Oil and gas
Capital Confidence Barometer
Middle-market deals to predominate
Innovation, complexity and disruption define the new M&A market

Our 12th Global Capital Confidence Barometer finds the global M&A market maintaining the positive momentum that developed during 2014. For the first time in five years, more than half our respondents are planning acquisitions in the next 12 months, as deal pipelines continue to expand.

Executives express increasing optimism in the global economy, with much broader consistency across geographies than in 2014. This economic optimism, combined with steady confidence in corporate earnings and other leading market indicators, is fostering an environment where companies are preparing bolder moves, including M&A, to generate future value.

Our survey reveals three key reasons for the sharp increase in dealmaking intentions. First is the arrival of new entrants – both start-ups and companies returning to the market after staying on the sidelines for several years. Second, divergent economic conditions are accelerating cross-border M&A, as existing momentum in many developed markets is further fueled by falling oil prices and currency fluctuation. And third, disruptive innovation is driving dealmaking at every level of the enterprise.

Of course, challenges remain prominent on the boardroom agenda. Greater volatility in commodity and currency markets, geographic divergence in economic conditions and monetary policies, and lingering geopolitical concerns all present complexity. As well, rapid technological change is creating new risks such as cybersecurity, which has emerged as a core business issue that must be managed as part of the dealmaking process.

Notwithstanding these risks, the overall view in this Barometer is of a global M&A market on an upswing after years of crisis. Companies are learning to create opportunity and drive growth amid a more competitive economic and geopolitical landscape. After a half-decade of stagnation, we are seeing the bold beginnings of a new kind of M&A market – one marked by innovation, complexity and disruptive change.

Key global M&A findings

- 56% of companies expect to pursue acquisitions in the next 12 months
- 73% of M&A activity will be innovative investment
- 50% increase in intent to pursue upper-middle-market deals
- 47% of companies intend to complete more deals than in the prior year
- 45% are proactively guarding against cyber breaches in their M&A process
Cautious optimism defines the new oil and gas M&A market

Our 12th Capital Confidence Barometer characterizes the oil and gas M&A market once again as one of cautious optimism. There is increasing optimism around the global economy, but there are still big risks for the oil and gas sector from geopolitical instability and uncertainty (e.g., as usual, the Middle East and North Africa, the widening battle with Islamic extremists, the ongoing dispute between Russia and Ukraine, the unresolved Iranian sanctions issue), from commodity and currency volatility, in particular around crude oil prices and the strengthening of the US dollar.

Since last fall, sluggish oil demand growth has collided with strong supply and a repositioning by OPEC to create a sharp downward movement in global oil prices. Oil and gas companies have responded to the price collapse with an intense internal focus – aggressively cutting spending and costs, postponing new final investment decisions (FIDs), and improving operational efficiency.

Uncertainty about where oil prices will land after their months-long slide has dramatically disrupted the global market for oil and gas M&A activity. After a very strong second half of 2014, the first quarter of 2015 was the quietest in recent memory. But it’s not just the level of oil prices – it’s the volatility. As long as buyer and seller agree on pricing outlook, then a price at which to do a deal can be found. Sellers typically set price expectations based on the oil/gas price at the time they decided to sell, while buyers can be more current. Until the uncertainty diminishes and we have some clarity about the oil price trajectory, deals will be harder to do.

For most of the last three years, growth has led the strategic agenda for oil and gas companies. Now, unsurprisingly, it’s much more about optimizing the portfolio, managing the cost base and managing the risk profile. Only the US midstream, fed by the huge infrastructure requirements of the “shale revolution,” remains a hot spot in an otherwise lackluster deal market.

Altogether this means more oil and gas assets on the market now than in many past years, and while what has been described as a “wall of money” waiting in the wings, in a buyer’s market, deals are taking longer to close. The megamerger of Shell and BG announced early in the second quarter has been seen by some as the harbinger of renewed strength in the M&A market for oil and gas. While we think that the deal is reflective of a specific clear strategic fit, rather than a definitive shift in the market, we do, however, see grounds for some optimism performance oriented oil and gas dealmaking, in the second half of the year.

