Oil and gas

Capital Confidence Barometer

Cautious optimism to fuel M&A rebound
94% expect the global economy to improve or at least be stable over the next 12 months

53% see increased geopolitical instability as the greatest economic risk over the next 12 months, up sharply from six months ago

61% are primarily focused on optimizing capital, as opposed to merely preserving capital; this is a sharp reversal from a year ago when companies were primarily focused on investing

53% are expecting the oil and gas deal market to improve over the next 12 months

68% expect that their deal pipeline will increase over the next 12 months, almost double compared to expectations six months ago
A note from Andy Brogan, Global Oil & Gas Transaction Leader

Our 11th Capital Confidence Barometer characterizes the oil and gas M&A market as one of cautious optimism. The global economy is seen as increasingly stable and dealmaking expectations are increasing, but they nonetheless remain relatively modest.

The issues surrounding the oil and gas M&A landscape are primarily uncertainty and volatility. Geopolitical risk remains very high, given recent events in the Middle East and North Africa, the widening battle with Islamic extremists, the dispute between Russia and Ukraine, the unresolved Iranian sanctions issue and the Ebola epidemic in West Africa. While the broader economy is increasingly seen as stable, growth is still anemic and has notably slowed oil demand growth.

As the industry has moved into the autumn, this sluggish oil demand growth has collided with strong supply growth to create a sharp downward movement in global oil prices. Uncertainty about where oil prices will land after their months-long slide will likely disrupt the global market for oil and gas acquisitions over the short-term. 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. While uncertainty continues at high levels, deals will be harder to do.

While the oil and gas industry is no stranger to volatility, for the past three years the fluctuations in oil prices have calmed dramatically, creating a solid starting point for oil and gas dealmakers – but that is changing now. Additionally, we have seen activity over the last two years turn the seller’s market into a buyer’s market.

In particular, the state-owned Chinese oil companies have piled up on crude reserves and are distracted by on-going restructuring, and can no longer be counted on as an aggressive bidder in major auctions. Likewise, often pressured by shareholder activists, US oil firms are pulling back on international investments and pumping more cash into their US operations.

Two or three years ago, growth led the strategic agenda for oil and gas companies. Now 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, but in the buyer’s market, deals are taking longer to close. But as oil prices adjust to a slower global economy, we do see some cautious optimism for dealmaking, which is supported by the resilience the market has historically shown.

A note from Pip McCrostie, EY Global Vice Chair, Transaction Advisory Services

Our 11th Capital Confidence Barometer predicts healthy growth for M&A globally, which should take the market back to levels last seen before the financial crisis.

Acquisitive appetite has increased and deal fundamentals – credit, cash and prices – are strong, as is confidence in economic stability. The biggest indicator of this positive sentiment is deal pipeline, which has increased by a remarkable 30% since April. In addition, two-thirds of executives expect M&A pipelines to expand further over the next year – more than double the number expecting expansion six months ago.

As we predicted in our previous Barometer, 2014 has seen a big increase in multibillion-dollar deals. Now, increasing competition at the top end and a renewed focus on growing core businesses will fuel more middle-market deals.

The majority of acquisitive companies are now focusing on M&A to strengthen their core business, with an eye to boosting market share, managing costs and improving margin growth.

Megadeals are set to continue. However, the next chapter of the M&A story should be middle-market deals fueling an M&A rebound globally.
Macroeconomic environment

Despite an increase of disruptive geopolitical influences, greater confidence in global economic stability lays the foundation for future M&A.

The number of executives that view the global economy as stable has more than doubled in the past 12 months.
Oil and gas executives are cautiously confident in the stability of the global economy

While fewer executives today believe the global economy is improving, the number that believe the economy is stable has more than doubled. Greater confidence in economic stability allows companies to plan more freely for growth and M&A, and stability is an essential ingredient in a healthy M&A environment. Another positive signal is that the number of those who believe the economy is declining has dropped to negligible levels.

