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Q&A

Interview: Resetting the Services Sector

Restructuring is taking over the oil and gas industry corporate landscape, with the decimated oil-field services sector at the leading edge of this trend. Rogers Herndon, managing director at restructuring giant Alvarez and Marsal, sat down with Energy Intelligence to discuss how services firms are starting to understand their future in a smaller, leaner sector over time. Herndon's various roles across the energy industry include five years as CEO for US onshore-focused Quintana Energy Services.

Q: What are oil-field services companies doing to navigate this environment?

A: We see that management teams have done quite a lot. Our analysis shows average cost reductions from the end of 2019 to the second-quarter 2020 totaled almost 30% in G&A [general and administrative costs, such as salaries]. When we step back and look at G&A as a percent of revenue during 2019, that number was closer to 10%. Fast forward to the second quarter and despite having cut 30%, now G&A as a percent of revenues increased to over 20%. Why? Revenue has dropped by as much as 60% in some cases. I think everybody would agree that 20% G&A as percent of revenue is not sustainable. Where do we go from here? Will revenue rebound, and when, or do we need to rethink our cost structure to adjust to the current environment?

Q: That would seem to depend on the outlook for oil prices. We've seen recovery from the bottom, but is it enough to help services companies survive?

A: Commodity prices are right now in what I call a dead zone. They're just high enough where they're above shut-in economics to a large degree ... but they are below the threshold that's required for any meaningful ramp in drilling and completion on a large scale. You're in this dead zone, and so that would lead you to temper your expectation of revenue growth.

Q: What should companies do next?

A: Companies really are going to get focused on what we consider to be zero-based resets — resetting cost structures, operating cost structures, operating locations, geographies, offerings, as well as the G&A component — design it to the current new near-term normal and do it in a way where you get the benefit

of that operating leverage when the revenue does come back in line. We think it's very commendable what companies have done. I mean, they worked hard, they got [costs] out and now things have stabilized to a degree. Now it's time to really bite the bullet and work on the next 12 to 18 months. The added element in all this is you think forward to what a recovery would look like when we get out of this dead zone and drilling and completion resumes.

Q: When the market does recover, what will it look like? How might it change?

A: One of the main differences is really the makeup and concentration of the upstream customer base. Of the number of rigs that we've got, how many operators control 50% of those rigs? The number is roughly midteens. If you go back two-plus years ago, that number is easily double that. So if you imagine a 100-rig increase from here, which is quite a large percentage increase. Which operators stand the next 100 rigs up or the equivalent frac fleet count? The majority will be those 15 or so players. The next conversation is going to be around the top five or 10. They will likely take a bigger chunk of the pie. It will be a much different landscape than it was in 2018-19.

Q: So how should the services sector prepare for that?

A: In really every oil-field services company, you've got to map that future out in terms of what basins and what your customer base is going to look like. If you're not relevant to that concentrated, and continuing to be concentrated, customer base, you're going to have some challenges. You've got to become relevant.

Q: Oil-field services strategies seem to have swung from one's focused on market share to a focus on margins. Will this change persist?

A: One of the things that we've seen working with our customers broadly is how to improve margin, how to defend margin, how to defend cash flow, how to become cash-flow neutral to positive. In this environment, a big part of that exercise is getting rid of unprofitable revenue. It actually goes counter to market share. It's getting rid of unprofitable or neutral margin [offerings] and then focus on the truly profitable differentiated

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product services and geographies. That's largely a defensive and appropriate business measure that's going to continue as we grind through this.

Q: That would imply that we will need to see further consolidation, something that has been talked about for years. Are we getting there?

A: I think what we've seen evolve out of the second quarter sets the stage for everybody to kind of check the social issues [of thinking of each other as competitors] at the door. How do you really survive in an uncertain timeline with G&A at these levels? Those are the ingredients I think were needed to bring people to the table and hopefully negotiations aren't breaking down over a percent of ownership here. Honestly, that has to happen.

Q: What are your thoughts on Schlumberger's sale of its North American frac fleet to smaller rival Liberty Oilfield Services?

A: A transaction such as this has the potential to be a win-win for both parties and for the rest of the completions market. This benefits North American onshore oil-field services players by removing excess capacity by either permanently decommissioning assets or using it as maintenance equipment. For Schlumberger, it allows them to pursue an asset-light operating

strategy while maintaining a meaningful equity stake in a large pressure pumping business. For Liberty, through consolidation, economies of scale are created along with opportunities to deliver supply chain and operating efficiencies by vertically integrating wireline and frac sand assets.

Q: Does it present a blueprint for further consolidation in the sector through similar equity-driven deals, or is the setup too unique to replicate?

A: There are plenty of other opportunities for value creation consolidation. However, the ability to check all the boxes of technology, market share, balance sheet, vertical integration and operating efficiencies on such a large scale will be tough to replicate.

Q: How does restructuring/bankruptcy impact the pace of consolidation?

A: It does move us definitely in that direction. This is a very key area that noteholders are focused on. When they're in these conversations, it's around the cost structure and the viability long term. It's less about making up on a 2020 recovery. That's a gamble. It's more about, let's make a bet on platforms that we can get cost efficiencies out of, that have differentiated platforms, and that will be the consolidator. So if you're going to make a bet on a recovery, that's how you want to make the bet. ■