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Growing competition amid high prices for oil and gas M&A

BY RAMESH RAMAN AND JUAN MARCANO

Record oil prices and profit windfall for oil and gas companies have prompted a new wave of aggressive mergers and acquisitions. After having rewarded their shareholders with historical dividends during the past two years, international oil companies seem to have found a new channel to employ their excess cash. However, in an already strongly consolidated market, the risk of aggressive valuations of assets is high. An examination of some of the forces at work behind these current trends can help assess the risks and rewards of this current M&A surge.

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In the 1990s the wave of consolidation in the oil and gas sector was prompted by low crude oil prices and the perceived necessity to join forces to stay competitive in the market to achieve economies of scale. The rationale behind this new generation of mergers, exemplified by deals such as the acquisition of Unocal by Chevron, seems to be a global race for reserves. Private sector companies that fail to replace a clear majority of their production, 70-100 percent as a rough guide, through reserve additions will effectively see their longer term cash flow generation affected. National oil companies are under pressure to secure the reserves needed to fuel their economies' future growth. The Unocal bid is a good illustration of the trend. Chevron, ENI and CNOOC were all interested in Unocal's assets in markets around the globe, from Azerbaijan to Indonesia to the Congo to the United States, as a means of adding to reserves and securing supply.

Acquiring assets in new production areas is seen as the best way for oil and gas companies to grow and add to their reserves. This is particularly critical in a time when reserves in traditional production basins such as the North Sea and North America are depleting; and even though the acquisition of rival oil companies seems extremely expensive in this environment of high prices, this strategy is seen as necessary for survival.

High oil prices have left oil and gas companies, both majors and independents, flush with cash, and by acquiring reserves these companies can continue their growth of cash flow into the future. The competitive search for investment opportunities is forcing companies to look outside their traditional areas. As a result, competition for exploration contracts is fierce, and is made even more so by the emergence of national oil companies on global markets. National oil companies are no longer staying in their domestic markets, they are hunting for reserves on the global markets as well. European oil companies are investing in Latin America and American companies are lining up for Libyan exploration contracts. Gazprom provides a good example of this new aggressive strategy. The Russian gas giant has decided to open its Shtokman field to investment by international oil and gas companies. This decision makes sense since Gazprom needs the complex technology required for exploitation under the harsh natural conditions of the Barents Sea. But the highlight of the deal is that the equity share of Gazprom's partners in the project will be directly proportional to their willingness to grant the Russian company stakes in their own international assets. The emergence of new players on the global market, in particular China and India, has strengthened the competition for resources.

Given the competitive environment, oil companies are pursuing increasingly risky assets. Reserves located in politically instable environments are now highly sought after. West Africa and Central Asia, among others, are seeing new exploration developments despite the uncertain political situation. Also, evaluation of reserves can be challenging in these regions, since original studies often were performed with rudimentary technology. However, the lack of clear data does not appear to be dampening the interest of international oil companies. Uzbekistan for instance, whose reserves will not be fully re-evaluated before five years, recently signed an MOU with Korea National Oil Corporation and Kogas for upstream development. The hunt for assets and new reserves to satisfy energy needs is further reinforced by the perception that oil companies and economies must diversify their sources of supply so as to become less vulnerable to the increased political instability in many oil exporting countries.

In addition to seeking new frontiers, acquisitions are also being made to consolidate market positions in traditional markets. ConocoPhillips acquired Burlington Resources and its US gas assets for $36bn. The high price paid reflects the current market environment and raises questions on the valuation of oil and gas assets. Indeed, the cost of oil and gas reserves is on the rise globally, as the price of proved reserves has tripled worldwide between 2004 and 2005, to reach $9.6/boe according to Paula Dittrick from *Oil and Gas Journal*. This trend is particularly strong in the US and Canada, where it reached $14.62/boe in 2005. In Canada alone, top deals involved reserves priced over $30/boe.

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Another area where there has been activity in the M&A market is in unconventional oil and gas resources. New technologies and high energy prices are making unconventional resources once thought to be economically unviable appear more and more attractive. A case in point is the heavy crude belt of the Orinoco region in Venezuela and the tar sands of Alberta, Canada. In the quest to secure previously ignored or hard to get reserves, oil companies are looking to invest in or acquire small technology firms that are working on new developments that could make the search for oil less of an art and more of a science. Recently, in one of such transactions a consortium composed of Norsk Hydro, Chevron and Energy Ventures invested in a small UK firm, Stingray Geophysical, whose technology could aid the recovery rate from offshore oilfields.

The refining industry, a segment where margins have been traditionally low, is another area that seems to present attractive targets for M&A. In the US, this industry has been challenged by regulations and the demand for clean fuels, forcing smaller and mostly inefficient operations to close. On top of regulatory constraints, not-in-my-back-yard (NIMBY) sentiments have led to the abandonment of some important projects, leaving the major oil companies with no option but to look for refining facilities and capacity elsewhere. High demand and high prices have spurred a new wave of consolidation and investments to capture the extra profit margin from the deficiencies in global refining capacity. Together, refining and petrochemicals accounted for the biggest slice of downstream-asset market activity in 2005 in terms of deal volume. However the high cost of such investments based on short-term profit consideration has to be weighted against the risk of having too much idle capacity in the future.

Finally, there is a growing trend with the emergence of financial players such as investment banks, hedge funds and private equity firms in the mergers and acquisitions market. Their presence is partly due to the fact assets are priced so high that equity alone is no longer sufficient to fund an acquisition, especially for medium-size firms. Hedge funds have notably become one of the largest providers of debt to the sector, and have been particularly active in acquiring mid-stream assets such as pipelines and gas-processing facilities. Moreover, many investment banks have been setting up their own energy commodity trading capabilities and have injected substantial capital in acquiring oil and gas assets at every level to back their trading efforts. The oil windfall has reemphasised the importance of marginal production making the exploration and exploitation of small or ageing fields a profitable venture. As big firms are pursuing more ambitious growth opportunities, private equity firms and alternative investments are becoming the new source of funding for acquisitions of start-ups in the North Sea that aim to fully exploit residual reserves. This led to a sizeable amount of asset transfer between international oil companies and smaller entities during the past two years.

The global increased demand for energy has positioned the oil and gas sectors and M&A activities for continued growth. But, the conditions are changing as high oil prices and the increasing presence of national oil companies are pushing the traditional players to areas normally considered off limits. High prices and increased competition have put significant pressure on independents. If they are to remain in the market, they will have to collaborate with increasingly active financial players. ■

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