector manufacturing knowledge.

Dutch OFS Sector

The Dutch oil field services (OFS) sector is gaining prominence with a rise in M&A activity, including the rumored divestment by Arle of Stork Technical Services and Fugro's apparent search for a buyer for its subsea business. The Dutch market continues to have a relatively high private ownership (40%[1]) and limited private equity ownership (c14%[1]). With record revenues in 2014 (c€23 bn[1]), Dutch OFS companies have benefited from the strong fundamentals of recent years. However, this doesn't mean that the Dutch sector has escaped the wider OFS down-turn. Major offshore construction companies, as well as small services focused companies, are currently facing a rapid decline of projects and pipeline while margins on new projects are significantly below previous years. Dutch M&A activity in Q1 to Q3 was also at the low end of the quarterly deal activity that peaked at seven deals a quarter in the heady days of 2011-2014.

Support has come from a weak euro, enabling Dutch service companies to better compete against UK and US players. Further M&A and consolidation is anticipated in the sector.

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A&M VIEW

Further restructuring expected

Many companies have been able to create enough buffer to cope with a lower oil and gas price for a certain period. Management and shareholders are not yet willing to start cutting back operations and personnel, as they anticipate a (potentially rapid) revival of the oil and gas market and fear losing their competitive edge if they instigate. In contrast to UK and US based OFS companies, staff reductions in the Netherlands have been limited.

Companies can be expected to follow the generic strategies of:

- using up balance sheet reserves
- decreasing operational cost base
- selling non-core assets.

However, as oil price remains low and a strong recovery is not expected in the near-term and sale of non-core assets appears difficult (due perhaps to unrealistic seller price expectations) – the potential for forced operational restructuring lies on the horizon.

[1]Dutch Chamber of Commerce, A&M research

Emergence of the Infrastructure Funds

What is interesting about recent oil infrastructure deals is that the buyers have been traditional infrastructure funds. Whilst it may seem obvious that infrastructure funds can be expected to buy infrastructure, the nature of the assets bought is more unusual. Infrastructure funds, typically with a shareholdings consisting of pension funds, college endowments and other yield hungry investors, have traditionally invested in assets with stable/predictable cash generative income. It is therefore interesting that CLH bought the UK Governments GPSS jet fuel pipelines, thought to require significant restructuring; Antin Infrastructure Partners recently completed the purchase of the throughput challenged North Sea CATS pipeline from BG and BP; and iCON Infrastructure Partners bought Lukoil's Rotterdam bunker fuel terminal, with exposure to the vagaries of the oil storage market.

A&M VIEW

A natural progression but patience required

The move of traditional infrastructure funds into an industry typically occupied by storage/pipeline companies or oil majors suggests several factors:

- Reduced availability of attractive assets in traditional focus sectors such as gas, power and water
- Traditional oil infrastructure owners provide limited M&A competition as most are seeking to divest non-core or under-performing assets
- Low debt costs justify exposure to more volatile assets

Infrastructure funds will need to be patient since many of these assets will require a period of restructuring before achieving the traditional level of income predictability.

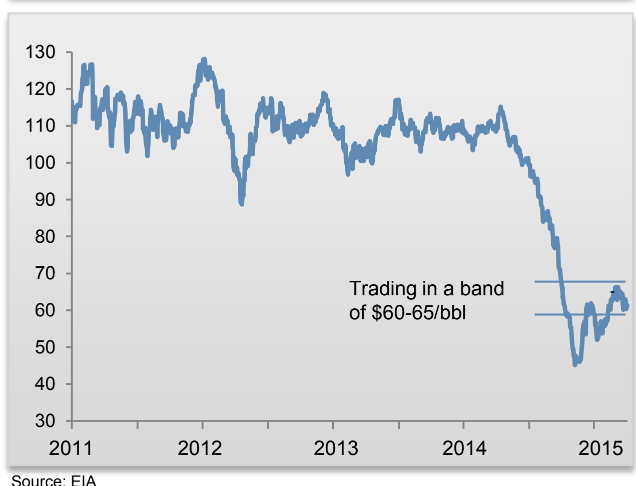
In the current oil and gas environment, many companies need the support of experienced professionals who can work alongside management to deliver solutions to complex problems.

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.

