EUROPEAN OIL AND GAS MARKET UPDATE

November 2016

ALVAREZ & MARSAL

OIL PRICE

"It's a brave person who bets against this combination of factors." This was the reaction of oil industry and hedge fund veteran Andy Hall to the Organization of the Petroleum Exporting Countries' (OPEC) announcement on 27 September of a production cut of 200 to 700 kilobarrels (kbbl) per day. For a short period, the market agreed, with Brent Crude rising from c.$47 per barrel (bbl) to a high of just under $53 per bbl by early October, a 12-month peak.

Then reality appeared to dawn: OPEC has failed to define how the cuts would be shared and the schedule for these; Iran and Iraq have insisted on exemptions; Russia on one hand signaled support, whilst on the other has increased output to post-Soviet era record levels of more than 11 mbpd (million barrels per day); and Saudi Arabia is finding itself in a familiar position of having to shoulder the cuts.

Adding to the woes: The end of October saw a record 14 million barrel weekly increase in U.S. crude stocks; U.S. crude production increased for two consecutive weeks; the U.S. rig count has escalated from a minimum in May and is now c.38 percent above this low; to top it off, with higher crude prices in October, many U.S. producers will have taken the opportunity to hedge production at above $50 per bbl.

By 9 November, a new price factor came into play: the market does not appear to have yet decided the impact that a Donald Trump presidency will have upon prices. As we go to press, crude prices remain volatile as speculators await an outcome from the end of November OPEC meeting.

A&M VIEW

Trump's Foreign Policy is Key to Price

Similar to the Brexit vote, the immediate aftermath of Trump's surprise victory was a currency, stock and oil sell-off. Whilst volatility will subside, a key question is how a Trump presidency will impact the oil industry and oil price.

Many have focused on Trump's impact to the supply side of the industry. With a stated intent to reduce legislative, environmental and planning burdens, at first glance this would appear bearish to price: easing the ability to frack; facilitating the development of major pipelines such as Keystone XL and Dakota Access and rescinding support for climate initiatives and renewables can all be seen to be adding more U.S oil to an over-supplied market. However, this assumes that any extra U.S. oil can be economic at even lower prices, a position that is not obvious. Keystone development would support Canadian oil – an outcome that appears counter to Trump's trade rhetoric.

In contrast, Trump's demand-side impact and particularly his foreign policy appear critical to prices. Trump's position on trade has been aggressive, notably toward key players such as China, creating a material threat to demand and oil prices. In the case of Iran, he has threatened to repeal the nuclear agreement that brought them back to the global market action, a situation that could drive prices higher.

In summary, whilst Trump's actions to support U.S. industry may gain populist support, their impact upon oil prices may be more minor compared to his foreign policy positioning.

INNOVATION

Operators throughout the oil and gas supply chain have historically excelled at innovation. With a collection of like-minded and focused problem solvers, ready funding and a "frontier" perspective that saw obstacles as simply opportunities to demonstrate rapid progress, innovation found fertile ground in wells across the world. Such innovation shines through in myriad examples such as artificial lift, directional drilling, fracking, drillships, 3D/4D seismic, subsea trees, etc. When faced with the challenge of how to get more out of existing wells and how to access hitherto unreachable reserves, the oil and gas industry has time and again stepped up to the plate and succeeded.

Until recently, much of the above innovation was focused on maximising revenue for producers by maximising the volumes from current, and potential future, reserves. Whilst volume-maximising innovation remains undoubtedly welcome (particularly for existing production), the focus has necessarily now changed. Determining how to get more volume is good, but how to get more volume at much lower costs is better.

A&M VIEW

Necessity is the Mother of Invention

The shale producers in the U.S. demonstrate the key point here admirably. Faced with being uneconomic as oil prices fell, producers targeted reducing costs. Some cost efficiencies were achieved through squeezing suppliers harder (an ongoing lesson for all), but there were also internal innovations in well design, drilling and completions. In total, reductions in production costs of 40 percent to 50 percent were achieved, enabling more wells to be kept economic.

In A&M's view, it is essential that the oil and gas industry worldwide similarly focuses on cost reduction innovation across operations and supply chains. Part of the solution will be new technical innovations, but another important part will be rethinking the fundamental operating model. Examples will include better asset tracking, management and utilisation, better labour deployment and skills leverage, and better contract management with a focus on value creation. The winners in these challenging times will embrace the necessity.

OIL FIELD SERVICE (OFS) FIRMS – RECENT RESULTS

Q3 results demonstrate the continued distress in the OFS sector. Quarter-on-quarter sales were at best flat whilst some players took solace in sales being "only" down a maximum of 3 percent.

