Is your portfolio fit for the future or fashioned on the past?

Global oil and gas transactions review: mid-year update
2018 began with optimism: oil prices on an upward trajectory, oil companies starting to increase investments again, and a growing number of transactions, raising a number of questions:

**Can this combination lead to an increase in deals in 2018?**

**Will companies change their portfolios to position them for a new medium-term supply-demand dynamic and seek to create optionality to enable a response to evolving energy technologies?**

**Would the rising oil price expectation and longer-term uncertainty increase valuation gaps and caution, delaying the expected deals?**

**Would the tax changes in the world’s largest oil and gas asset market change behavior?**

So far, the evidence from completed transactions suggests steady-state rather than any step change in activity. Indeed, transaction volumes continued to decline, especially in upstream. However, behind the statistics, increasing preparatory work across sellers and buyers does seem to point toward a healthy announced deal flow for the second half of the year.

<table>
<thead>
<tr>
<th></th>
<th>2018 (Jan-May)</th>
<th>2017 (Jan-May)</th>
<th>Y-o-Y change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value ($B)</td>
<td>Deals</td>
<td>Value ($B)</td>
</tr>
<tr>
<td>Upstream</td>
<td>50.2</td>
<td>357</td>
<td>78.9</td>
</tr>
<tr>
<td>Downstream</td>
<td>63.8</td>
<td>67</td>
<td>27.0</td>
</tr>
<tr>
<td>Midstream</td>
<td>60.0</td>
<td>62</td>
<td>57.5</td>
</tr>
<tr>
<td>OFS</td>
<td>2.6</td>
<td>78</td>
<td>11.2</td>
</tr>
<tr>
<td>Total</td>
<td>176.5</td>
<td>564</td>
<td>174.7</td>
</tr>
</tbody>
</table>

Source: EY analysis of data from Derrick Petroleum Services

If we look at what is driving the current wave of portfolio analysis, a few themes begin to emerge which we believe will be key transaction drivers for the foreseeable future. Although these themes apply to the entire industry, their impact and therefore the portfolio response varies for each class of market participant.
The oil company dilemma

Oil company management has always faced challenges making long-term capital allocation decisions in an industry where short-term financial results are driven by unpredictable geopolitical factors and volatile supply and demand dynamics. Prediction is incredibly difficult but a normal business process. As such, forming a view on the commercial impact of the change in supply and demand from the combination of emerging energy technologies, new production techniques and shifting geopolitical roles (OPEC+) is not fundamentally different from the types of challenge that the industry has faced before when new basins came into the market.

What is different this time is the uncertainty regarding where different asset types will eventually position on the cost curve as a result of the new production technologies. This is due to both the continuing cost evolution in unconventional projects and the impact accelerating digital technologies are having on conventional operating costs. What is also different this time is that the longer-term demand for hydrocarbons is now in question and there are no reliable ways to predict how this will unfold. How companies respond to these challenges is driven both by their own views on the future and their current portfolio position and opportunity set. However, there are common themes we are seeing and these are what we expect to drive activity in the M&A market in 2H 2018.
Right now, oil companies regard their core business as the profitable production of oil and gas. The events of the last few years have made all oil companies focus on building a portfolio that sits in the optimal part of the cost curve based on the opportunities available to them. What is available varies by type of company.

- NOCs with privileged access to intrinsically cost advantaged hydrocarbon basins seek to continue developing these assets, but are now thinking creatively to access needed capital. For example, Petrobras has announced plans to divest in Sergipe Alagos Basin, and the Vitol-led group has bid for Petrobras’ Nigerian assets.

- Resource challenged NOCs are reverting to opportunities where intergovernmental relationships and geopolitical factors, limit the access from competitors.

- IOCs are currently pursuing a balanced approach, evolving as the pervasive impact of new technology and its influence on customer and investor decision making becomes clearer through:
  - Continuing gas portfolio build-out where access has historically been less restricted and IOCs’ size, capital resources and global reach provide a natural competitive advantage.
  - Focused incremental developments around current key asset hubs to deliver short-term earnings and cash flow growth.
  - Extraction of capital from lower-return components of the upstream portfolio; including exits from mature basins where the fragmented asset base and limit of operational ability to boost performance, make them a less attractive use of capital and management time.
  - Extraction of capital from lower risk and return components of the upstream asset base where buyers with a low cost of capital exist (e.g., pipeline and storage infrastructure).