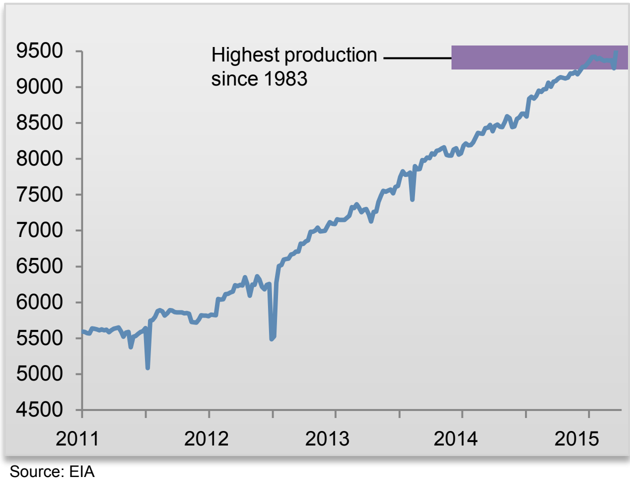
OIL AND GAS OBSERVATIONS – KEY MARKET SIGNALS

Brent Front Month Oil Price ($ / bbl)



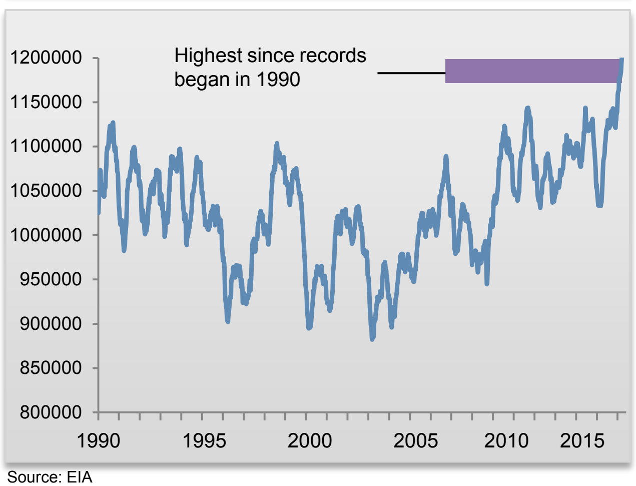
Source: EIA

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



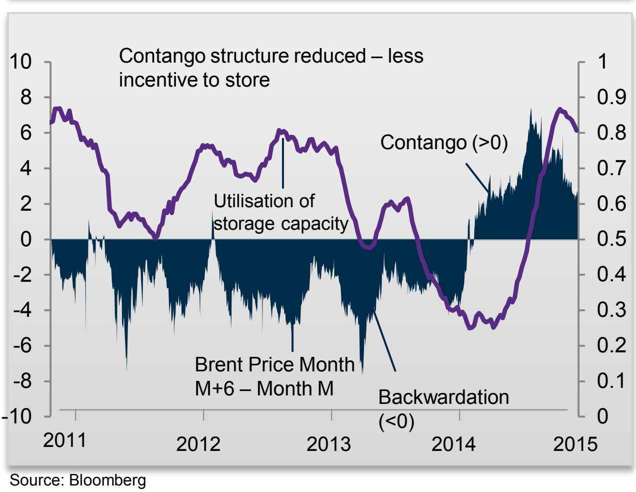
Source: EIA

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



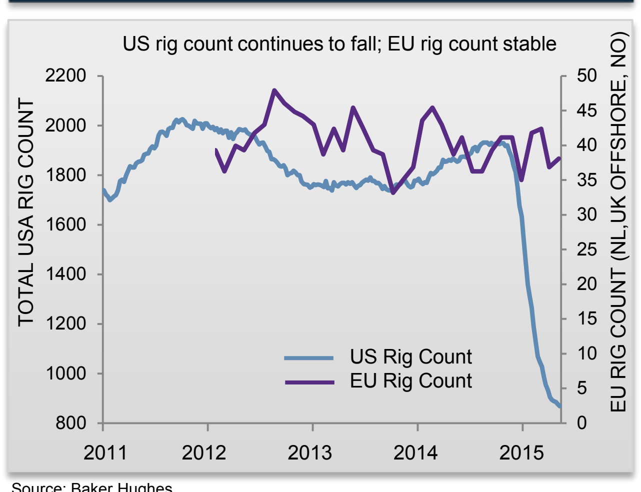
Source: EIA

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



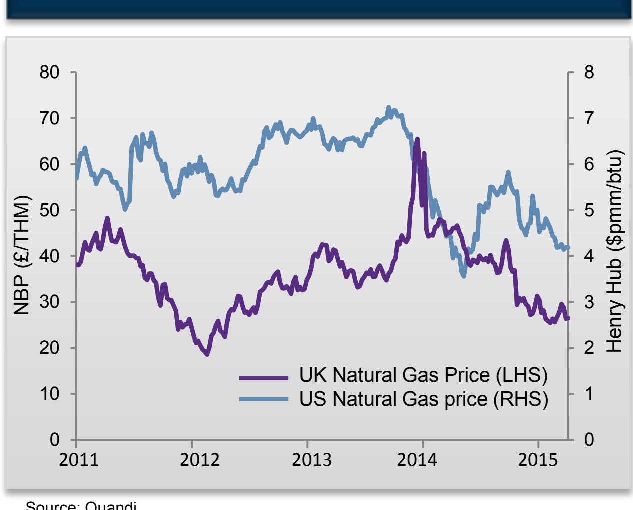
Source: Bloomberg

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:

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