EUROPEAN OIL AND GAS MARKET UPDATE

May 2015

A & M

ALVAREZ & MARSAL

OIL PRICE

Crude price has continued to rally up to $7/bbl (13%) over April. Saudi military action in Yemen is typically cited as the cause of the most recent price rise. Yemen borders the Bab-el-Mandeb Strait, through which oil tankers must pass on their way to or from the Suez Canal. According to the Canal Authority just over 3 million barrels per day (c3% of world oil supply) passes through the 2 mile-wide canal based upon 2014 figures. Those on the buy-side of the market appear to be pricing in significant disruption to this shipping route, along with potential further escalation of conflict in the region.

The fear premium appears significant, causing Brent to surge $17/bbl (39%) from a January low of $45/bbl. This sustained spike in price appears to have encouraged a more bullish view on the sector by certain players. In April, Societe Generale raised its 2015 average Brent forecast to $59.5/bbl, whilst Bank of America Merrill Lynch (BOAML) raised its 2Q15 Brent forecast to $63/bbl stating *"The market seems to have found a spot price low"*.

On the demand side both China and Europe experienced worse than expected PMI figures, while US crude stocks continue to build, with a 2% rise in April.

The oil market price recovery appears precarious. Sustaining or building upon current price levels seems to be contingent upon a Middle East conflict to offset continued poor demand.

A&M VIEW

Fear premium disconnected from reality

Oil price continues to appear disconnected from fundamentals as reflected in the reaction to the conflict in Yemen. Despite the Suez Canal being an important trade route, several other key facts should also be considered:

- Net flow of oil through the canal is relatively small at 0.6 million bbl/d as North/South flow partially offsets South/North flow
- The Sumed pipeline connecting the Red Sea to the Mediterranean, was estimated in 2011 to have spare capacity of 1.3 million bbl/d
- Very large crude carriers (VLCCs), the transport of choice for larger producers and refiners, cannot transverse the Suez Canal and instead use longer routes via Southern Africa.

Accordingly, in the event of a closure of the Suez Canal the crude oil and product markets would re-balance. Crude oil stranded in the Mediterranean would be processed in Europe, albeit with a quality penalty. Crude oil stranded to the south of the Suez could be re-routed via Southern Africa, incurring higher cost and transit time. European refinery margins could rise to help fulfill short-falls in products. Crude stocks at current record levels, would also aid any short-term supply/demand shock.

Market players need to continue to be robust to a price correction to $30-50/bbl if fundamentals again drive price.

Shell/BG Merger

Shell's announcement of a £46bn take-over of BG on the 8th April, the second biggest oil & gas deal in history, may be the first of many provoked by the market malaise. BG had been identified as a take-over candidate for several parties for some time. The 30% fall in BG share price over the past 12 months, on the back of oil price and high exploration costs and production issues made them a compelling target.

Shell claim that the combination will yield £1.7 bn of annual cost savings through synergies. Several market commentators have pointed to the strong strategic rationale of creating an LNG super-major, with the addition of BG's Brazilian and Australian assets to Shell's existing portfolio. However, some questions have been raised regarding the price paid. Neil Morton of Investec pointed out that the 50% premium to the BG share price to be paid by Shell requires crude to hit $90/bbl by 2018. Rystad Energy similarly took the view that the 50% premium was fair if oil was priced around $105/bbl in 2020. It's clear that Shell is betting that the current price levels cannot persist.

A&M VIEW

A worrying signal for oil field services

A&M has found market sentiment to be that more M&A activity was expected in the current environment. Oil price uncertainty appears to be leaving a large bid-ask spread between buys and sellers, whilst even seemingly challenged E&P players are appearing to be valued by the capital markets according to the forward oil price curve i.e. not distressed pricing. With oil price uncertainty remaining and with the strong price paid by Shell for BG, it is unclear whether this mega-deal deal will encourage activity in the near-term.

The Oil Field Services (OFS) sector should be fearful of the cost saving impact of the combination. Shell has acquired a 25% increase in reserves in the attractive provinces of Brazil, Australia and East Africa. Much of the synergy value quoted will therefore likely come from reduced exploration and appraisal, particularly in mature parts of their portfolio such as the North Sea. Acquiring rather than locating new reserves may be a cheaper model mimicked by others, reiterating the need for OFS players to be robust to a further downturn scenario.

OFFSHORE RIG UTILISATION

Over the 12 months to end April 2015, the oil price has fallen by c40%. In normal circumstances this would have had a heavy impact on offshore drilling rig utilisation, particularly given their high cost base compared to onshore drilling rigs. However a global review of offshore rig utilisation over this period shows that it has held-up surprisingly well. The North Sea is largely stable currently at 83% compared to 85% a year ago, West Africa is 65% vs 67%, and the Persian Gulf and Brazil are flat at 75% and 92% respectively. Some geographies have suffered notable declines (notably Gulf Of Mexico at 38% vs 54%) but overall utilisation is reported at currently 63% compared to 71% a year ago.

