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FROM THE INSIDE OUT

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North American Oil and Gas Companies Must Transform to Survive

Few sectors are in greater need of transformation than oil and natural gas producers in North America. With the relatively stable oil price of the last four years, too many small producers lack the scale to cover their production costs and as a result, have built up substantial debts: S&P figures show around $137 billion in borrowings will be due by 2022.

This has resulted in bankruptcies and heavy losses for investors. Capital markets have turned their backs on the industry, leaving businesses struggling to use their own cash flow to maintain production. Additionally, this thirst for cash to fund debt service has caused companies to prioritize tapping into their very best resource plays. The issue is compounded as these rich resources experience rapid depletion rates.

"These are capital-intensive businesses with limited access to capital markets," says Seth Bullock, Managing Director with Alvarez & Marsal's (A&M) Restructuring and Turnaround practice in Houston, Texas. "They're having to operate within their cash flow which traditionally they have not been able to do, except for the very largest producers that have scale. It's created distress and now it's decision time."

Transforming operating costs is both essential and highly challenging for two reasons. The first is straightforward economics. To break-even, companies in West Texas need to produce at least 80-100,000 barrels of oil a day, says Lee Maginniss, Managing Director with A&M's Corporate Performance Improvement practice in Dallas, Texas. Each year production declines by at least 15 percent as resources are depleted, so companies need capital to drill new wells just to maintain production levels. With limited access to capital markets, cost control and a more efficient use of existing capital are the only levers to pull.
The second issue is expertise. In many cases, management teams that were hired with the expectation of a commodity price boom and rapid growth, lack experience in streamlining costs.

Necessary Changes
As a result, A&M is working with a number of energy companies to transform their operating costs. They fall into three broad categories, according to Mr. Maginniss: energy producers that have already been through a debt restructuring as a result of bankruptcy and are under pressure from new equity holders to find a sustainable operating model; companies seeking to tackle costs before it becomes a problem; and those pursuing economies of scale by merging with a similar-sized producer.

The most fruitful areas for cost savings include more cost effective production operations, improved capital efficiency and reduction of spend on external service providers and suppliers. The challenge is that oil and gas companies often have long-standing contracts and close relationships with their suppliers, making management teams reluctant to challenge them to provide the most competitive prices. Corporate sales, general and administrative (SG&A) cost reductions are often necessary as well, but these are difficult to tackle because 75 percent of the SG&A spending typically comes from the payroll; and finding savings means making difficult decisions about staff cuts. The objective view of external advisers can be useful in fully capturing these opportunities, says Mr. Maginniss.

Reality Check
Because of the state of affairs, the industry has attracted significant activist activity in recent years. Activist investors are launching campaigns and are frequently pursuing a merger and acquisition thesis which says that energy companies are subscale and need to get bigger to survive, therefore should position themselves for sale.

Long-term, a sustainable recovery for the North American oil and gas industry means consolidation. This means leaving a small number of large players, as is already the case in other parts of the world. However, many management teams are overly optimistic about how much runway they have. They are not ready to accept that their operating models are unsustainable, nor are they proactively seeking merger opportunities to build scale at current valuations.

“Some companies have not given up and still believe they’ll be able to find additional financing or that the commodity price will bounce back,” says Mr. Maginniss. “The wildcard that could help them is geopolitics, if a situation develops which drives up oil prices,” he adds.

Yet even that is unlikely to unlock capital markets in the short term, as investors recover from their recent losses. Instead, the focus for the year ahead must be on merger and acquisition opportunities coupled with corporate transformation to capture economies of scale, cut costs and optimize the capital structure.

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