# Oil & Gas Observations

## Q1 2017

# OIL PRICE

OPEC members have used 'excellent' and 'unprecedented' to describe the first month's compliance with pledged cuts. OPEC-11 compliance is seen at a historical high of 82 percent of the pledged 1.16 million barrels per day cut – compliance during the 2009 cuts was 60 percent. The market has been a strong believer in the OPEC strategy; Reuters reported on 22 February that net long positions held by funds sat at 144 million barrels of WTI future and options, the widest margin versus net shorts since data was first tracked 10 years ago.

Price has held in the mid-50 dollars per barrel, although it is refusing to increase to the $60/bbl heights anticipated for the second half of 2017 by market watchers like Goldman Sachs.

In contrast, futures contracts are indicating strength in the crude market. The contango in the oil prices has continued to evaporate – front month (m) to 6 month (m+6) contango has fallen from +$4.25/bbl in early November 2016 to a mere $0.61/bbl by mid-March. Current contango levels are insufficient to justify multi-month storage of oil and create an incentive for oil to be released from storage.

Market watchers have begun to ask whether OPEC will extend its production cuts beyond its planned 6 months. Patrick Pouyanne, CEO of Total has already indicated that he is convinced cuts will be expected due to current high stocks. As we edge towards April, Brent price has slipped towards $50/bbl, perhaps a sign that market bulls may have declared OPEC's victory too soon. OPEC meets in May to decide the future strategy.

# A&M VIEW

## ARE WE SEEING A FALSE DAWN?

We caution that it is too early to declare the beginning of recovery in the oil market. Global stock levels are the primary measure of success; whilst moving towards a backwardated price structure is a welcome situation, other fundamentals point stubbornly towards a continuing malaise:

- **OPEC compliance is poor:** Whilst 82 percent compliance is historically impressive, this is primarily achieved via over-performance by Saudi Arabia, Algeria, Gabon, Iraq and Venezuela – collectively 31 percent of pledged cuts had less than 30 percent compliance
- **Global stocks are at record highs:** In mid-February the EIA showed a seventh straight build in U.S. crude stocks
- **Drilled but uncompleted** (DUC) count in the U.S. after a period of stabilisation in 2016, has risen by 7 percent since September 2016 to sit at 5381 at the end of January. With relatively low cost to put into production, the rise in DUCs can be viewed as further adding to crude stocks
- **U.S. production continues to rise.** The U.S. rig count has now risen 86 percent since June 2016, bringing new production to market

We remain concerned that supply side measures appear to have had limited impact upon key measures. We fear that we are seeing a false dawn in market recovery. Market players should continue to protect against a scenario of a deterioration in pricing.

# ACTIVIST ACTIVITY

Like it or not, shareholder activism is a growing factor in the corporate world globally. Activist investors have typically been more active in the U.S. but over recent years they have been looking further afield with Europe and the U.K. in particular being prime targets. Indeed there were public activist campaigns launched against over 100 target companies in 2016 in Europe, representing an increase over 2015 of over 100 percent – and these are just the public campaigns – many more campaigns go unreported.

The Oil & Gas sector is a growing target area for activists. Recent target companies have included BP, NRG Energy, Transocean, Hess Corp and Marathon. There are also many examples of campaigns that have not been made public.

The launch of an activist campaign can lead to a range of issues for incumbent management and Boards, including time consuming and expensive counter-actions, shareholder persuasion and proxy battles. An awareness of what draws such activists, and the resulting ability to manage or avoid the triggers can benefit all parties.

# A&M VIEW

## WOLVES AT THE DOOR

A&M has undertaken a detailed analysis of all public, and some private, activist actions in Europe in 2015 and 2016. Based on that analysis it seems clear that such actions against Oil & Gas businesses in Europe is likely to grow over at least the next two or three years. The continued reduced revenues and challenges to Gross and EBITDA margins are leading to a widening range of success by management teams in addressing these issues. Management who are behind the curve in this regard are more likely to see the wolves gathering at the door and demanding improved results. Where management teams do not deliver, they will find a growing appetite for shareholders to take decisive action.

Another key area of activist pressure is likely to be around M&A. The continued relatively low oil price makes greater consolidation, particularly within the Upstream sector, highly economically attractive. The identification of the right targets with solid synergies and positive net value-add post-merger/acquisition will reap market-beating rewards for the parties (and wolves) involved.

# E&P – RISE OF THE INDEPENDENTS

New entrants may be providing an unexpected lifeline to the North Sea. Whilst for many years independents such as Premier Oil, Enquest and Apache were viewed as the natural consolidators in the sector, balance sheet woes and large capex commitments have limited their ability to profit from the ongoing exit of the majors from the North Sea.