Schlumberger led the pack, scraping a positive net income of $176 million for the quarter. Halliburton just broke even with a $7 million result. Baker Hughes had a net income loss of $430 million, which was at least better than its last quarter loss of $760 million. Weatherford delivered a massive $1.8 billion loss; even when adjusted for the Zubair project, net income still declined quarter-on-quarter by 38 percent to an adjusted $349 million.

Quarter-on-quarter comparisons tend to flatter in Q3 due to the seasonal peak in OFS activity. A bleaker picture was presented by year-on-year comparisons: Schlumberger led again with a 17 percent fall in sales, Weatherford was the laggard with a 39 percent drop; with its associated loss, this may have prompted the resignation in mid-November of Chairman and CEO Bernard J. Duroc-Danner.

A&M VIEW

Refinancing Discussions to Become the Norm

Weatherford personifies a major challenge in the sector: the company has $7.5 billion of debt (as of September 2016), which is 65 percent of its enterprise value, and needs to service this in the face of ravaged demand and resultant increasing losses.

Moody's recently estimated that the oil field services sector has debts of $110 billion that will mature over the next five years. The vast majority of the debt (75 percent) lies with the smaller firms with revenues less than $2 billion, with 48 percent of issuers having less than $500 million revenues.

With continued sector distress, it appears that the banks and equity holders must increasingly steel themselves for restructuring discussions.

Equity holders can best position themselves in these discussions, having already taken major steps to reposition costs structurally and not just on a variable cost basis.

BAKER HUGHES / GE DEAL

The break-off of the Halliburton (HAL)-Baker Hughes (BHI) mega-deal in May 2016 was expected to spur further merger and acquisition (M&A) action. So it proved in November, with GE Oil & Gas and Baker-Hughes agreeing to merge to form a $32 billion revenue entity, just short of the $35 billion behemoth originally envisioned with the doomed Halliburton deal.

The deal allows GE to move closer to its aim of being a software giant while the merger combines complimentary offerings, bringing together GE's production systems expertise, equipment for rigs, artificial lift and processing with BHI's expertise in drilling, production and services. The combination will create the second largest player in the OFS sector. The question left is how other major players and heavily indebted smaller players will now react.

A&M VIEW

A Compelling Deal

The tie-up looks like a natural defence in a difficult environment with at least three positive aspects:

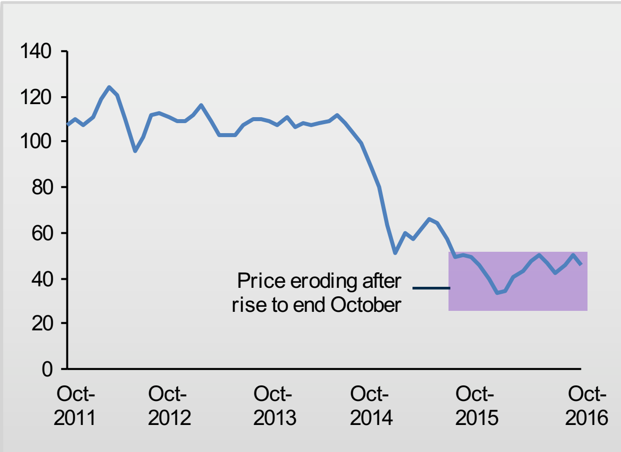
1. Complimentary: There appears to be good synergy between GE's equipment-heavy offering with the service-heavy offering of BHI, a combination that is unlikely to fall foul of regulatory scrutiny, contrary to that with HAL.
2. Cost Synergies: With $1.6 billion of run-rate cost synergies expected by 2020, the deal should deliver a vital cost reset needed to remain competitive.
3. Balance Sheet: BHI enters the merger with a reported c.$1 billion of debt paid down via contribution from the $3.5 billion HAL break-up fee whilst GE will contribute $7.5 billion as its contribution to the deal. The combination has a strong balance sheet in a sector that is ravaged by debt, placing it well to further consolidate.

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

Founded in 1983, Alvarez & Marsal (A&M) is known for its distinctive restructuring heritage, hands-on approach and relentless focus on execution and results.
With clients across the energy investment lifecycle, A&M can:

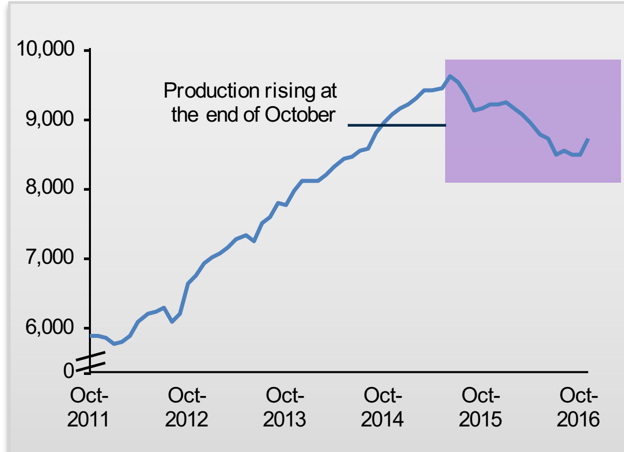
- Assist companies pursuing acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition / carve-out integration planning and execution.
- Work with the company management to optimise cost and capex. Analyse asset performance and portfolio prioritisation to identify divestiture opportunities. Improve the company's planning and financial control processes and systems.
- Support the management, legal and financial advisors of distressed companies to stabilise operations and cash flow and extend the "liquidity runway." Provide interim management positions as appropriate.