But sharply rising geopolitical risks remain the greatest economic threat

Although they do not expect major shocks to the economic or financial system, our respondents identify geopolitical instability as the biggest potential threat to their business. Driven by tensions between Russia and Ukraine, the unresolved Iranian sanctions issue, the Ebola epidemic in West Africa, spreading conflicts and extremism in the Middle East, geopolitical issues figure more prominently than they did six months ago. In contrast, concerns about slowing growth in emerging markets have lessened.

Outlook for corporate earnings shows growth

The number of executives who are confident about the outlook for corporate earnings has more than doubled over the last 12 months. Confidence in credit availability and short-term market stability was also up strongly for our oil and gas executives.

Confidence in market indicators driving hiring intentions

Improved sentiments are driving hiring intentions. Oil and gas companies are significantly more confident about hiring than they were six months ago: more than half (54%) expect to create jobs or hire talent, up from 37% in April 2014. The number of companies planning to reduce their workforce has dropped to 5% from 14% six months ago.
Corporate strategy

Companies are making moves to position themselves for growth in a challenging environment shaped by fast-emerging global megatrends and enhanced shareholder engagement.

In line with their growing confidence in global economic stability, more companies are expanding their core business by changing their mix of products and services and increasing product introductions. Our survey shows a fivefold increase in the number of companies adopting both of these strategies.
Cost reductions and operational efficiencies take precedence over growth

For oil and gas companies, the focus on growth is distinctly tempered by a disciplined approach to cost reduction and operational efficiency, as executives remain mindful of lessons learned during the global financial crisis. Fewer companies are preoccupied with maintaining stability and even fewer are focused on survival.

Organic growth centers on higher-risk core capabilities, but some lower-risk strategies also remain attractive

In line with their growing confidence in global economic stability, companies are taking on more risk as they expand their core businesses by changing the mix of products and services. Our survey shows a fivefold increase from a year ago in the number of oil and gas companies changing their product mix.

This reflects a pattern of complex activity where companies are divesting non-core units and strengthening and expanding their core and complementary businesses through sophisticated transactions, such as asset swaps, spinoffs and joint ventures.

Capital allocation to M&A remains measured and disciplined

Oil and gas companies are not planning acquisitions at the expense of organic growth. Rather, they can be expected to pursue only those deals that are aligned to their strategy.
Activist shareholders influence the boardroom agenda

The C-suite agenda, in particular the organic and inorganic growth priorities, is increasingly being swayed by the growing influence of shareholder activism. In the past year, activists at several major US oil and gas companies have forced modifications in the strategic direction of the company.

Q: Which of the following has been elevated on your boardroom agenda as a result of shareholder activism? Select up to two.

Cost reduction: 52%
Strategic divestment: 40%
Portfolio analysis: 28%
Cash dividend payments: 21%
Acquisition: 17%
Spin-off/IPO: 11%
Our shareholders have not raised these issues: 11%
Share buyback: 4%

With growing success and greater influence, activist investors continue to rise in prominence as the market enters a new phase of low but stable growth. Cost management, portfolio optimization and returning cash are key areas of focus. M&A will also likely be part of the story with asset sales and acquisitions as part of the ever-broadening activist dialogue. As a result, companies are stepping up their efforts to manage shareholder activism, enhancing communication with stakeholders, monitoring signs of activist pressure and performing ongoing portfolio reviews.

Q: How are you preparing to manage any shareholder activism?

Not applicable: 1%
Making management changes as a result of activist intervention: 8%
Monitoring early warning signs for activist pressure: 11%
Ensuring we have open and proactive lines of communication with our shareholders: 14%
Conducting an “activist audit” – continue with improvement around cost, efficiencies and performance: 17%
Conducting ongoing portfolio review to grow revenue, increase margins and optimize value: 22%
Prepared: 27%
Massive global changes reshaping corporate strategies

Oil and gas executives expect global megatrends – particularly shifting work patterns, new government strategies and digital transformation – to have a significant impact on their business and acquisition strategies.

