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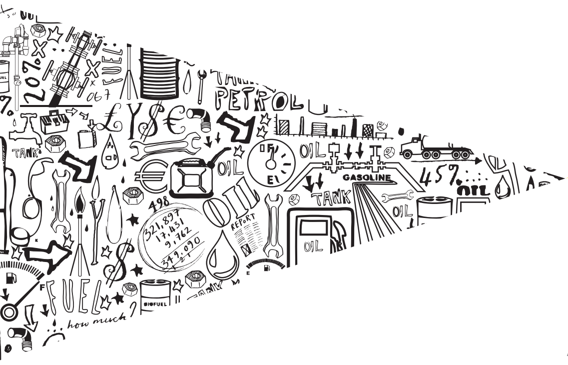
Outlook May–October 2013

Oil & Gas

Global Capital Confidence Barometer



Growing forward

An imperative to act: seizing first-mover advantage as confidence returns

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Our eighth Global Capital Confidence Barometer shows a clear rebound in corporate confidence. After years of conservative decision-making, executives are steadily trending toward an investing agenda. But are companies being bold enough?

Expectations for global economic growth, corporate earnings and credit availability are at some of their highest levels in two years. Broader equity markets had a strong first quarter of the year in just about all geographies. Normally, this positive sentiment would translate into significant capital investment and M&A activity. However, our respondents are gravitating toward lower-risk value-creation and growth strategies.

The current situation can best be described as a confidence paradox — a disconnect between confidence and M&A activity. Before the financial crisis, economic sentiment and M&A activity moved in harmony. However, in the "new normal" economy, these indicators are decoupled. Macroeconomic risks, such as the Eurozone crisis, US sequestration and slowing emerging markets growth, have given companies pause. Consequently, some of the world's richest and most mature economies, which would be expected to lead a recovery, lack confidence within their borders, lowering appetite for capital investment worldwide.

Valuation levels and sentiment suggest companies now face is a window of opportunity to seize first-mover advantage in a market gaining momentum. History shows that first movers in any economic cycle can create differential value and position themselves for sustained market leadership. Now is the time to invest and grow forward.

Key findings for oil and gas

- More than 44% feel that the global economy is strongly or modestly improving, up sharply from just 27% six months ago.
- Confidence in the local economy is also up modestly.
- Credit market tightness is notably easing.
- The oil and gas M&A appetite is improving compared to six months ago.

About this survey

The Global Capital Confidence Barometer is a regular survey of senior executives from large companies around the world, conducted by the Economist Intelligence Unit (EIU). Our panel is comprised of select Ernst & Young clients and contacts, and regular EIU contributors. This snapshot of our findings gauges corporate confidence in the economic outlook, and it identifies boardroom trends and practices in the way companies manage their Capital Agenda.

Profile of respondents

- Panel of more than 1,600 executives surveyed in February and March 2013, including 152 oil and gas executives
- Companies from 50 countries
- 794 CEO, CFO and other C-level respondents
- More than 912 companies would qualify for the Fortune 500 based on revenues

The Capital Agenda

Based around four dimensions, it helps companies consider their issues and challenges, understand their options and make more informed capital decisions.

1. **Preserving capital:** reshaping the operational and capital base
2. **Optimizing capital:** driving cash and working capital and managing the portfolio of assets
3. **Raising capital:** assessing future capital requirements and assessing funding sources
4. **Investing capital:** strengthening investment appraisal and transaction execution

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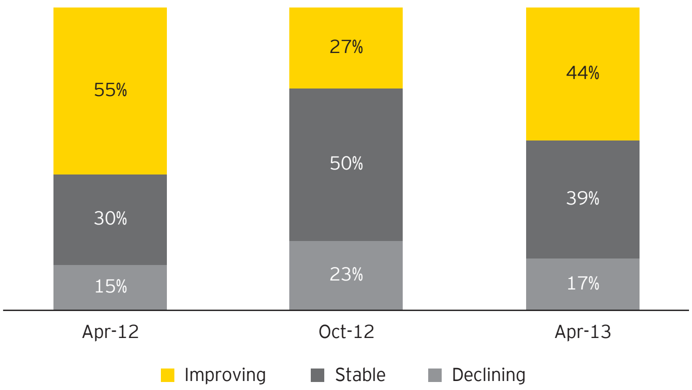
Economic outlook

