

## **2010: The Return of the IOCs?**

TAYLOR-DEJONGH

*Written by Afonso Reis e Sousa (Director), Shamshek Asad (Head of Research)  
and Eugene Zamastyanin (Associate) Taylor-DeJongh.*

### **Annus Miserabilis**

2009 was a miserable year for oil and gas M&A. With just 32 deals sized over US\$ 10 million,<sup>1</sup> the first quarter of the year was described as “a 10-year low” by IHS Herold.<sup>2</sup> In each of the ensuing two quarters the number of deals recovered to around 70; however the combined value of all deals announced in the first three quarters barely crossed the US\$80 billion mark – and that includes the US\$19.5 billion merger of Suncor and Petro-Canada in the early part of the year, an outlier by any measure.

The widely expected resurgence in M&A activity in the latter part of the year failed to materialise. In part this was due to the continuing oil price volatility, but the relative leniency of lenders (who had been expected to sharply reduce borrowing bases following the fall in oil prices) also helped avert the anticipated asset fire-sales.

National Oil Companies were the pre-eminent M&A players throughout much of 2008 and 2009, but their private-sector counterparties – led by Exxon Mobil and ENI – began to flex their muscles in late 2009. Is this the portent of things to come?

### **National Oil Companies Unleashed**

There was a spurt of activity on the part of the NOCs, from both resource-poor and resource-rich countries, entering the market as acquirers in 2008 and 2009. Of the 20 largest deals announced in 2009, seven included participation of NOCs on the buy-side (see table below). Their targets were often corporate entities, suggesting that, in addition to seeking reserves, NOCs are actively targeting skilled personnel, management and relationships.

Date	Target	Status	Value (US\$mil)	Acquirer
12/13	XTO Energy	Announced	40,763.53	Exxon Mobil
03/22	Petro-Canada	Closed	19,478.12	Suncor Energy
06/24	Addax Petroleum	Closed	8,882.35	Sinopec
03/24	Compania Espanola de Petroleos	Closed	4,469.11	ADNOC
10/31	Encore Acquisition	Announced	4,347.34	Denbury Resources
04/07	Gazprom Neft	Closed	4,200.79	Gazprom
10/05	Jubilee Oilfield (Kosmos Energy)	Announced	4,000.00	Exxon Mobil
10/21	Harvest Energy Trust	Closed	3,809.61	KNOC
03/30	Bashkir Oil and Energy Group	Closed	2,500.00	Sistema JSFC
08/04	Tristar Oil & Gas	Closed	2,425.88	PetroBakken Energy
07/10	Venture Production	Closed	2,316.86	Centrica Resources (UK)
03/30	MOL	Closed	1,802.51	Surgutneftegaz
08/31	Athabasca Oil Sands	Announced	1,726.64	PetroChina
11/23	Blocks 1 and 3A in Uganda	Announced	1,500.00	ENI
04/27	Atlas Energy Resources	Closed	1,427.63	Atlas Energy, Inc.
12/11	Block 32 oilfield in Angola	Announced	1,300.00	Sonangol
07/14	KazMunaiGas E&P JSC	Closed	939.00	China Investment Corporation
02/05	Petro-Tech Peruana S.A.	Closed	900.00	KNOC; Ecopetrol
05/06	Oranje-Nassau Energie	Closed	838.04	Sumitomo; Dyas UK; ONH
11/25	Oil & Gas Properties in Permian Basin (TX and NM)	Closed	800.00	SandRidge Exploration and Production

A new development in the NOC's (and other quasi-sovereign entities') acquisition strategy in 2009 was a focus on direct NOC-to-NOC dealing. A joint bid for Petro-Tech Peruana by KNOC and Ecopetrol, CIC's investment in KazMunaiGas, and loans-for-oil deals between China and Rosneft and China and Petrobras suggest that NOCs are finding it easier to deal directly with one another.

Considering the proportion of world oil reserves off-limits to IOCs (65% according to an estimate by PFC Energy<sup>3</sup>), the growth of NOC-to-NOC relationships is a significant development.

The “National Interest” considerations of the NOCs have also proven to be effective in dealing with “IOC-hostile” oil provinces: Chinese, Korean and Russian NOCs and their affiliates have been able to pursue deals that are perhaps too “difficult” for the IOCs. The latest heavy oil tender in Venezuela is a good example: of 19 potential bidders, 12 are either NOCs or entities implicitly backed by their respective states.