Q: Which of the following will affect your core business strategy most in the next 12 months? Select up to two.

The oil and gas industry is confronting what is often called “the great crew change,” as the “baby boom bubble” that dominates most senior leadership teams moves toward retirement. Driven by changing expectations and needs by both employers and employees, the traditional talent contract is also being rewritten. An increasing number of mobile, more tech-savvy workers are changing the nature of work and the workplace. The move to a more flexible workforce in conjunction with the digital transformation will provide more opportunities for collaboration and productivity, as well as acquisitions. Dealmaking in many parts of the industry, especially those that are high-tech or IP-rich, will center on the battle for talent.

Governments worldwide are rethinking their strategies and policies in response to huge challenges. From building social safety nets in key emerging markets to reducing deficits and debt in developed countries, governments are trying to meet these challenges without dampening economic expansion. These changes have far-reaching implications for business, creating an urgent need to stay agile, keeping up with policy changes and ensuring compliance and collaboration with public-sector agencies.

In contrast to the overall trend toward a focus on the core, technology assets are in demand in nearly every sector. Emerging technologies are combining with advanced networks, computing and new ways of communicating to fundamentally change businesses. In oil and gas, there is a continued push to develop and implement new technologies to improve recovery, increase efficiency and reduce costs. Additionally, the “digital oilfield” is creating dramatic efficiencies as well as opportunities. As companies adapt to these advances, dealmakers in all industries will need to decide how they strategically invest in technology.

Q: Which of the following will impact your acquisition strategy most in the next 12 months? Select up to two.
Companies are focused on optimizing their capital

Q: On which of the following capital management issues is your company placing the greatest attention and resources?

Raising: Do we have the right capital structure to meet our strategic priorities?
With an active focus on growth and healthy balance sheets, companies are expecting to take on more leverage to fund deals; 28% 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 actively beginning to focus on investment, building dealmaking rigor and discipline, and setting the stage for later growth; 11% of oil and gas companies are 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 growth, executives are no longer focused on preserving capital but are now turning to other Capital Agenda areas.

Optimizing: What steps can we take to maximize our portfolio’s performance?
More than 61% of oil and gas executives are planning to optimize capital and preparing to increase their focus on strategic dealmaking.

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

The appetite to execute deals is cautiously growing, and deal pipelines are set to expand further. M&A activity is about to reach pre-crisis levels. Transformative M&A will continue; however, the strongest growth in M&A activity in the coming year will be middle-market momentum as companies strengthen their core businesses.

The surge in megadeals during 2014 is having a ripple effect on the M&A market. They increase confidence in M&A and trigger transaction activity further down the deal chain.
A cautious rebound seen in oil and gas M&A activity

Oil and gas executives see accelerating M&A market in the near term

An improving view of the resilience of the global economy, strong equity markets and enhanced corporate earnings have helped boost the outlook for M&A among oil and gas respondents. But their optimism is a cautious one, given that the strength of the optimism has declined over the past year. While 2014 has been notable for several high-profile megadeals, overall oil and gas deal activity has been disappointing. However, the Barometer suggests that middle-market M&A will provide a significant lift to deal activity.

More than half of all oil and gas respondents expect deal volume to increase further in the next 12 months, again somewhat less so compared to the previous two Barometers. Importantly, the number of respondents anticipating deterioration in the M&A environment is now negligible. North American-based assets have dominated activity in recent years, and are expected to continue to do so in the next year.

Oil and gas appetite to acquire continues to slide

Oil and gas companies’ appetite to do M&A remains modest and has declined over the last three Barometer surveys, with 25% of oil and gas executives expecting to pursue acquisitions in the next 12 months, down from 30% in the April 2014 survey, and down from 39% in October 2013. As noted earlier, growth has become less of a focus for oil and gas companies, with companies increasingly focusing on cost reductions and operational efficiency.

