Who Will Survive the Oil & Gas Shakeout?

Vance Scott,
EY

Energy companies with larger reserves and well-by-well cash flow analysis are better positioned to weather the storm of low oil prices, while companies with fewer reserves on hand will feel the pressure to meet operating costs and dividend and debt obligations, says EY's Vance Scott

While the price of oil continues to drop as 2016 approaches, many private equity firms have earmarked dry powder to take advantage of distressed opportunities in the sector. However, those opportunities have yet to materialize, according to Vance Scott, Americas Oil and Gas Leader for Transaction Advisory Services at EY.

"Many of the companies are in a leveraged position and have protected themselves on the price side with 12-to-18-month hedges," he says. "And other companies reset some credit positions, which also gave them some flexibility, and those are probably the key drivers as to why we haven't seen as much action as others have predicted at this point in time."

Still, Scott says the sector will likely see opportunistic buying by spring 2016 if there is no rebound in commodity pricing before then. If the price of oil remains below $50 per barrel, many of the private equity firms active in the sector will be forced to take action.

"I know many of the PE firms have funds sitting there and are ready to move in," he says. "They're looking to get in at the bottom of the cycle with some upside by backing good management teams that can drive higher performance."

Scott adds that in the past the smart money went to exploration companies successful in locating hydrocarbons. But with the relatively new shale dynamic happening today, the winners are going to be those that can operate effectively and do very good sequenced operations in drilling and production programs. "Private equity's begun to understand that, and many of these companies have the right teams lined up and ready to go," he says. "They just need convergence around what's going to happen with oil prices and be able to close that window so that the deals can actually start happening."

To that point, the management team profile that will add value to distressed energy companies has evolved over the past 12 months. While fundamental management skills aren't any different, the ability to process information and make decisions quickly will be a key benefit to creating value. Understanding the geology, as well as the way a company deals with capacity, will continue to be an important aspect of a successful E&P organization.

Scott says one concern he has is with so-called "lean thinking." He

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explains it from an operational perspective, that if a system is made too lean, value is destroyed because there isn't enough capacity. "If you go too lean, you cannot achieve what you need to do because you 'starve the line,' in operations engineering and industrial engineering language."

EY has done extensive research into the kinds of energy firms that are poised to be successful and the kinds that are bracing themselves for hard times ahead. Scott says that by looking at cash flow, credit and hedged positions relative to the obligations on interest, and payments and dividends, the picture becomes substantially clearer. But he also points to the size of a company's reserves as an indication of how long it can sustain such a low-cost environment.

"The larger the reserve base, the stronger the position will be to weather the storm we're in," Scott says. "We call it 'reserve resilience.' But the other thing we've discovered is many companies will see higher variability in their reserve performance with changes in commodity pricing."

The feeling is that those companies will be under a greater pressure to cover debt and dividend and to meet their operating costs on both development and operating expenses.

For some companies, master limited partnerships have been a major source of capital, but the low price of oil has had a negative affect on investors. Scott says he doesn't see those stocks going away anytime soon, particularly in the midstream. "As long as interest rates remain what they are, that construct will not go away," he says. "And it does have a structural advantage from a tax position. I would not have the same opinion on the upstream side, however."

Still, private equity firms that invest heavily on oil and gas remain bullish on the sector, looking forward to a technology revolution that they think will lower the cost of extracting oil out of the rocks, thus changing the economics and creating profit.

Scott says there's validity to that notion. "When we had the run-up to $100-per-barrel oil, there were many executives of companies saying, 'We've got to do something about our cost structure,' and many took bigger positions of the total value pool in the value chain.

But when prices declined, they said, 'We want a 30 percent reduction right now.'"

That step caused a reset in cost structure, and a lot of changes occurred in the service sector in response to that. What that does, says Scott, is "fundamentally change the overall drilling and lifting costs around wells. "If you can lower the cost of drilling, you can drill more and hedge the volumes and still get the returns you're looking for," he adds. ■

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