Global economic outlook has brightened

The global economy showed some signs of stabilizing in early 2012, but the hoped-for recovery never really gained traction, and the global economy seemed to bottom out in late 2012. While the slowdown persists in Europe, some rays of hope are emerging in the US and Japan, and the emerging economies are recovering from their slowdown. Notably, the oil and gas companies in our survey are significantly more optimistic about the future of the global economy than they were six months ago.

More than 44% of the oil and gas company respondents believe the global economic situation is improving, up from 27% in October 2012. There has also been a decrease in the number of companies who report declining sentiment, from 23% to 17%. Oil and gas companies are also generally more optimistic than the broader global sample of respondents.

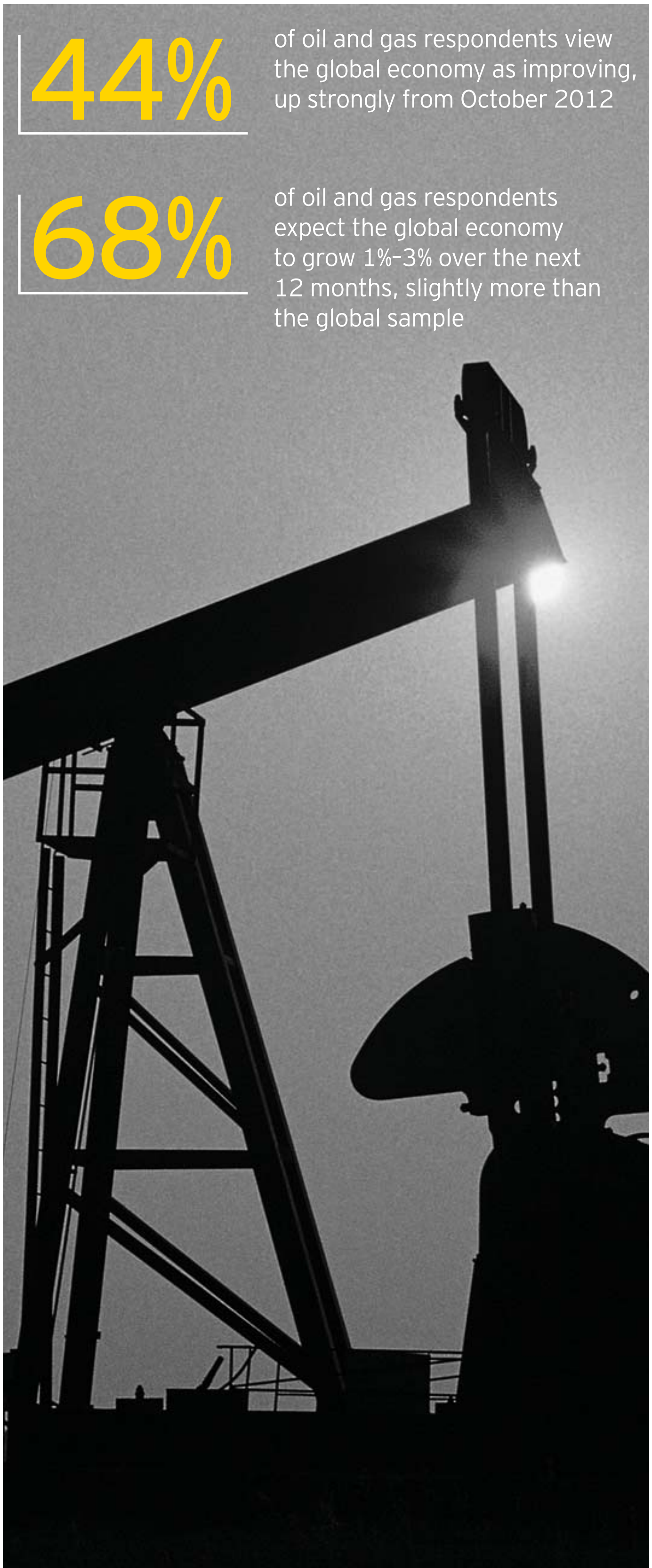
What is your perspective on the state of the global economy today?