- Increasingly important investment destinations for the IOCs which are expected to drive more M&A activity include:
  - Investment into assets currently at the higher end of the cost curve where technology is expected to reposition their economics and where the assets show extreme capital flexibility, such as Concho’s acquisition of RSP Permian for US$9.5 billion.
Expansion of the deep-water footprint in both existing and new basins as technology developments enable reserves to be developed at a lower cost. For example, oil majors Exxon, Chevron, BP among others paid signing bonuses of US$2.5 billion to secure acreage during Brazil’s last deep-water licensing round.

The IOCs’ ability to differentiate their relative performance on any reserve using technology which only they can afford to develop, could be an emerging theme, providing them with a durable competitive advantage and underpinning their buy-side M&A activity in the future. However, to pursue this advantage, the IOCs’ investment community must decide how they want leadership to prioritize growth investment versus near-term cash returns through dividends and share buy-backs. For the last decade, the emphasis has been very much on the latter.

The independent operators face a different challenge set. Moving from the historical exploration-led strategy toward repositioning themselves as niche players in particular basins. We see alliances and joint venture formations to cut costs, drive efficiencies and deliver returns becoming a core independent oil company strategy.

Increasing integration to drive returns

Downstream has proven an ability to generate returns through price volatility and mitigate longer-term demand uncertainty. This is underpinning an active market for downstream assets as both hydrocarbon-long NOCs and IOCs look to rebalance their portfolios toward a heavier downstream weighting. Petrochemical attractiveness is also being reassessed. Although much of the capital will be deployed organically, the rebalancing will inevitably drive M&A activity as well.

In addition to physical integration, more IOCs and NOCs are building out their trading functions as an alternative way of achieving some of the benefits of integration in a much less capital intensive way.

In order to access the molecules that feed their trading functions, both the IOCs and the commodity trading houses have extended their operations to trade finance, organizing the financing of asset acquisition and development in return for long-term supply agreements, as in the case of Vitol’s loan for an oil deal with Nigeria.
Although a consensus is emerging that oil and gas will decline as a component of the primary energy mix over time, there is currently no consensus on the speed at which this will happen or which alternative technologies will ultimately displace them.

Within the core of the oil companies’ portfolios, the material reaction has been to increase the investment in natural gas, and this looks likely to accelerate now that it appears China has committed itself to growing its consumption of LNG. However, many of the larger companies are also looking at how they can profitably position themselves in other elements of energy supply. These investments include:

- Growing power businesses (including downstream power)
- Renewables
- Alternative fuels
- Energy storage
- Energy services
- Energy management
- Chemicals applications

These investments are tending toward the venturing end of the spectrum though some are now beginning to become more sizable, if not material, in the context of the average overall IOC portfolio.

The transformation of the upstream business has brought the oilfield services (OFS) business to a crossroads. Staying competitive has traditionally meant cutting costs, but those opportunities are now largely exhausted and the attention of OFS companies has turned toward integrated service offerings, innovative pricing and commercial models.

To have a competitive advantage and get a decent return on equity and capital, large OFS players need to be integrated to deliver every individual component to the field for NOCs and independents. It will be the integration that drives margins, not the individual components.

The first half of this year has shown us that disruption has the potential to chill transactions. In the upstream sector, rising oil prices have raised questions about sustainability. Overall, deal value and deal volume are down and disagreement over valuation has impacted at least one high-profile, high-value deal. In the long run though, transition, disruption and the thirst for growth will require companies to re-engineer themselves. Much of that re-engineering will need to happen in relatively short order and require companies to buy rather than build. The optimism for 2018 is justified, but will companies move fast enough to deliver to their plans and find the right acquisition?
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 oil field 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.

© 2018 EYGM Limited.
All Rights Reserved.
EYG no. 010224-18Gbl
BMC Agency
1008071
ED None

In line with EY’s commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

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/oilandgas