Key oil and gas findings

- 97% expect that the global economy will improve or at least be stable over the next 12 months
- 34% see increased volatility in commodities and currencies as a big economic risk over the next 12 months
- 94% are primarily focused on raising/optimizing capital, as opposed to investing or merely preserving capital
- 99% are expecting the oil and gas deal market to improve or at least remain stable over the next 12 months
- 56% expect their companies to actively pursue acquisitions over the next 12 months
Macroeconomic environment

Despite greater confidence in global economic stability, increasing volatility in commodities and currencies and continuing disruptive geopolitical influences lead to cautious optimism for future M&A.

Oil and gas executives are optimistic about the global economy

There has been a sharp upswing in confidence with 85% of oil and gas respondents now seeing global economic conditions improving. Greater confidence in economic improvement allows companies to plan more freely for growth and M&A. Another positive signal is that the number of those who believe the economy is declining has dropped to negligible levels.

But increased volatility in commodities and currencies has become major economic threat

Increased global and regional instability due to continuing tensions between Russia and Ukraine, the unresolved Iranian sanctions issue, and the spreading conflicts with Islamic extremists in the Middle East are generally viewed as the greatest economic risks. However, due to the sudden and steep fall in the price of crude, and increasing uncertainty about future prices, oil and gas respondents now view increased volatility in commodities and currencies as an equally important risk.

Leading to hiring freeze and planned reduction of workforce numbers

Due to uncertainty about the short-to-medium term outlook for the price of crude, the number of oil and gas companies that plan to hire has come down by two-thirds since October 2014. The number of companies that plan to reduce workforce has increased.

What is your perspective on the state of the global economy today?

What do you believe to be the greatest economic risk to your business over the next 6–12 months?

With regard to employment, which of the following does your organization expect to do in the next 12 months?
Companies focus on conserving cash while looking for acquisitions

Given the current oversupply, the implications of the accompanying price drop are still very real – lower prices mean that many projects are no longer viable. So, while today’s environment may not exactly be a new normal, the uncertainty is still creating significant instability. As executives seek answers and work to develop a game plan for the future, their immediate strategic response is to conserve cash by reducing dividends, postponing FIDs and reducing costs. According to Wood Mackenzie, over 125 companies have announced cuts in capital expenditures, which will reduce upstream exploration and development expenditure by about 25% in 2015. Having said that, companies with a stronger balance sheet are actively scouting the market to make opportunistic acquisitions.

Cost reductions and operational efficiencies take precedence over growth

Growth is no longer a key focus area, with cost reduction and operational efficiency taking its place. Our survey shows a more than threefold increase over the last two years in the number of respondents with a primary focus on cost reductions and improving operational efficiencies.

As margins become increasingly squeezed across the value chain, operational excellence has never been more critical to drive positive returns. Across the industry, companies are under pressure to contain and reduce costs through efficiencies in the operations they manage.
Fundamental global changes reshaping oil and gas corporate strategies

Q: Which of the following will impact your core business and your acquisition strategy most in the next 12 months?

**Entrepreneurship rising** – Growth in global entrepreneur class will require more supportive ecosystems

- Core business: 29%
- Acquisition strategy: 33%

Entrepreneurs are the lifeblood of economic growth worldwide, both as employers and as producers of innovative products and services. They drive upstream and downstream value-chain activities. The growth and prosperity of all economies – developed and emerging – rely on robust entrepreneurial activity.

While some entrepreneurial activity is still motivated by necessity, “high-impact” entrepreneurship, once largely confined to mature markets, now drives emerging market expansion. Indeed, many emerging-market entrepreneurs are building scalable enterprises that capitalize on local needs and serve as business role models.

The rise of this entrepreneurial spirit is accelerating the introduction of new entrants to sectors that rely on intellectual property, such as consumer products, life sciences and technology. This means both challenges for existing players and opportunities as innovative start-ups attract MBA activity.

**Global marketplace** – Economic power shifts east and south, driving patterns of trade and investment

- Core business: 40%
- Acquisition strategy: 10%

Faster growth rates and favorable demographics in key emerging markets are expected to feature prominently over the next decade, as the gulf between developed and emerging countries continues to shrink and a new tier of emerging nations is driven by its own nascent middle classes. Increasingly, innovation is taking place in emerging markets, with Asia as a major hub. At the same time, the battle for talent will be increasingly fierce, driving greater workforce diversity to secure competitive advantage.