Dealmaking challenges still persist: just over 40% of oil and gas executives are confident about the likelihood of closing acquisitions. This may be because of increasing rigor in the search for strategically aligned assets, more thorough due diligence or greater competition. More than half of all oil and gas executives are however, confident in the quality and number of acquisitions that are available.
Middle-market deals expected to fuel an M&A rebound

Oil and gas executives expect that core and bolt-on acquisitions will drive middle-market deals.

**Q: What is the maximum single deal value expected over the next 12 months?**

Our previous Oil and Gas Capital Confidence Barometer correctly predicted the rise of multibillion-dollar deals in 2014. These megadeals are having a significant ripple effect on the M&A market. They increase confidence in M&A and trigger transaction activity further down the deal chain.

Even with the restrained appetite to acquire, we now expect to see a new wave of M&A with much more focus on mid-market-sized deals. This new middle-market momentum should lift M&A activity as companies seek to strengthen – and expand – their core business. The oil and gas climate continues to remain favorable for large acquisitions as well, but the growth of M&A should be defined by the major shift in focus among respondents looking to do deals valued at US$250 million and under. The upper end of the M&A market should continue to see some megadeals, but we can also now expect a formerly subdued middle market to vigorously enter the fray. The net result should be a far more buoyant deal market than we’ve seen for the past five years.

The majority of oil and gas companies are focusing on acquiring businesses in their core sectors, with an eye to boosting market share, managing costs and improving margin growth. As cost efficiencies are paramount, for the vast majority, planned M&A activity will consist of bolt-on acquisitions that will complement their current business model.

The increasing influence of shareholder activism is helping to ensure that cost management remains a critical component of organic and inorganic growth strategies. Half of respondents say that cost reduction has been elevated on the boardroom agenda as a result of shareholder activists.

The majority of deals swelling pipelines are focused on strengthening the core business, by boosting market share, managing costs and improving margin growth.
Deal pipelines expected to expand even further in the next year

Bullish deal intentions as pipelines swell

The number of oil and gas companies that have more than five deals in the pipeline has increased significantly. Renewed discipline in dealmaking is forcing companies to thoroughly examine many more investment opportunities to find the best strategic fit.

A further sign of growing momentum: more than two thirds expect M&A pipelines to expand further over the next year – almost twice the number expecting increases six months ago. This move toward larger pipelines bodes well for a rebound in M&A in the near term – especially in the middle market, where there are more assets for companies to target.

Q: How many deals of all sizes do you have in your pipeline today?

<table>
<thead>
<tr>
<th>Number of Deals</th>
<th>Apr-14</th>
<th>Oct-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;5</td>
<td>19%</td>
<td>28%</td>
</tr>
<tr>
<td>4</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>12%</td>
<td>24%</td>
</tr>
<tr>
<td>2</td>
<td>31%</td>
<td>36%</td>
</tr>
<tr>
<td>1</td>
<td>19%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Q: How do you expect your deal pipeline to change over the next 12 months?

<table>
<thead>
<tr>
<th>Expectation</th>
<th>Apr-14</th>
<th>Oct-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase</td>
<td>68%</td>
<td>38%</td>
</tr>
<tr>
<td>No change</td>
<td>20%</td>
<td>56%</td>
</tr>
<tr>
<td>Decrease</td>
<td>12%</td>
<td>6%</td>
</tr>
</tbody>
</table>

| Oct-14 | Apr-14 |
Dealmaking focuses on core business

Acquisition plans center on core

Oil and gas companies are planning to strengthen and expand the core. They are assessing a range of transaction drivers – but cost efficiencies are paramount. The majority of companies are focusing on acquiring businesses in their core sectors, with an eye to boosting market share, managing costs and improving margin growth. This is strongly aligned to their focus on organic growth plans.

Consequently, for the vast majority of companies, planned M&A activity will consist of bolt-on acquisitions that will complement current business models or be in adjacent markets. A third of oil and gas companies plan to make acquisitions that give them access to new technologies or intellectual property.