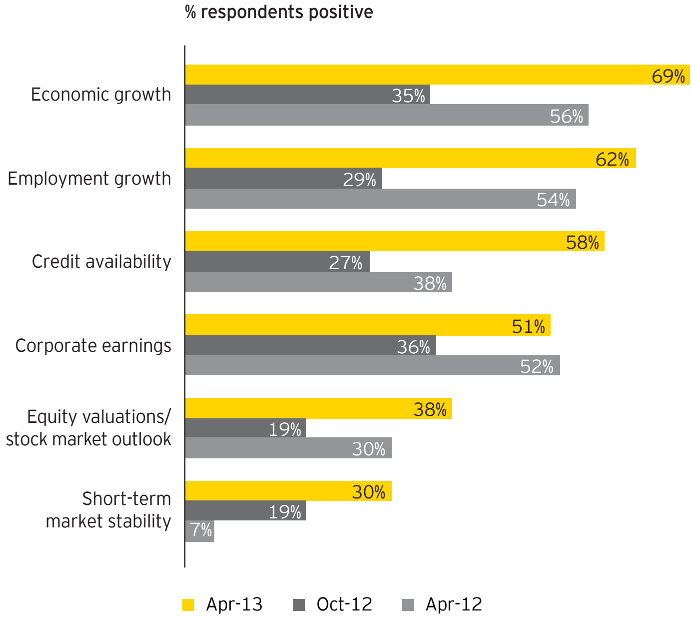
Confidence among our oil and gas companies was up significantly across a broad range of economic indicators, with confidence levels doubling in several cases. More than half of oil and gas respondents reported being positive about economic prospects in terms of economic growth, employment growth, corporate earnings and credit availability. As noted above, oil and gas respondents were generally more confident than the average global respondent for every indicator, except in the case of short-term market stability.

44% of oil and gas respondents view the global economy as improving, up strongly from October 2012

68% of oil and gas respondents expect the global economy to grow 1%–3% over the next 12 months, slightly more than the global sample



What is your level of confidence in the following economic indicators at the global level?



Viewpoint

The growth dilemma

When does risk aversion itself become a risk?

Over several Barometers, we have observed a disconnect between macroeconomic conditions and corporate action – improving confidence and strong deal fundamentals have not led to a rebound in M&A.

This corporate caution is understandable. The global financial crisis has been drawn out, with moments that suggested turnaround that never materialized. Amid this persistent crisis environment, the current generation of corporate leaders has pursued growth largely through organic measures or optimization efforts. In general, these leaders have been rewarded by boards for their conservative instincts.

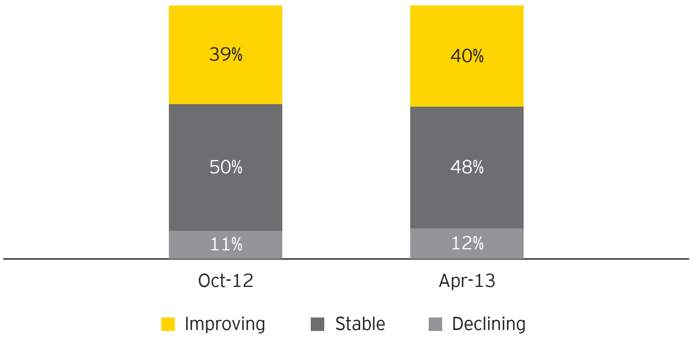
However, we may be nearing the point at which this sustained caution itself becomes risky. Organizations in search of growth may need to take an informed risk to achieve their strategic objectives and to outpace competitors. First-mover advantage is a constant, even in today's markets.

