CONFIDENCE GAME

Huge deals came back just in time in the summer of 2014 as the rest of the year unspooled a tickertape of declining oil prices. In 2015, deals will be made by aggressors and risk takers.

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The marvel of 2014's multibillion-dollar A&D performance was not its impressive haul, but the fact that deal-making remained on fire even as oil prices went down in flames.

February 2014 saw the last strong uptick for WTI prices, when crude values increased 7% to \$100.82/bbl. From then until June, the price hovered around \$100. WTI prices fell gradually and then into a downward death spiral in the second half. By fourth-quarter 2014, prices were down 43%. In the New Year still more pain awaited E&Ps, and WTI dipped below \$45.

For those willing to look into the future, the upswing after a bust can be a giant payday. The wait is on now for the cycle to bottom out and begin that climb. Until then, the deal pace is expected to crawl along for at least the first quarter. Mergers are more likely than outright acquisitions. Aggressive buyers will pursue deals, but only after serious gut checks.

The year 2014 was a record for E&P onshore deals. Including corporate transactions, 142 deals worth \$85.7 billion were transacted. That topped records set in 2012 when 101 transactions led to \$79 billion in deals, according to Chris Simon, managing director, head of A&D, Raymond James.

Onshore E&P deals, many struck in the second and third quarters, totaled \$51.9 billion, Simon said.

What stands out to Sylvia Barnes, managing director and head of KeyBanc Capital Markets Oil & Gas Investment and Corporate Banking Group, is that deal-makers held on and completed transactions in second-half 2014 despite fading commodity strength.

The only deals that get done are with people that have almost that Marine mentality of storming the hill when there's an advantage, when it's dawn and the enemy is tired and sleeping, Sylvia Barnes, managing director and head of KeyBanc Capital Markets Oil & Gas Investment and Corporate Banking Group, said.

One of the year's marquee deals and the largest of 2014 was Encana Corp.'s purchase of the Permian Basin's Athlon Energy for \$7.1 billion.

"Encana had to have some resolve to get that deal done," she said. "Looking in the rearview mirror, I'm sure some people are saying, 'Why didn't they step away?' "

Barnes said she doesn't know of many deals left on the cutting-room floor by New Year's Day.

"I was surprised what actually did get done in 2014," she said. "We started to see crude prices drop midyear and then they really started to fall out of bed at the end of September."

The pace of deal activity going forward is a matter of much speculation. Without doubt, bargain hunters will look for distressed sellers. For now, though, the distance between bidders and sellers' valuations has muted transaction activity.

David Zusman, managing partner and chief investment officer of Talara Capital Management, predicts a transition for the industry. The rapid decline in crude prices will cause producers to high grade their assets, cut costs and renegotiate borrowing terms with banks.

"Make no mistake, some companies will find themselves in real trouble, ending only in a total restructuring," he said. "Other companies, however, are in a great position to have higher margins at \$60 oil than they did at \$80 oil—through efficiency gains as properties shift from delineation to development."

Charles Dewhurst, partner and leader of the Natural Resources practice at BDO, said a survey of CFOs suggests deal flow growth remains possible. In 2015, half of CFOs surveyed indicated they plan to secure outside capital from private-equity funds, a 25% rise over 2014.

"The industry might be anxious in the near term about price volatility, but its optimism toward deal flow suggests that the long-term outlook is bright," Dewhurst said. "The recent oil price drop is but a blip on the radar in the bigger picture. Natural gas remains strong and private equity is hungry for smart natural resources investments, all of which point to a strong future for the sector."

History suggests that once calm is restored, the deal pace will be back on. Since 2005, U.S. onshore oil-weighted transactions of \$20 million or more, when compared with historical WTI pricing during periods of great price volatility, slow down or halt altogether due to price uncertainty, according to Simon.

"Very few transactions were announced in November or December," he said. "Some deals that were in progress will not close, but a number are continuing negotiations and will be transacted."

Boomsday

The fictional detective Sherlock Holmes once observed that the "world is full of obvious things which nobody by any chance ever observes."

Barnes said the industry has seen the boom-

As service companies adjust prices and efficiencies improve, some companies may generate higher margins at $60 oil than they did at $80 oil, David Zusman, managing partner and chief investment officer of Talara Capital Management, said.

Charles Dewhurst, partner and leader of the Natural Resources practice at BDO, said the industry might be anxious now because of oil prices, but is optimistic about deal flow.

bust cycle again and again.

