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M&A Views

Deloitte M&A Views podcast:

Are brighter days ahead for energy M&A?

Rob: Welcome to Deloitte's M&A Views podcast, where we tap into what Deloitte professionals know about making smart, strategic M&A decisions. I'm Rob Dietrich. Today, trends in M&A in the oil and gas industry. We have with us Melinda Yee, a Deloitte partner and a leader in the Oil and Gas M&A Services practice, and Brian Boufarah, a partner and leader of Deloitte's Energy, Resources, and Industrials M&A practice.

It seems for our topic today, the good starting point for any discussion of oil and gas M&A trends has to be maybe a nod to the terrible year the industry just finished. There were the fewest deals in more than a decade, very slow first half, but a rebound in the second half. So the first obvious question is, are you guys seeing continued rebound in oil and gas deals this year?

Melinda Yee: Sure. So, I think the quick answer is yes, we are seeing a rebound in activity. It may not be a sharp increase in activity, but we are seeing more deals, both being announced, and then also hearing about more deals that are underway and in discussions. In terms of where it's at, we are hearing some upstream activity, but I would also say the midstream sector, which is a sector that a lot of infrastructure funds are interested in and private equity are interested in.

Rob: Okay, there are some interesting questions about what kind of buyers we have. Let's walk through first, Deloitte has identified a number of trends for 2021. One of the most important is that this industry is just simply going through a reset. Are we faced with a situation because of this reset where there's a bit of a lack of financially strong buyers, and is that affecting the M&A in this sector? Brian, shall we go over to you on that?

Brian Boufarah: Sure, I'll jump in here. It's interesting, when you talk about the lack of capital. There is a trend that's been a number of years in the making. So I think the first piece is price stability, financial investors' desire to take money out and not just put money in for investment and growth capex. That's one trend. I think the other that really became much more clear that it is a permanent trend and not just a one-off thing and perhaps accelerating as a permanent trend is really around ESG and focus on renewable and less carbon. When you put both of those together, I do think it puts some pressure on the amount of capital that's available to the industry. That also creates a lot of opportunity in some regard. But when you have businesses that are likely to produce cashflow and not a lot of capital coming that way, they could create some really good opportunities for people.

Rob: Even as the pandemic disrupted oil and gas—the oil and gas industry—last year, the energy transformation continued apace, or accelerated, really. That's shaping M&A activity. Am I getting that right?

Melinda Yee: So if you look at some of the European oil and gas companies, I believe there are five that have announced carbon neutral targets and to be carbon neutral by 2050, and with that, it's less than now 30 years, and it sounds like a long time, but it is in order to meet some of the goals that they've set for themselves, and so as part of that, they do have to think about their strategy and not only what they're doing internally in their organizations, but also what consumers and their customers and how they're using their products and how that is having an impact on the environment as well.

Rob: And let's just focus this for a second too back to the question, Melinda, of M&A activity.

Melinda Yee: You certainly see folks reevaluating their portfolio and thinking about what that means for their strategy going forward or what their strategy means for their portfolio going forward, I should say. They may not necessarily divest completely of a particular area, but they might shift more dollars, let's say, into something with a lighter carbon footprint, so shifting from oil to natural gas or shifting to hydrogen investment as a fuel.

Rob: That's interesting. Let's talk for a second about one of the trends we did see in the second half of 2020 as there was more upstream dealmaking. One of the things that was going on was simply consolidation focused in the Permian Basin, for example. Do you think that that's a trend that is continuing?

Melinda Yee: Sure. So the Permian Basin has been popular for a while, and that continues to be the case. That's where I think we've seen the most activity, and we do expect it to lead into consolidation in other basins. In some cases it may be warranted where maybe you have too many producers operating in a particular basin and they could really get economies to scale if they were to consolidate and acquire neighboring acreage and be able to create some of the efficiencies that come along, cost efficiencies, drilling efficiencies, et cetera, that come along with that.

Rob: That's important at a time when the commodity price doesn't support sort of every company's production.

Melinda Yee: That's right. In a low commodity cost environment where you don't have that top line growth, then you really have to make sure you're managing your internal cost structures and what you're spending. And that's part of the reason why you saw so much of a pullback from a capex perspective and new drilling. However, with commodity prices moderating around $60, it makes it easier to plan for the longer term when you have that stable commodity price environment.