In the current climate, transformative M&A – high-value acquisitions that significantly change the size of the acquirer – and deals that shift the scope of their business look set to continue. More than a third of respondents are considering such transactions. However, middle-market deals look set to drive volume in the M&A market over the coming 12 months.

Q: What are the main drivers impacting your M&A strategy over the next 12 months? Select up to three.

- Reduce costs, improve margins: 45%
- Move into new geographical markets: 41%
- Access new technology/intellectual property: 35%
- Improvements to supply chain: 34%
- Move into new products/services areas: 32%
- Gain market share in existing geographical markets: 31%
- Acquire talent: 24%
- Acquire assets at a discount - opportunistic M&A: 19%
- Optimize tax efficiencies: 11%
- Navigate regulatory issues: 7%
- Leverage regulatory/legislative opportunities: 3%

Q: Are your M&A deals planned to be in or outside your core sector?

- We are looking to acquire competitors/similar companies in our core sector: 77%
- We are looking both inside and outside of our core sector: 15%
- We are looking outside of our core sector: 8%

Q: Your planned M&A will mostly be:

- Bolt-on (complement current business model): 64%
- Transformative (high value acquisition which significantly changes the size of acquirer): 36%
Stable valuations to enable dealmaking

Modest valuation gap and confidence in asset prices underpin positive deal sentiments

There is a strong consensus among our oil and gas survey respondents. More than one half of executives see only a small discrepancy between buyers’ and sellers’ expectations on asset valuations. This, combined with the outlook for stability in the valuation gap and the overall value of assets, will encourage dealmaking in the near term.

The number of respondents that see the current valuation gap as either higher or lower than 25%, which would be difficult to resolve through negotiations, is now down to only about 1%.

The more stable outlook for both the valuation gap and price of assets in the next 12 months reinforces the view on stability in macroeconomic conditions and the M&A market. As buyers become more confident in newly acquired assets’ long-term value, and sellers no longer hold out for higher prices in the future, volumes should accelerate – especially in the lower middle market, where the valuation gap is most easily bridged.
Debt to fund future dealmaking

Balance sheet strength leads to drop in highly leveraged companies

Leverage has declined since the global financial crisis, thanks mainly to increases in equity value. More than 70% of the oil and gas companies in our survey report a debt-to-capital ratio of less than 25%, leaving them well positioned to withstand any near-term increase in interest rates.

Strong balance sheets leave room for debt

More than half of oil and gas executives expect their companies’ debt-to-capital ratios to increase over the next 12 months, indicating confidence in credit availability and a willingness to take on more debt to fund growth ambitions. Their willingness to do so has risen sharply over the past year.

As a result, more than half of the oil and gas respondents expect debt to be the company’s main source of financing over the next 12 months.
Pursuing deals across multiple markets, despite the challenges

Targeting acquisitions across both developed and emerging markets

Oil and gas executives see their acquisition and investment focus increasing across a wide array of markets, both developed and emerging. In our recent survey, oil and gas respondents saw their focus turning slightly more to the emerging BRIC markets (Brazil, Russia, India, and China) than the non-BRIC emerging markets, with the increase in focus on developed markets also less.

Rising geopolitical and regulatory concerns are the biggest deterrents to new investments into certain markets

Oil and gas executives see political and regulatory risk as the biggest deterrent to making investments in other markets. Concerns over the lack of infrastructure to support growth were also seen as very important for our oil and gas respondents, as was slowing economic growth.

Internal capabilities are seen as the biggest challenges to deal strategy and success

Oil and gas executives see their own internal capabilities (or lack thereof) as the biggest challenges to their deal strategy and success. Deal execution and post-deal integration capabilities were seen as the top challenge, while a lack of managerial focus on M&A was seen as the second-most important challenge. Notably however, as could be implied from the earlier discussion, shareholder activism was also seen as a big challenge.