Leading companies are laying the groundwork for taking action when the time is right. That means honing their Capital Agenda: fine-tuning the capital structure, defining core businesses, executing divestments when necessary, and putting in place proper risk management and governance. Most important, it means answering the questions, "Where do you want to grow?" and "What will it take?"

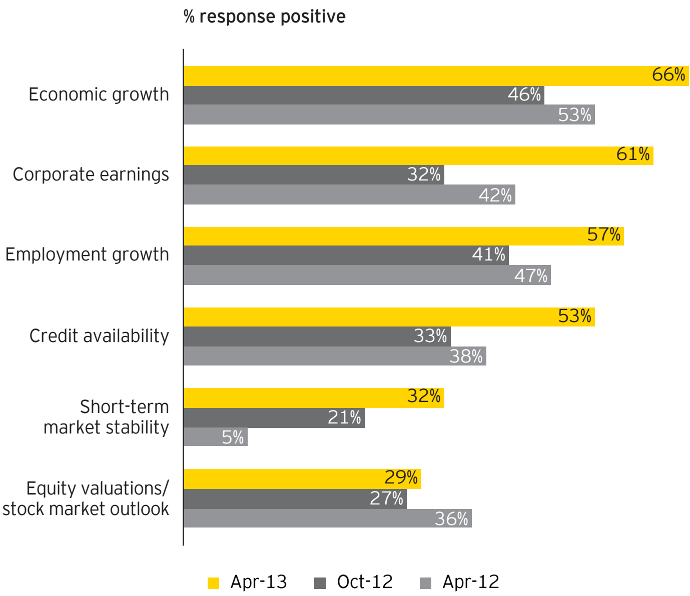
Local economic sentiment also strengthens

In line with the global results, positive local economic sentiment has also increased. Once again, the oil and gas respondents were slightly more optimistic than the broader sample. Similar to sentiment at the global level, confidence across a broad range of economic indicators was up at the home/local level for our oil and gas respondents. Additionally, oil and gas respondents in emerging economies were notably more optimistic about their local economy than were their counterparts in the more developed economies.

What is your perspective on the state of the local economy today?



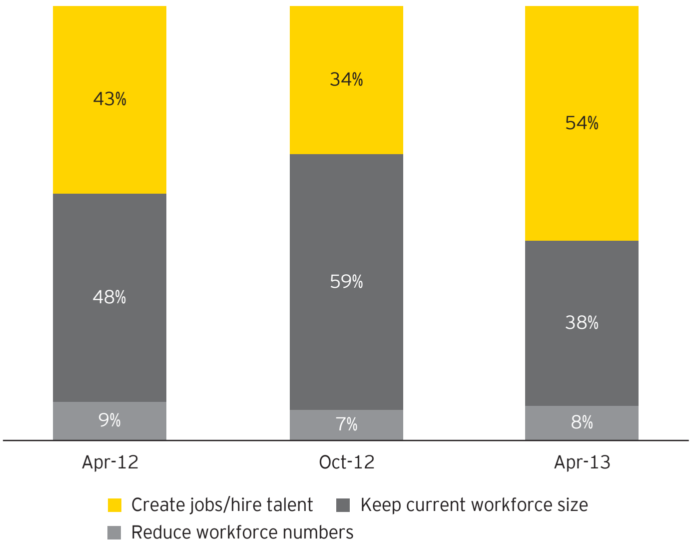
What is your level of confidence in the following economic indicators at the home/local level?