However it was not all plain sailing for the NOCs in 2009 and they experienced disappointments as well. A joint bid by CNOOC and Sinopec for Marathon’s 20% stake in Angola’s Block 32 was pre-empted by Sonangol. Similarly, the Libyan government blocked an attempt by CNPC to acquire Verenex, a company primarily focused on Libya. Verenex was instead bought by the Libyan Investment Authority for 30% less than the CNPC offer. The “National Interest” cuts both ways.

### **IOCs Strike Back**

U.S.-based oil supermajors have been relatively inactive over the last few years, with the last major deal being ConocoPhillips’ acquisition of Burlington Resources in early 2006. Exxon Mobil, Chevron and their peers have instead focused on developing legacy projects and distributing excess cash to shareholders through share buy-backs. While they did sell and buy assets (that is, after all, the bread-and-butter of the E&P industry), the focus was on optimising existing portfolios rather than acquisition-led growth.

Like their U.S. counterparts, European IOCs have also been conservative in their acquisition strategies – with one notable exception: Italy’s ENI, led by Paolo Scaroni, has traded more than US\$40 billion in assets (as both seller and buyer) since the beginning of 2007, with the largest deals linked to Russian state oil companies.

Many IOCs explored JV structures to enter the capital-intensive U.S. unconventional gas market in 2008 with BP, Statoil and ENI joining forces with local producers in Barnett, Woodford and Marcellus. Rock-bottom Henry Hub pricing in 2009 dampened the Europeans ardour, although the first working day of 2010 saw Total announcing the acquisition of a 25% share in Chesapeake’s Barnett shale gas portfolio.

Despite significant cash reserves, the supermajors kept their powder dry for much of 2009. Undoubtedly, this was in part a “wait-and-see” attitude in the face of declining oil prices and the global financial crisis; however, it also reflected a divergence in valuations. Potential acquisition targets, and their shareholders, were unwilling to sell-out at the low values caused by the market overcorrection. On the other hand the supermajors found it difficult to justify to their own shareholders paying significant premia during the worst of the crisis. Repeated rejection of Total’s bids by UTS’s shareholders is a good example of the divergence in expectations between buyers and sellers.

### **What’s Next?**

Oil prices have recently stabilised around US\$75/bbl (if you can call \$20 volatility “stable”), and OPEC appears committed to maintaining prices in the range of US\$70-80/bbl<sup>4</sup>. This in turn has led to greater convergence of expectations between buyers and sellers. True, F&D costs have come down somewhat in recent months, increasing the attractiveness of organic growth for the IOCs. Nevertheless, we expect M&A to pick up significantly over the course of the year.

Resurgence of deal flow requires funding and the capital markets continue to show limited appetite for upstream risk. Large, well capitalised firms – potentially pressured by expectations from analysts and shareholders to replace reserves or diversify product mix or geographic presence – remain therefore in the best position to take advantage of opportunities in 2010. Exxon Mobil’s recent bid for Kosmos Energy’s stake in Ghana’s Jubilee Field, or ENI’s interest in Heritage’s Ugandan assets, illustrate the point. However, absence of financial market liquidity continues to put pressure on smaller companies. The capital expenditure deferrals of the last couple of years were short-term fixes, not long-term solutions.

Several other trends are likely to play out in 2010 as well:

- *Financially robust independents and NOCs will be able to pick up assets thrown up by the IOC portfolio optimization process. Shell’s recent decision to sell some of its North Sea and Nigerian assets is likely to attract such buyers, as should the planned divestiture program of ConocoPhillips.*
- *The U.S. is bound to have relatively limited representation in global oil M&A, until there is greater clarification on the current administration’s regulatory stance on the oil and gas sector. While any new regulations are unlikely to cause a mass exodus of investment from the U.S. oil sector, changes could affect the appetite for U.S.-based assets.*
- *Privately-held oil companies, which traditionally rely on acquisition debt finance and private-equity funding, are likely to remain cautious in the short run. However, a recent lender price survey found that banking price decks have increased, albeit marginally, from the previous third quarter.<sup>5</sup>*