Instead several new independents, with large ambitions have emerged. Chrysaor (backed by Barclays) recently acquired c.50 percent of Shell's North Sea assets for $3.4 billion. Siccar Point energy (backed by Blackstone and Blue Water Energy) acquired OMV's North Sea assets for c.$1 billion. Chemical player Ineos created an upstream platform through its acquisition of the former RWE North Sea assets from Letterone for $750 million.

With a common characteristic of management by industry veterans, backed by private rather than public funds, these more naturally nimble independents bring a fresh approach to a troubled sector.

# A&M VIEW

## POSITIVE TREND FOR SURVIVAL OF THE SECTOR

Though success is far from guaranteed, we see the rise of the new independents as a positive trend for the industry:

- In a mature basin, many new projects are incremental and relatively small scale. In larger, often capex constrained, established players such projects are likely down the interest curve and may not be developed
- A private equity mindset, in particular a ruthless pursuit of reduced costs, is vital to survival in the sector and something new independents bring. Ineos being a case in point from its downstream experience on cost improvement and asset investment which we expect to see deployed in their North Sea portfolio
- New entrants can bring new ideas. We expect this willbring change in vital areas such as infrastructure access and methods of project finance

We expect the trend of divestment by majors to continue, with the potential emergence of other private equity backed new independents; this may be vital for the sector survival.

# DELAYED EFFECTS IN THE DUTCH OFS MARKET

Many of the major players in the Dutch OFS market including Boskalis, SBM, IHC and Fugro have recently announced significant losses over 2016.

Due to the longterm nature of a large part of the projects for these companies, the effects of the drop in oil price and subsequent cut of capex budget of the oil majors now only becomes visible through the impairment of assets, provisions for loss making projects and restructuring costs.

Ironically it looks like the drop from $100 a barrel to $30 is now starting to hit, despite the recovery of oil prices over the last quarters.

Management are right-sizing their organisations to the new reality as they expect the market to remain weak for the coming years (as the delay effect goes two ways).

## A&M VIEW

### OPPORTUNITIES FOR THE BEST IN CLASS

The delayed effects of the oil crisis in the Dutch market appear to more apparent than in other European countries and especially when compared to the U.S. We feel that this could bring opportunities for the 'best in class' companies and private equity investors because of:

- Companies need to dispose of non-core assets to free up capital (also to pay off debts)
- No cash available for M&A activities
- Problems at the large Dutch companies will have a negative impact on their suppliers
- Multiples should come down especially when compared to other (overheated) sectors

**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:**

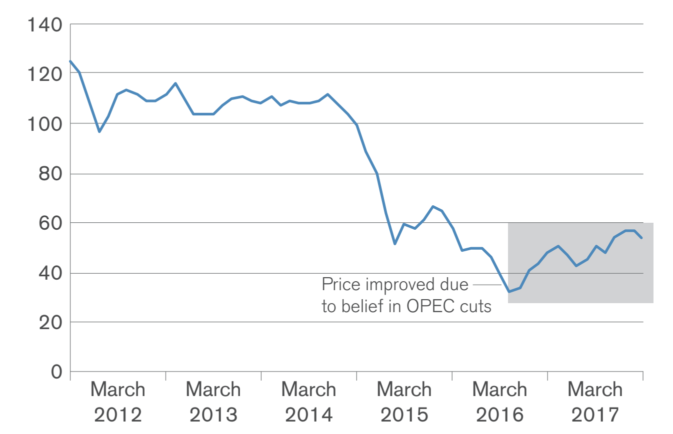
Assist companies pursuing acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/ carve-out integration planning and execution.

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.

