Transforming for success in an era of abundance

As shale producers in the US confront persistent low oil prices, the US Shale industry is transforming, refocusing on fundamentals and entering a new era that requires close and disciplined attention to operational efficiency, capital structure and portfolio management.

Transforming for success in an era of abundance

Our industry is undergoing a tectonic shift. Gone are the hopes for a V-shaped recovery from the downturn that started in late-2014. Launched by technology that unlocked shale oil, we have entered an "era of oil abundance", and we are scrambling to adapt. With lower than expected global demand growth, this era of abundant oil supply has softened market response to geopolitical triggers and changed the global pricing dynamic. "Unconventional wisdom" now calls for a structurally lower price point defined by US Shale economics, along with expectations of compressed and more frequent price cycles because shale production can more quickly enter and exit the market in response to price signals.

In the wake of these changes, the financial community is now viewing the oil and gas sector differently. With breathtaking crude price declines, the oil and gas producer risk-return profile has changed dramatically, and access to cheap capital — which was a key US unconventional production growth driver — is declining, especially from traditional sources such as banks. Tighter credit liquidity is also driven by regulatory pressures on traditional lenders that aim to prevent systemic banking risks — the Dodd-Frank effect. Going forward, a growth agenda is unlikely to command higher multiples. Stung by recent equity value collapse and insolvency fears, investors will be far more likely to reward oil and gas companies that are agile in capital allocation, adept at optimizing margin and focused on reducing variability in free cash flows.

The implications for the US onshore exploration and production (E&P) sector are far-reaching. Financial stress resulting from drastically low oil prices and unwinding hedges is creating significant turmoil, especially among the independents. For example, EY recently conducted a review of the top 100 operators in US onshore, and the results are sobering. About a third of the companies are in financial distress and will require some level of restructuring in the near future absent a significant oil price recovery. An estimated 40% to 50% of the companies are in survival mode, with just enough liquidity to weather the storm for the next one to two years. Long expected merger activity has not materialized among many of these companies due to change in control provisions and other negative debt covenant restrictions. The remaining 20% to 30% are in position to capitalize on the downturn with well-considered inorganic growth strategies.

An "abundance era" calls for transformational moves in (1) operational practices, (2) capital structure and (3) portfolio strategy. Management focus will shift through these three components, depending on the current company condition.

Enduring truth — operational excellence is a strategic imperative

Cost control is always an important contributor to US independent player success — even when oil prices are in the US$60/bbl to US$100/bbl range. Efficiency programs, working capital reduction initiatives and procurement efforts are proven cost structure control mechanisms that help oil executives manage price-driven margin variation.

The current situation is different. Low oil and gas prices are challenging all companies, regardless of commodity mix (oil or gas), geographic location or financial strength. Below US$60/bbl, a large proportion of exploration and production projects face marginal economics. And when prices drop below US$50/bbl, structural changes are needed to even approach investor-expected returns. Commodity price and cost structure impact all business aspects, including commercial strategies to manage downside risks, agile and effective capital deployment to navigate a very dynamic environment, and production management to extract as much value as possible from the existing asset base.

Business objectives across commercial, capital and production set a broad operational agenda that includes initiatives such as near-term cash release via managed services; cross-functional integration and process realignment to make better decisions faster; changes in performance objectives for staff and compensation philosophy; cost reduction sustainability efforts with key suppliers; rapid innovation to stay ahead of the competition; and the adoption of advanced digital technology to drive the next stage of collaboration and business intelligence.

Integrated transformational initiatives can shape the future E&P company by creating an agile organization able to capture the first-mover advantage and deliver robust performance in a tight margin environment.

Foundational — aligned capital structure enables success

Tighter capital availability and shifting investor expectations are driving changes in E&P company capital structures. The near-term need for many players is to manage cash flow and cover debt payments that are due. Lowering debt is high on the C-suite agenda, especially for companies with aggressive growth strategies structured around relatively cheap debt capital. Asset divestments, debt maturity renegotiation and new equity investment sources are all potential avenues to deal with the near-term issues. In the future, projects requiring lower capital levels that have shorter payback periods will likely be more palatable to US independents than mega-projects with longer execution periods that often contain high technical and operational risks. In this new environment, onshore unconventional assets offer definite advantages. Oil and gas companies must now quickly adjust these levers, in light of tightening credit markets in the US coming under increasing regulatory scrutiny, as the US Government seeks to avoid systemic risk to the financial system.