But overpaying for assets has been the biggest issue in the past

Despite concerns with internal capabilities affecting prospective dealmaking, oil and gas executives believed that overestimation of strategic value and/or a willingness to pay too high of a multiple was the most significant factor that caused recent deals to not live up to expectations.

Q: How has your acquisition strategy toward/focus on investing in the following markets changed versus 12 months ago?

<table>
<thead>
<tr>
<th>Market Type</th>
<th>Increase</th>
<th>Stayed the Same</th>
<th>Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-BRIC emerging market</td>
<td>52%</td>
<td>48%</td>
<td>3%</td>
</tr>
<tr>
<td>BRIC emerging market</td>
<td>49%</td>
<td>54%</td>
<td>2%</td>
</tr>
<tr>
<td>Developed/mature market</td>
<td>44%</td>
<td>49%</td>
<td>3%</td>
</tr>
</tbody>
</table>

Q: If you are slowing or stopping your investments into certain markets, to what do you attribute this changing sentiment?

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Oct-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political/regulatory risk in those markets</td>
<td>45%</td>
</tr>
<tr>
<td>Lack of infrastructure to support growth in those markets</td>
<td>25%</td>
</tr>
<tr>
<td>Slowing growth</td>
<td>23%</td>
</tr>
<tr>
<td>Currency risk</td>
<td>4%</td>
</tr>
<tr>
<td>Complexity and transparency</td>
<td>3%</td>
</tr>
</tbody>
</table>

Q: What are the main challenges to your M&A strategy over the next 12 months? Select up to two.

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deal execution and integration capabilities</td>
<td>40%</td>
</tr>
<tr>
<td>Lack of internal resources to handle the deal</td>
<td>18%</td>
</tr>
<tr>
<td>Valuation gap</td>
<td>21%</td>
</tr>
<tr>
<td>Lack of managerial focus on M&amp;A</td>
<td>29%</td>
</tr>
<tr>
<td>Shareholder activism</td>
<td>26%</td>
</tr>
<tr>
<td>Adverse economic environment</td>
<td>16%</td>
</tr>
<tr>
<td>Funding availability</td>
<td>12%</td>
</tr>
<tr>
<td>Regulatory environment</td>
<td>6%</td>
</tr>
<tr>
<td>Adverse political environment</td>
<td>14%</td>
</tr>
<tr>
<td>Insufficient opportunities/suitable targets</td>
<td>7%</td>
</tr>
</tbody>
</table>

Q: For acquisitions recently completed, what was the most significant issue that contributed to deals not meeting expectations?

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic value overestimated/purchase price multiple too high</td>
<td>36%</td>
</tr>
<tr>
<td>Poor execution of integration</td>
<td>13%</td>
</tr>
<tr>
<td>Product/Sales price and margin deterioration</td>
<td>21%</td>
</tr>
<tr>
<td>Unforeseen liabilities (tax, HR, pension etc.)</td>
<td>14%</td>
</tr>
<tr>
<td>Sales volume declines/Loss of customers</td>
<td>9%</td>
</tr>
<tr>
<td>Poor operating cost assumptions</td>
<td>7%</td>
</tr>
</tbody>
</table>
In August and September, we surveyed a panel of more than 1,600 executives in 62 countries; more than half 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 and construction.

Global companies’ annual global revenues ranged from less than US$500m to greater than US$5b: <US$500m (18%); US$500m–US$999.9m (24%); US$1b–US$4.9b (31%); and >US$5b (27%).

More than 800 companies would have qualified for the Fortune 1000 based on revenue.

Global company ownership was publicly listed (64%), privately owned (22%), PE/portfolio-owned (9%), family-owned (3%), and government/state-owned (2%).

The Global Capital Confidence Barometer gauges corporate confidence in the economic outlook and identifies boardroom trends and practices in the way companies manage their Capital Agendas – EY’s framework for strategically managing capital.

It is a regular survey of senior executives from large companies around the world, conducted by the Economist Intelligence Unit (EIU). Our panel comprises select global EY clients and contacts and regular EIU contributors.