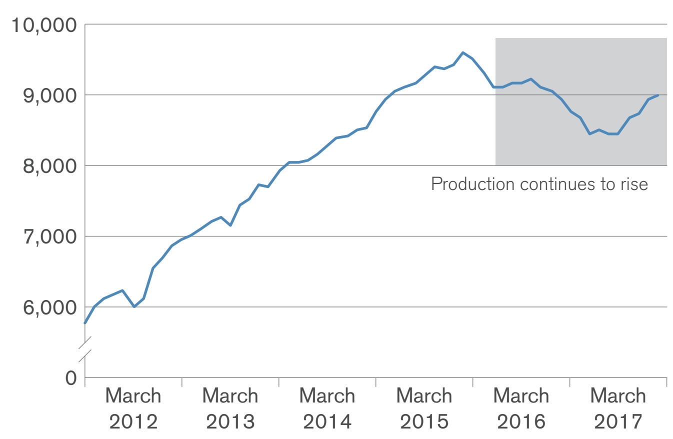
# OIL & GAS OBSERVATIONS – KEY MARKET SIGNALS

### Brent Front Month Oil Price ($/bbl)



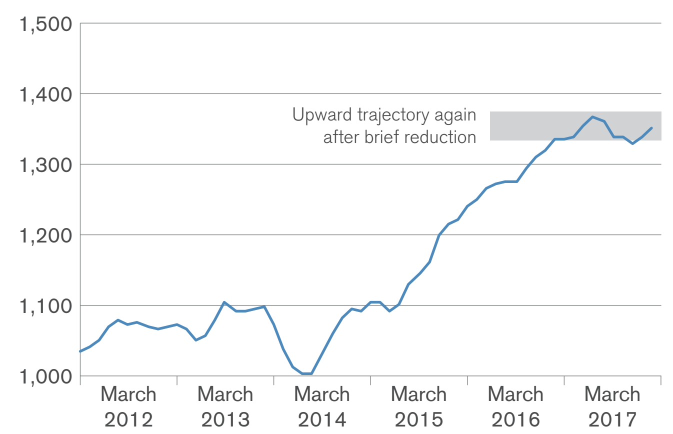

Source: CapIQ

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




Source: EIA

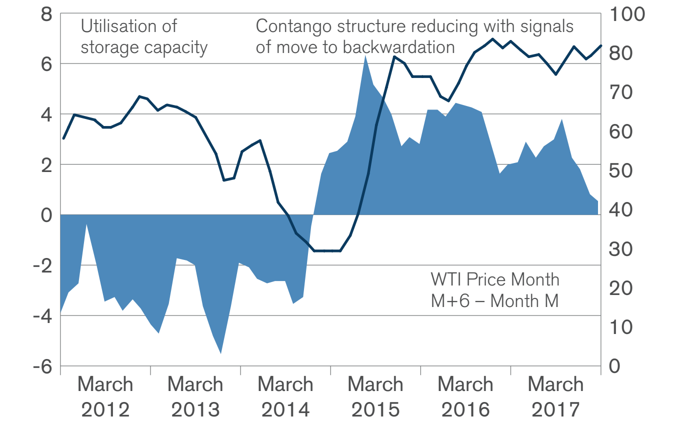
### U.S. Crude Oil Stocks (Exc SPR) (mmbbl)




Source: EIA

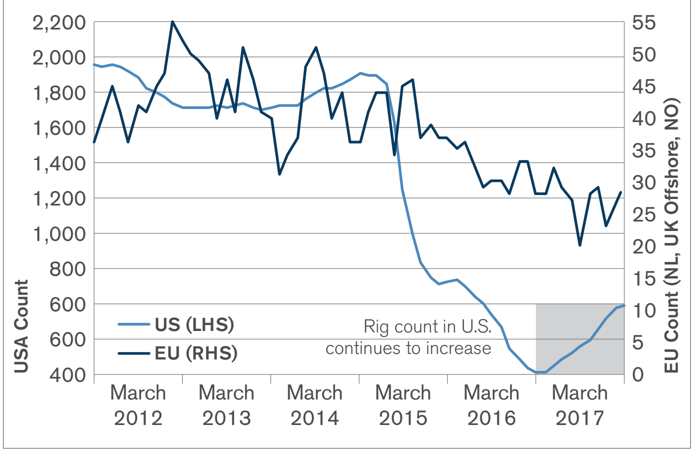
### Brent Month M+6

M ($/bbl) (LHS) & Cushing* Utilisation (%) (RHS)



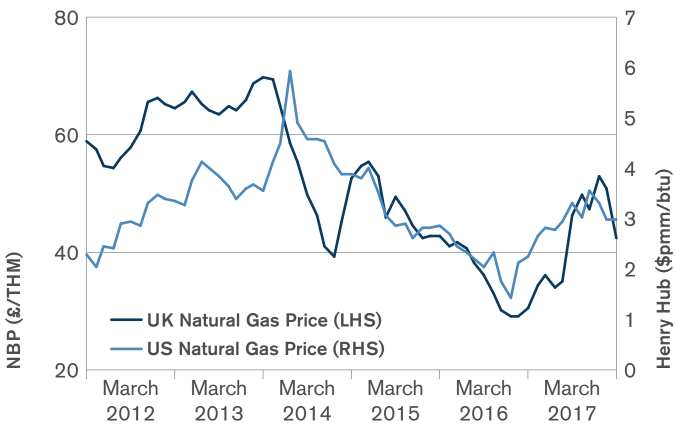

Source: Bloomberg, EIA

### Rig Count




Source: Baker Hughes

### Gas Price




Source: CapIQ

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