The world’s economies are expected to remain highly interdependent – via trade, investment and financial systems – driving the need for stronger policy coordination among nations and resilient supply chains for companies operating in this environment. At the same time, domestic interests will continue to compete with the forces of global integration. These trends will affect companies’ core business and acquisition strategies regardless of location, but executives nonetheless must consider not only what they do, but where they operate.

**Digital future** – Technology is disrupting all areas of enterprise, driving opportunities and challenges

- Core business: 21%
- Acquisition strategy: 12%

Fueled by the convergence of social, mobile, cloud and big data, and the growing demand for anywhere, anywhere access, technology is disrupting all areas of the enterprise – across industries and geographies.

Key to operational efficiency within oil and gas organizations has been the adoption of digital oilfield technology to enhance reservoir recoverability, optimize production, reduce health, safety and environment (HSE) risk and improve collaboration with oilfield services companies.

Operational efficiencies top oil and gas boardroom agendas

Q: Which of the following has been elevated on your boardroom agenda?

**Strategic decisions (spin-off/ IPO)**

- Core business: 9%
- Acquisition strategy: 3%

**Returning cash to shareholders**

- Core business: 3%
- Acquisition strategy: 4%

**Changing commodity prices**

- Core business: 16%
- Acquisition strategy: 32%

**Reducing costs/ improving margins**

- Core business: 44%
- Acquisition strategy: 3%

Given the focus on costs, reducing costs/improving margins becomes the number one boardroom agenda. Many oil and gas companies also see the current environment as a great opportunity to acquire cash strapped and distressed companies, leading to increased focus on evaluation of acquisition opportunities. Enthwile major issues such as returning cash to shareholders or shareholder activism have now been pushed far down the table.

Companies are focused on optimizing their allocated capital

**Raising: Do we have the right capital structure to meet our strategic priorities?**

To weather the current downturn or make opportunistic acquisitions, companies expect to raise equity and/or take on more leverage. 16% of oil and gas executives expect to focus on raising capital.

**Investing: What is the best way for our company to grow – and is it aligned to our core business?**

Companies are scaling back capex, with only 6% of oil and gas companies devoting their attention and resources to investing.

**Preserving: How can we improve the performance of our assets?**

As companies come out of survival mode and focus on operational optimization, executives are no longer focused on preserving capital but are turning to other Capital Agenda areas.

**Optimizing: Which steps can we take to maximize our portfolio’s performance?**

More than 57% of oil and gas executives are planning to optimize capital by shifting their focus on reducing costs and improve operational efficiencies.

A strong Capital Agenda should be at the core of all strategic boardroom decisions. It is the framework for all growth and capital management questions.
M&A outlook

M&A activity in 2014 surpassed pre-crisis levels. Although opportunities are abundant, lower capital allocation for acquisitions and execution challenges will lead to more M&A activity in the middle market.

M&A intentions stable as market digests record deals in 2014

M&A activity in 2014 reached its highest level in the last five years, but oil and gas executives see a more stable global M&A market in 2015, with more than half expecting stability and nearly half expecting improvement.

However, due to the increased price volatility, the deal market in Q1 2015 collapsed, with total reported deal value falling by more than 70% from Q4 2014. The second quarter has begun well with the announcement of the Royal Dutch Shell/BG Group megamerger and increased news flow about other potential deals. With private equity firms having raised a lot of money and currently waiting on the sidelines, deal activity should pick in the coming quarters.

Sharp uptick in expectations to pursue acquisitions

The sudden and steep drop in the price of crude has severely impacted oil and gas companies with a primary focus in upstream and oilfield services, forcing many companies to propose opportunities to merge to cut costs and quickly raise cash capital by divesting assets/issuing debt and/or equity. As more consensus on price develops, expectations for deal activity over the next year have risen significantly.

No shortage of quality assets available for acquisition

Due to the increase in the number of opportunities to make acquisitions, the percentage of oil and gas respondents that expect to pursue an acquisition has almost doubled since April 2014. The quality of acquisition opportunities has also improved since April 2014, but the likelihood of closing deals has declined slightly.
Stable valuations to enable dealmaking

More deals during the next 12 months than the prior 12 months

With increased focus on middle-market deals, oil and gas executives are confident of executing deals. More than 60% of the oil and gas executives expect to complete at least two deals during the next 12 months. Furthermore, more than 50% of oil and gas executives are confident of executing more deals in the next 12 months than deals completed in the prior 12 months. However, unlike in the past, wherein growth was the primary driver for deals, the current environment is more focused on identifying companies that have a more strategic fit or will help reduce costs.