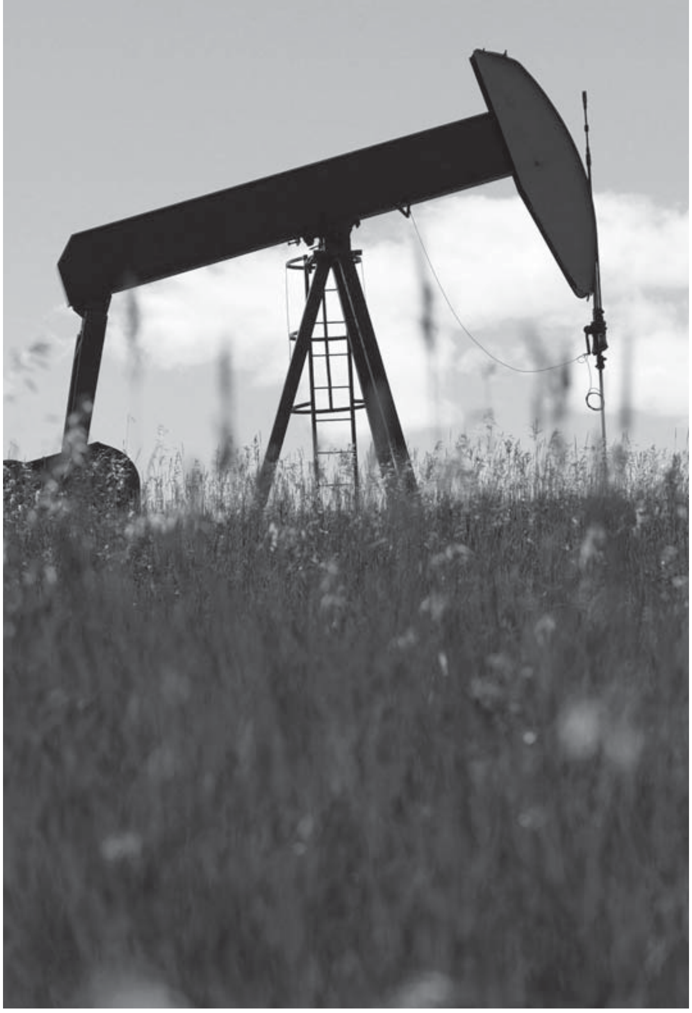
A supportive regulatory environment and increasing economic confidence drive job creation

An overwhelming majority – more than 80% – of oil and gas respondents see the current regulatory environment as supportive of business growth initiatives, at both the global and local/domestic level. That perceived support and the increasing economic confidence are driving job creation.

With regard to employment, which of the following does your organization expect to do over the next 12 months?



92% of oil and gas companies expect to maintain or increase their current workforce in the next 12 months



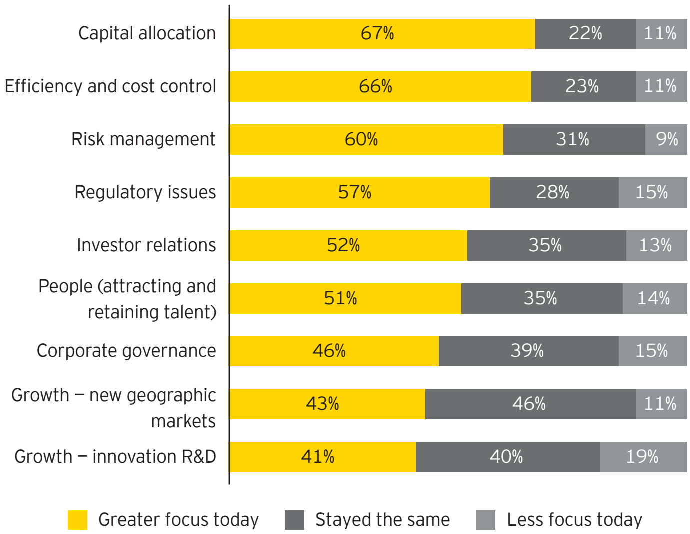
Boardroom agendas shed some of their conservatism

Reflecting to some degree the increasing optimism, oil and gas boardroom agendas are changing, with capital allocation moving up to the top priority and the more conservative agenda items – efficiency and cost control along with risk management – which had led the agendas in October, slipping slightly in priority. Also moving up on boardroom agendas were regulatory issues, investor relations, people issues and growth in new geographic markets.