Rob: And we do have a stable commodity price environment?

Melinda Yee: We do. Well, relatively.

Rob: Until we don't, right? Let's hit one more of the trends that we've identified. And this is, I think, an important trend. This is the sources of capital question. Over the past several years, this is not just in the pandemic, but certain sources of capital, ranging from private equity to the ability to issue equity, if you're a larger company or venture capital. A lot of that has all but disappeared from the sector—debt issuance becoming a really important way to source fresh capital. Can we talk a bit about the implications of that for dealmaking.

Brian Boufarah: Sure. I expect to see a couple of different trends, and you're already seeing these. One is this consolidation of companies more on an equity basis. And so you've seen this in the industry, and you've seen even the private equity investors putting together some of their existing portfolio companies to be less like having a different management team focused on different fields and more on having one team manage two or three historical portfolio companies. And so it allows them to be a little more focused on their SGNA spend around that opportunity.

Look, I think it's real that the environment we were in, which was just spend and invest, spend and grow, has caught us a little bit, and now investors expect a more current cash return on their investment. And that effectively means that you need to really be focused less on this long-term growth and more on this idea of producing a good, stable return as you're going along your journey and continuing to develop and grow as a company.

Rob: Melinda, do you want to weigh in as well on this sources of capital question? Because I think it's an interesting one.

Melinda Yee: Sure. So from a capital perspective, I think we went a long time without seeing a lot of IPOs, and to Brian's earlier point, in a lot of the transactions that were happening in 2020 and really even in late 2019, for that matter, you were seeing equity given as compensation rather than cash. And so that allowed companies basically to combine, achieve economies of scale, and both have skin in the game to ride out the upside, so to speak, when it came to the appreciation in value from an equity perspective. A lot of it depends upon the capital markets and how open the capital markets are going to be to the industry. And during 2020, they certainly were not open to the industry. As commodity prices start to increase and stabilize, I think that gives that community, that investor community, a little more certainty and gives banks more confidence in terms of forecasts and lending.

Rob: We've used up most of our time here. Is there anything else that I haven't thought to bring up here that you think is an important trend or something you're seeing in the M&A market right now that you wanted to make sure we talked about?

Brian Boufarah: I guess one area we haven't covered is, I actually think there's some exciting opportunity here for the right investors. So if you have large pension funds or invested in private equity or other private equity or corporates, or your large banks that might be looking to get away from high-carbon industries. That means it doesn't necessarily mean that the demand for the product has changed. It means that the capital is not coming into the industry. And so, therefore, there may be some great opportunities for family offices, other strategics, or certain investors that don't have those same ESG pressures and concerns to really drive a high cash cow kind of opportunity out of the industry. And so, I think there's going to be a big group of investors really focused on that and that oil and gas investing is going to be here for a long time, frankly, just to serve out the organic needs of the economy itself and the growth in the economy as we go through what will be a 20-, 30-, 40-year energy transition process.

Rob: Same question to you, Melinda. Anything that we haven't covered that you think is an important trend going on right now in oil and gas M&A?

Melinda Yee: There's always going to be a need to replace reserves. And so there's always going to be a need for reinvestment. The question becomes what's the timing of that. And to Brian's point, there's a buyer segment out there that may have some opportunities because folks have pulled back from the sector, from the general investor perspective. The other area that I might just mention is R&D and the innovation for the industry, and the fact that the way that you really drive additional, I guess, efficiencies and growth and reserves, for that matter, would be through innovation and through new technologies. And so there needs to be some level of reinvestment in R&D, for that matter, or maybe not reinvestment but continued investment in R&D. Those might be considered a little more venture-type activities, but those are the types of things that ultimately are needed down the road in order for us to achieve some of the ESG goals that have been put forth.

Rob: Melinda and Brian, thank you so much for joining me and taking the time today.

Melinda Yee: Absolutely. Thanks for having us.

Brian Boufarah: Thanks for hosting the call and really appreciate the opportunity to connect.

Rob: This has been Deloitte M&A Views. We've been talking today with Deloitte partners Melinda Yee, a leader in the M&A Oil and Gas Services practice, and Brian Boufarah, a leader of Deloitte's Energy, Resources, and Industrials M&A practice. I'm Rob Dietrich. Thank you for listening.

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