Middle-market deals to dominate

Increased focus on middle-market deals

Whilst last year’s announced acquisition of Baker Hughes by Halliburton and the recent Shell/BG transaction indicate it is possible to conduct very large acquisitions in the current climate, our survey indicates these will not be the norm for the bulk of transaction activity. The growth of M&A is likely to be defined by the shift in focus towards middle-market deals as more than 70% of oil and gas companies have allocated US$250 million and under for acquisitions, and are looking to make deals at or within that value.

More executives targeting acquisitions closer to home

Oil and gas executives see their acquisition and investment focus increasing across a wide array of markets, both developed and emerging. However, more than two-thirds of oil and gas respondents plan to transact in their immediate regions. Companies are planning to invest the majority of acquisition capital in developed markets, but emerging markets will still be targeted. However, slower growth across many emerging markets, driven by lower commodity prices, impacts M&A decisions.

The largest category of executives – more than 70% – are focusing their M&A strategies on cross-border transactions in their immediate region, driven by the ease of acquiring in common economic trading areas. This intention to acquire close to home is also boosted by the familiarity of investing in adjacent countries, which eases the path to cross-border M&A.

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Cybersecurity around dealmaking is a key concern for executives

implications of a cyber attack
Potential business risks of a cyber attack include theft of R&D and intellectual property, financial fraud and reputational damage. The disruption caused by an attack may extend beyond the company itself to the industry and the broader market.

In the case of M&A specifically, companies’ systems can be hacked or compromised during the deal process, with the intent to gain insider information. One obvious risk is manipulation of the stock price and the deal process. A less obvious but equally significant risk is the potential to gain strategic information that could be used to disrupt the company’s core business and competitive position.

Identifying the risk is the key step in managing it
The M&A process centralizes an organization’s strategy and information on all of its functions in one repository. This presents a unique cyber risk situation that must be managed.

One of the most important ways to manage cyber risk during the M&A process is to proactively determine who may be targeting the organization – and which information they might want to steal. While identifying these threats, companies should consider not only potential attackers from outside the organization but also entities with authorized access, such as supply- and distribution-chain vendors as well as other business partners. Even the target company in an M&A transaction could pose a threat, because any weakness in its security program could be exploited. Once these risks are identified, preventive steps can be taken to alleviate them.

Regulatory changes to drive M&A

Changes to the regulatory or legislative environment to drive M&A
Oil and gas executives see changes to regulatory or legislative environments as great opportunities that will impact their acquisition strategies. The opening up of the upstream sector in Mexico and Myanmar has also generated increased interest from both international and national oil companies. With companies trying to reduce costs and optimize existing operations, increased focus on gaining market share in existing geographical markets will be a key factor while pursuing acquisition.

But poor operating cost assumptions led to deals not meeting expectations
Oil and gas executives believe that poor operating cost assumptions was the most significant factor that prevented recent deals from meeting expectations. Falling product sale prices/ margins due to the drop in the price of crude was the second-biggest factor for deals not meeting expectations.

Many companies continue to attribute failure to achieve synergies and poor execution of integration as other reasons for deals not meeting expectations.

Fifty-two percent of oil and gas executives see changes to regulatory or legislative environments as great opportunities that will impact their acquisition strategies.
• In February and March, we surveyed a panel of more than 1,600 executives in 54 countries; more than 850 were CEOs, CFOs and other c-level executives, and more than 100 were from the oil and gas industry.

• Respondents represented 18 sectors, including financial services, consumer products and retail, technology, life sciences, automotive and transportation, oil and gas, power and utilities, mining and metals, diversified industrial products, construction and real estate.

• Oil and gas companies’ annual global revenues ranged from less than US$500m (16%); US$500m–US$1b (37%); US$1b–US$3b (10%); US$3b–US$5b (21%) and greater than US$5b (16%).

• Oil and gas company ownership was publicly listed (74%), privately owned (21%), family-owned (1%) and government/state-owned (4%).
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