Efficiency and cost control along with risk management still lead the boardroom agenda for the broader global sample of respondents but, as with our oil and gas respondents, are less of a priority than they were in October. And as with our oil and gas respondents, capital allocation is moving up in priority. By and large, the changes in the oil and gas boardroom agendas essentially mirrored those in the broader global sample.

Riskier growth measures, including research and development, are lower on the agenda. However, the findings in this Barometer point to a window of opportunity for accelerated growth. Economic confidence, credit conditions and valuations – along with a recent rise in shareholder activism – all signal an imperative to act. Prudent discipline and governance are necessities. But now may be the time for boards to achieve first-mover status.

How has the boardroom agenda at your company changed from a year ago?



As would be expected, risk prioritization is dominated by local concerns, with oil and gas respondents broadly split as to what the greatest economic risk was to their business.

What do you believe to be the greatest economic risk to your business over the next 6–12 months?

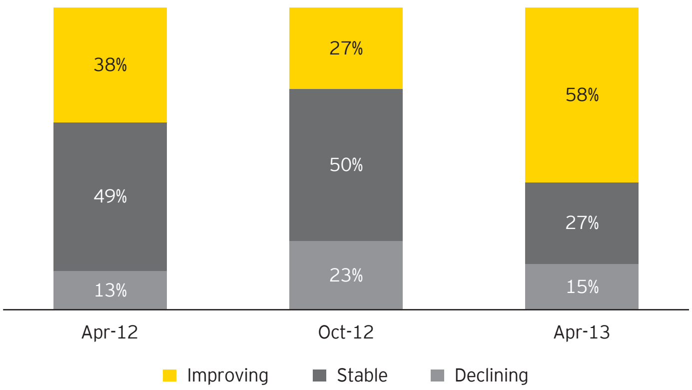
Access to capital

Credit conditions improving globally

While credit has remained broadly available, particularly to large-cap enterprises, our global respondents report a substantial increase in credit availability. Compared with two years ago, banks are on a stronger footing and better capitalized. Yet this healthier picture has not always translated into increased lending, as many banks tightened their lending standards, particularly for small-to-medium enterprise (SME) borrowers. Banks also face higher capital requirements under impending Basel III regulations, which could restrict their ability to increase the flow of credit into the economy.

The oil and gas panel similarly believes that credit conditions generally continue to improve, and compared to six months ago, the percentage of oil and gas companies seeing credit conditions loosening has increased substantially. Oil and gas respondents also expressed more optimism than the broader global group of respondents.

What is your level of confidence in credit availability at the global level?



85%

of oil and gas respondents view credit availability as stable or improving

Mixed global deleveraging trends

Over the past few years, many oil and gas companies have taken advantage of improved credit conditions and a favorable rate environment to strategically use additional leverage and reduce their cost of capital. But at the same time, over the last two years, more oil and gas companies have been looking to deleverage their balance sheets than to add leverage. And although we did see an increase in the proportion of companies expecting to finance to further expand their operations and increase their debt-to-capital ratios — 28% in April 2013, up from 21% in October 2012 — the proportion of oil and gas companies looking to take the opportunity to further deleverage (i.e., decrease their debt-to-capital ratios) increased even more sharply to 45%, up from 31% in October 2012.

Viewpoint

Credit availability as leading indicator

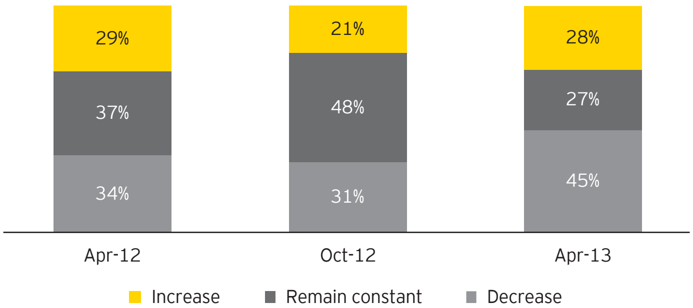
Our survey shows a higher percentage of companies expecting an increase in their debt-to-capital ratio, from 21% in October 2012 to 28% in this Barometer. Coupled with a large increase in those citing greater overall availability of credit (from 27% to 58%), this signals that respondents' appetite for leverage is poised to rise.