However, the devil is in the day-rate - the daily fee charged by the rig owners for renting and running the rig for a customer. Over the same period IHS reports that this rate has fallen by an average of 17%. This reduction is also notable given its consistency across different rig types – drillship and "standard" jack-up rates are down 18% and semi-submersibles down 17%. Only harsh-water jack-ups seem to have resisted the trend a little by posting a 14% reduction.

A&M VIEW

Flattering to deceive?

The reduction in day-rates for rig operators (which without compensating cost reduction initiatives goes straight to the bottom line) is a significant hit and one that is only partially masked by the headline utilisation numbers. Faced with a falling market, operators can take either the reduction in day rates or take the rig off contract and suffer the costs of transporting and then stacking (storing) the rig pending a new contract win. Assuming that the reduced day-rates provide at least some contribution to overheads, and given the high global liquidity and visibility in the rig market, the decision is relatively clear – keep the assets occupied, maintain customer connections and earn some contribution pending a market recovery. An understandable strategy, but it relies upon optimising contracts, margin enhancement and very importantly, the availability, visibility and management of liquidity. Contract management, cost reduction, supply chain management, capital expenditure controls and working capital management will all play key parts in enabling rig operators ride the current market downturn. The best operators are likely to use these tools to position themselves as strong players, ready to take advantage when the market returns.

IMPACT OF EXCHANGE TRADE

Further evidence of the causes of recent price rises were supplied by exchange data. As reported by Reuters and the FT, net-long positions on the International Continental Exchange (ICE) have reached record levels. The FT indicated that contracts equal to almost 265m barrels of crude oil (nearly 3x daily consumption) are currently held.

The holders of these positions (often hedge funds, or other large speculators) are betting on a continued rise in oil price. As Reuters reported, the ratio of long to short positions (currently 6.4) has been seen three times before and each time preceded a major drop in oil price.

A&M VIEW

Non-fundamental factors may drive price

Quantitative easing and low interest rates have supplied significant fire-power to hedge funds and other speculators. With large positions, potentially offsetting oil against other commodity markets, the trading strategies of such players is far from transparent, though their actions can have a dramatic impact upon price. Market participants need to be cautious when attributing cause and effect to oil price. In theory fundamental factors will ultimately dictate price, though the reality appears to be that there may be extended periods where exchange trade leads on price.

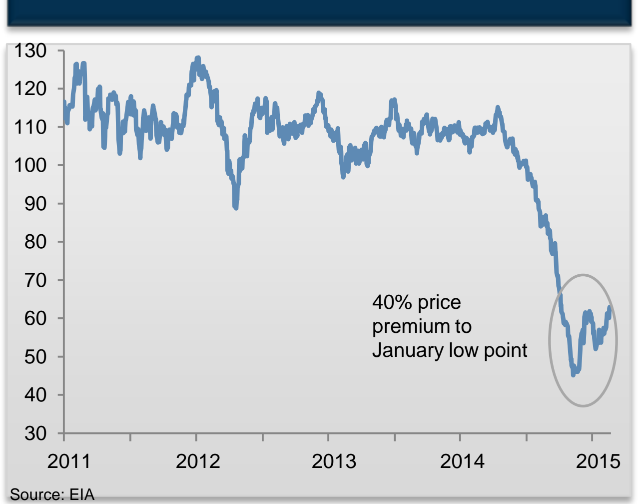
In the current oil and gas environment, many companies need the support of experienced professionals who can work alongside management to deliver solutions to complex problems.

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.

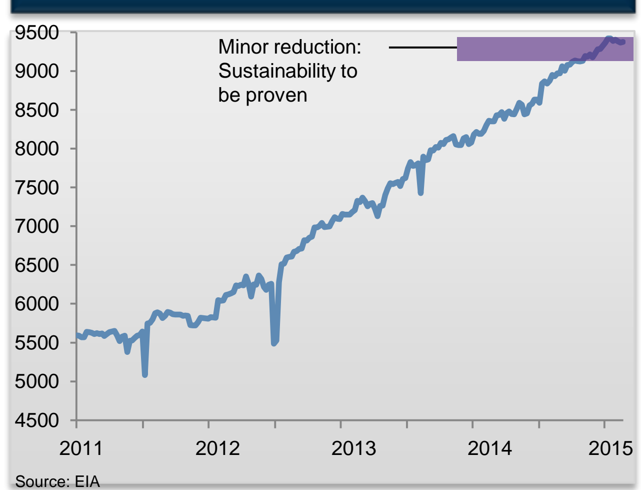
OIL AND GAS OBSERVATIONS – KEY MARKET SIGNALS

Brent Front Month Oil Price ($ / bbl)