Going forward, substantial capital is waiting on the sidelines. Investors will expect increasing return stability from the industry. Transitioning from "growth-to-return" is driving the emergence of certain traditional deal structures that are redesigned to protect from potential joint venture partner bankruptcy while bringing stable cash returns. Traditional approaches such as Drill Co are being re-invented to form investment vehicles with sufficient cash flow generation and growth potential, thereby balancing margins, liquidity and growth. Popularity is declining across other traditional approaches, such as "cash and carry," which historically funded the shale boom. Given the increase in bankruptcy risk, convertible hybrid financial instruments will likely be used widely to balance risk and return optionality.

Optimal — building the right portfolio

Portfolio strategies are also impacted by this new "abundance era." To date, M&A activity has mostly occurred at the asset level. Asset deals are the norm in the E&P business, but growing financial stress is now forcing a number of companies to divest parts of their operation as they struggle to manage through the cycle bottom. Prolonged low oil prices will most certainly accelerate the asset sale trend and stimulate corporate-level transactions — transactions necessary to build scale and financial strength. In this very fluid environment, we see three themes emerging:

- US shale assets continue attracting investor interest given their strategic advantages, such as equity resource access, faster payback, higher optionality and ongoing technical and cost resilience.
- Smaller investments with quicker paybacks are very much in favor as companies seek a new balance in their portfolios, one that allows for resource growth while managing price volatility.
- Companies are aligning their asset base with their core capabilities to create a competitive advantage and achieve scale that leverages basin knowledge and logistics infrastructure.

As oil prices remain low, a growing number of quality assets will enter the market. Competition for these assets will be significant given the huge amount of dry powder from private equity and other financial investors searching for an advantage in the downturn. Corporate buyers will need well-developed portfolio strategies that enable quick identification and closure for assets that meet their objectives. Currency available to most existing operators searching for portfolio upgrades will likely be heavily skewed toward equity — equity that will address financial leverage distress and prevailing market uncertainty. To overcome cash offers from the financial investor (private equity and sovereign wealth being most aggressive), corporate/strategic buyers must make a compelling and specific case for why they are best positioned to deliver value from the combination.

A sector in transition

E&P operators are not the only ones impacted by the current environment. The risk associated with low oil prices is affecting the entire industry value-chain. The oilfield service sector and midstream companies in particular, both of which benefited from increased oil production, as well as the refining sector, are all feeling the pain. Sizable operator insolvency can have immediate consequences for midstream business partners and other vendors. The industry is very connected via operational dependencies and contractual obligations. So far, the industry response has been sector-specific, with (i) service companies controlling cost, building scale and driving innovative solutions to alter project economics, (ii) refiners pursuing cost-cutting measures as the differential between Brent and West Texas Intermediate shrinks, ending access to cost-advantaged crude, and (iii) midstream companies increasingly looking at portfolio re-balancing to improve economics and better align with future areas for production growth and stability. The right question can change the focus of your business and shape your legacy.

Does the current situation call for a more integrated response to the structural shift? Will vertical integration help rebuild natural hedges? Will emerging industry-wide solutions address common needs (e.g., decommissioning campaign)? Others? A new playbook is being written and the oil and gas industry is undoubtedly being tested, but the industry will once again reinvent itself.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

How EY's Global Oil & Gas Sector can help your business
The oil and gas sector is constantly changing. Increasingly uncertain energy policies, geopolitical complexities, cost management and climate change all present significant challenges. EY's Global Oil & Gas Sector supports a global network of more than 10,000 oil and gas professionals with extensive experience in providing assurance, tax, transaction and advisory services across the upstream, midstream, downstream and oilfield subsectors. The sector team works to anticipate market trends, execute the mobility of our global resources and articulate points of view on relevant sector issues. With our deep sector focus, we can help your organization drive down costs and compete more effectively.

© 2016 EYGM Limited.
All Rights Reserved.

EYG No. DW0600
1602-1831695 SW
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com/us/oilandgas

Contacts

Deborah Byers
deborah.byers@ey.com
+1 713 750 8138

Linda Castaneda
linda.castaneda@ey.com
+1 713 750 1402

Mitch Fane
mitchell.fane@ey.com
+1 713 750 4897

Keith McGregor
keith.mcgregor@ey.com
+1 212 773 3719

Vance Scott
vance.scott@ey.com
+1 312 879 2185

Herve Wilczynski
herve.wilczynski@ey.com
+1 713 750 8671

Matt Shirk
matthew.shirk@ey.com
+1 713 750 8289

Thomas Thayyil Thomas
thomas.thayyilthomas@ey.com
+1 713 750 5236