Throughout the economic crisis, companies in preservation mode came to view the use of credit as a liability. But the reputation of credit, like the economy at large, is slowly being rehabilitated. After several Barometers in which more than half of respondents had low debt-to-capital ratios, in this issue that metric falls to 40%.

At a time of ample credit availability and historically low pricing, leading companies are coming to view credit as a tool to fuel their growth agenda.

In our April 2013 survey, more than 74% of the oil and gas respondents reported debt-to-capital ratios below 50%, with 40% reporting ratios of less than 25%. Both of these percentages declined, however, from our October survey. Clearly, some oil and gas companies, as well as companies in general, are choosing to shed some of their caution.

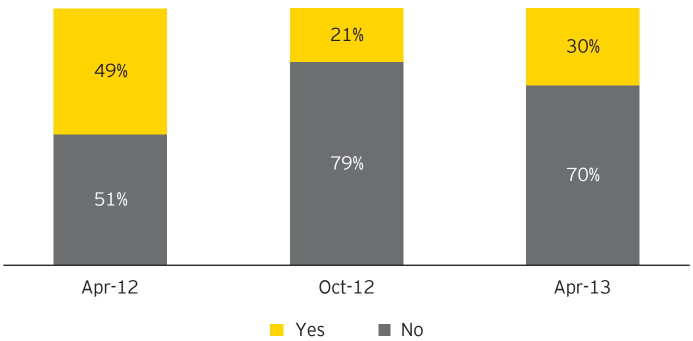
How do you expect your company's debt-to-capital ratio to change over the next 12 months?

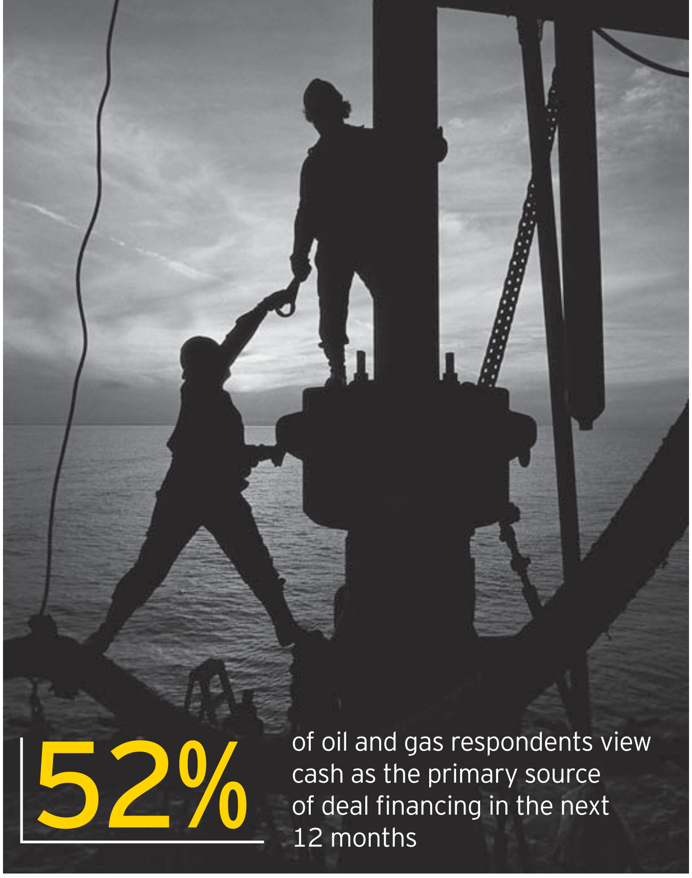


Debt decreases as a source of deal financing

Only 30% of the oil and gas respondents were expecting to refinance loans or other debt obligations in the next 12 months, up from 21% from the October 2012 survey, but still down from 49% in the April 2012 survey. With large-scale changes to their capital structures now completed, oil and gas companies are focused on refinements – reducing interest costs, extending debt maturities and removing restrictive covenants. Declining in importance for refinancing have been the optimization of the corporate structure and retiring of maturing debt.