"Somehow we can't seem to learn from it," Barnes said. "At least, the not-so-smart money is not learning from it. The not-so-smart money is pulling back."

The smart money is coming from firms such as Talara Capital, KKR & Co. LP, and GSO Capital Partners, a division of Blackstone. Blackstone appears eager to invest in energy, reporting in late January that it had raised $4.5 billion for a second energy fund in a matter of months.

Meanwhile, as a result of the price drop, dozens of E&Ps have been slashing 2015 budgets. Ultimately, the oil industry is a victim of its relentless drive to achieve, Barnes said.

"Engineers like to drill more and set a goal and exceed it and set another goal and exceed it. That's what we've done with drilling time and cost and productivity and well configurations."

That so many missed the looming oversupply problem is ironic, given that oil prices are symptomatic of supply and demand.

In hindsight, the monster year for A&D was in 2013. Operators focused on what they had in hand and it seemed the shale revolution was fairly mature, Dewhurst said.

"I didn't see anything in the landscape that made it primed for M&A activity," he said. "In retrospect, however, if you look at a maturing development like shale, it is primed for that kind of consolidation."

This year, declining commodity prices and distressed cash flow will be the primary drivers of deal flow. "There will be a lot of opportunities for people who have good access to capital, that are on a solid financial foundation to take advantage, if you will, of other people's failings," he said, adding that many of his business contacts in the restructuring, turnaround and bankruptcy consulting business are sharpening pencils and clearing their calendars.

Many companies broadened beyond what made geographic sense in a world that requires greater efficiencies. "They'll look to consolidate or hone in on their core plays," Zusman said.

The bleak and the bold

Oil and gas prices have retreated so far that assets acquired in early 2014 are now worth a fraction of their original reserve valuation. "In some cases, you can re-create assets through the debt markets today at a third of what transactions occurred for a year ago," Zusman said.

For Barnes, that signals an opportunity.

After a similar collapse in 2008, she said, anyone who bought anything in the months spanning the end of 2008 and the start of 2009 made a fortune. To make such a move requires low leverage and a lot of guts.

"Will they have the heart to? Only the brave will. Only the ones that want the headaches and are willing to go that extra mile," she said.

For first-quarter 2015, she sees few deals being done because of paralysis or uncertainty in boardrooms.

"The only deals that [will] get done are with people that have almost that Marine mentality of storming the hill when there's an advantage, when it's dawn and the enemy is tired and sleeping," she said.

Other transactions will be stock-for-stock mergers, not cash deals. Sellers will be unwilling to part with assets at low prices. "In a stock-for-stock deal, you ride the escalator up together," Barnes said. "Your board or your owners are willing to do an equity deal because they're retaining some upside."

For the long haul, Dewhurst said the fundamentals for the U.S. industry are good, but different regions and players are affected differently by the price collapse.

"The U.S. industry is probably in a somewhat neutral position compared to many of the other producing areas around the world," he said. Countries such as Venezuela and Russia are suffering greatly from low commodity prices. "The U.S. industry will be just fine. It's just a question of riding this out."

BDO's survey found that companies will also continue to focus investment in shale. About 47% of CFOs plan to increase their investment in unconventional plays. Offshore exploration continues to struggle, however. Nearly a half-decade after the *Deepwater Horizon* disaster, only 6% of CFOs cited offshore drilling as an area of investment.

Zusman said for now capital markets are tighter, and other providers of capital, including his firm, will view depressed equity and crude prices as an opportunity to step in and provide liquidity for the right assets, partnering with the right people.

Just as gas drillers weathered a massive downturn in commodity prices, so will oil companies. Natural gas companies, for instance, moved to streamline their operations and technology. Some horizontal well drilling times fell to six days from 30.

"Within the U.S. market it will be a race for efficiency gains, a race to high grade, a race to manage for the coming consolidation," he said.

Producers will move to drill the core of their property, which generally has higher EURs. "If you're able to high grade to areas with better recoveries, shift into a development mode and benefit from the service costs coming down, you can do quite well," he said.

Analysts expect service company costs to drop from 20% to 40%, depending on location and other factors. Some companies will ultimately grow and consolidate while others will be forced to liquidate assets.

Balancing liquidity will drive some A&D decisions. "In other cases, the decisions around asset divestitures and acquisitions will be driven by a desire to consolidate where you're drilling, and enable a greater focus on efficiencies," Zusman said. □

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