Brent Front Month Oil Price ($ / bbl)



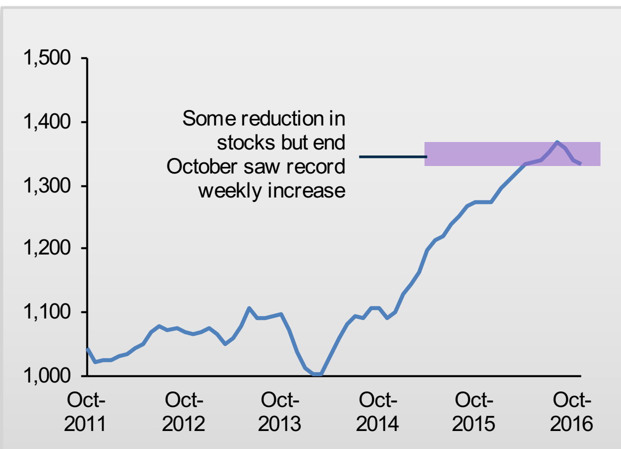
Source: CapIQ

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



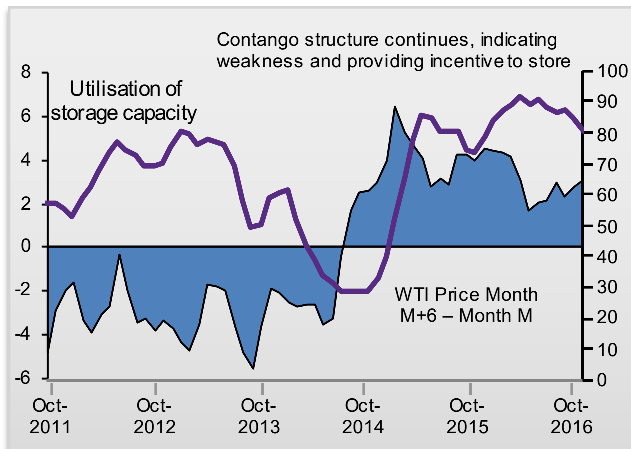
Source: EIA

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



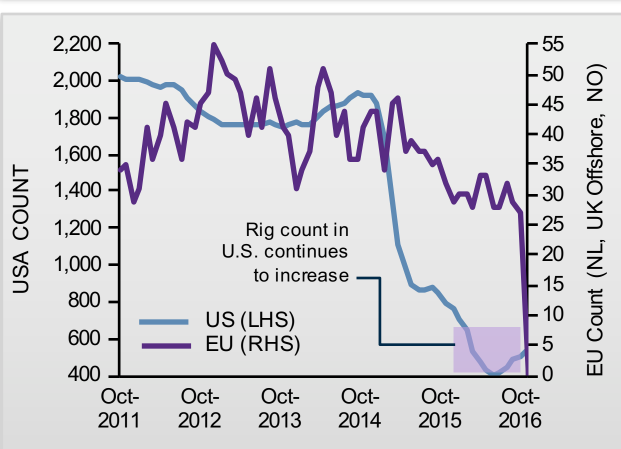
Source: EIA

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



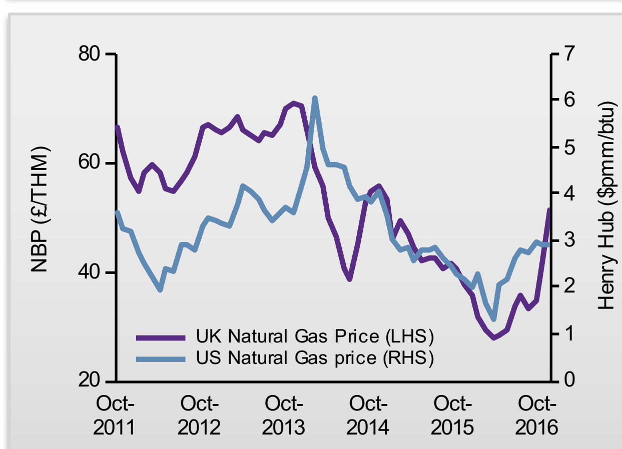
Source: Bloomberg, EIA

Rig Count



Source: Baker Hughes

Gas Price



Source: CapIQ

* Cushing OK is a key independent crude oil storage location. Current capacity around 74 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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