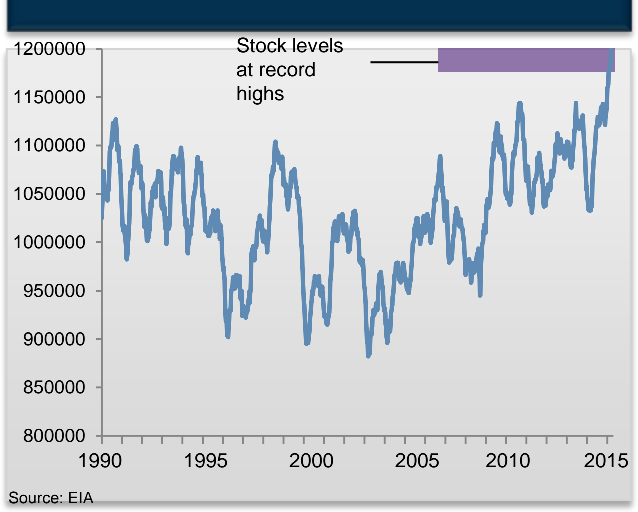
Source: EIA

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



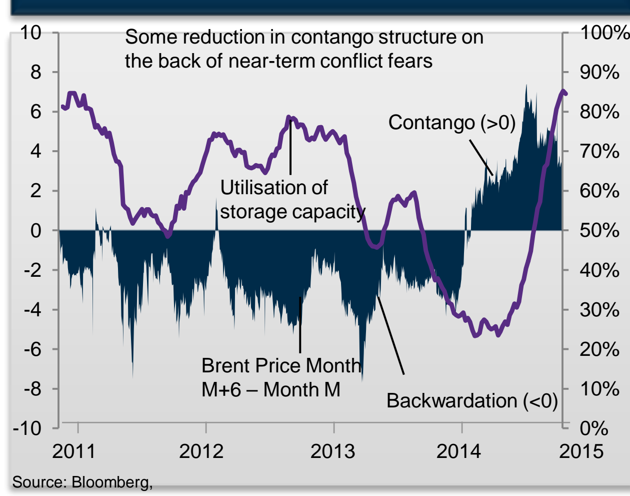
Source: EIA

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



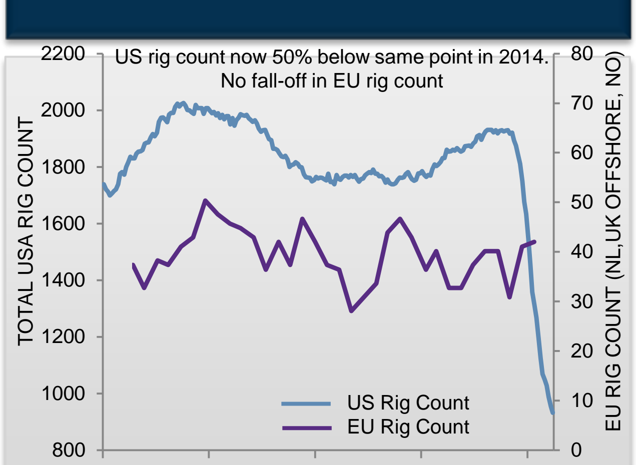
Source: EIA

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



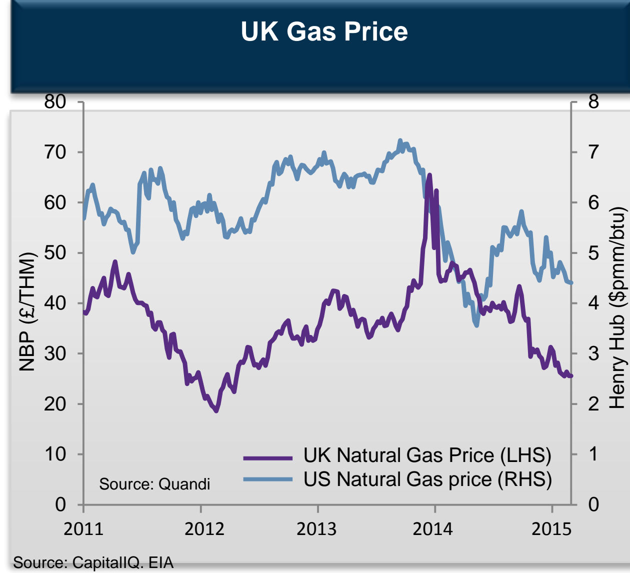
Source: Bloomberg,

Rig Count



Source: Baker Hughes

UK Gas Price



Source: CapitalIQ. EIA

* 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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