- Sovereign wealth funds may rise to prominence in 2010. 2009 witnessed the entry of new players into the market, such as the China Investment Corporation (CIC) and the Libyan Investment Authority, as well as Taqa's continuing build-up of its portfolio.
- The largest M&A deals in 2009 were predominantly oil-focused. However, in December Exxon Mobil announced its intention to acquire XTO for a staggering US\$41 billion, valuing it at approximately US\$2.94/Mcfe.<sup>6</sup> Given the outlook for US gas pricing, it is likely that Exxon Mobil is looking at the global deployment of shale gas technology rather than a purely domestic play. XTO's track record and ExxonMobil's global reach could lead to significant acquisitions overseas. However, the unresolved water issues at the Marcellus shale suggest that this will take some time – particularly in more environmentally conscious Europe.

### **In Summary**

In 2010, the M&A market is likely to be driven by buyers willing to pay a fair price for attractive assets or companies. While the NOCs are growing in importance, they lack (for now) the fire-power and expertise to compete head-to-head with the supermajors. The interest of sovereign wealth funds in oil and gas assets will continue to grow, competing directly with traditional private equity firms for quality assets; but neither has the resources to truly compete with cash rich IOCs re-entering the market with their fat chequebooks. We comfortably predict that 2010 is likely to be the year of the IOCs. (But we could be wrong).

#### **About the Authors:**

*Afonso Reis e Sousa (Director) – Mr. Reis e Sousa heads TDJ's London office. He advises on project financings, and has acted on a number of asset acquisitions and other M&A transactions. He specializes in the oil & gas sector and has worked on projects across Europe, the Middle East and Africa, in Russia and Australasia.*

*Shamshek Asad (Head of Research) – Mr. Asad manages the collection and analysis of key country, sector and business specific data, to be used in making credit and investment decisions in the oil & gas and power sectors. He assists with the negotiation of complex project finance transactions and merger & acquisition deals. Mr. Asad has significant experience in data analysis & reporting, strategy development, execution & evaluation and business development.*

*Eugene Zamastyanin (Associate) – Mr. Zamastyanin supports the company's M&A advisory business, performing financial modeling, valuation and market research activities.*

*He has recently evaluated a number of investment opportunities for placement of private capital in both upstream and downstream segments. Mr. Zamastyanin also provides research support to the firm's ongoing activities related to the O&G sector.*

#### **About Taylor-DeJongh:**

*Taylor-DeJongh (TDJ) is an independent, specialist investment banking firm that focuses on conventional and renewable energy, oil & gas, industrial and infrastructure business globally. The firm has over 28 years of success in providing investment banking services, including debt and equity raising, project financing advisory, project development and structuring services for energy and infrastructure sectors worldwide. TDJ has successfully structured and advised on over US\$70 billion worth of debt and equity investments in 100 countries, for power, renewable energy, oil & gas, LNG, petrochemical, industrial, transportation and other infrastructure projects. TDJ also advises clients on corporate finance, M&A and capital raising. [www.taylor-dejongh.com](http://www.taylor-dejongh.com)*

## **Executive Q&A with Terry Newendorp, Chairman & CEO of Taylor-DeJongh**

**Don't forget to read our interview with Terry Newendorp, CEO and Chairman of Taylor-DeJongh as he reflects on 2009 and looks ahead at the challenges and opportunities that await the industry as we move optimistically but cautiously into 2010.**

<sup>1</sup> Capital IQ data.

<sup>2</sup> "Upstream mergers revive after moribund first quarter," *Petroleum Economist*, September 2009.

<sup>3</sup> "PFC Energy 50 Ranking of World's Top Energy Companies: Traded NOCs Joining SuperMajors," *MarketWire*, 23 January 2008.

<sup>4</sup> Javier Blas, "Opec signals oil price target of \$70-\$80," *Financial Times*, 23 December 2009.

<sup>5</sup> "Energy Lender Price Survey Q4 2009," *Macquarie Tristone*.

<sup>6</sup> The value is based on: (1) Total consideration of US\$40,763.53 million at the announcement date, and (2) XTO reserves of 13,862.7 Bcfe as of December 31, 2008, consisting of: (a) Natural gas reserves of 11,802.90 Bcf, (b) Oil reserves of 267.5 MMbbl, and (c) NGL reserves of 75.8 MMbbl.