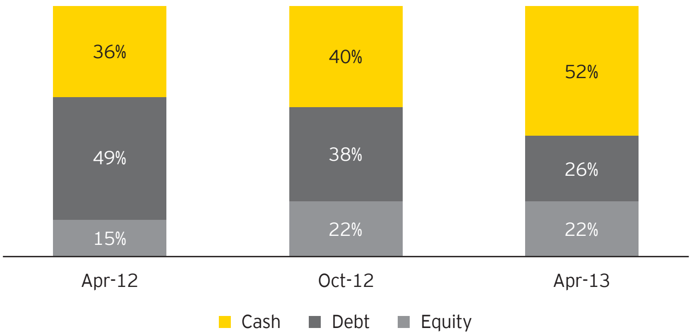
Does your company expect to refinance loans or other debt obligations in the next 12 months?





Debt has been declining steadily as the primary source of deal financing in the oil and gas sector: debt was seen as the primary source by 26% of oil and gas respondents in our April 2013 survey, down from 38% in October 2012 and 49% in April 2012. In contrast, cash has become increasingly more important for our oil and gas respondents.

What is your likely primary source of deal financing in the next 12 months?



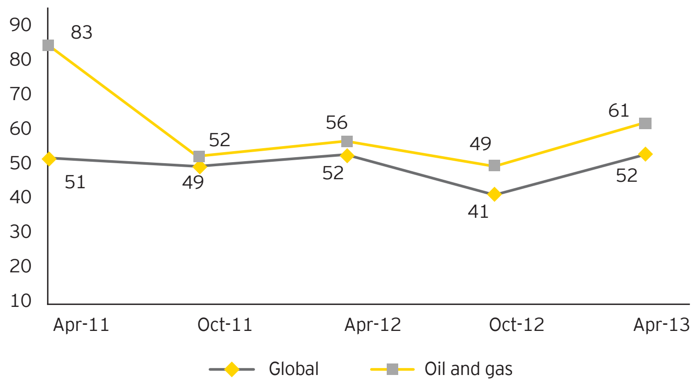
Growth

Growth focus returns

Prioritization of growth had broadly declined as companies in general became more focused on the fundamentals, but that decline has seemingly ended. Oil and gas companies' focus on growth had similarly been declining, but it turned up sharply in our April 2013 survey. Notably, our oil and gas respondents continue to be more focused on growth than the global sample of companies. Compared with six months ago, our respondents, both in the broader global sample as well as the oil and gas respondents, report a decreased focus on reducing costs, improving efficiency and optimizing capital.

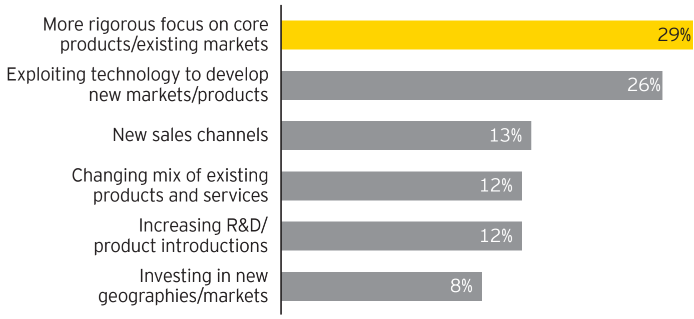
Growth remains the number-one objective for a majority of our oil and gas companies, with 61% reporting that growth is their primary focus, as compared to 20% whose primary focus was on cost reduction and operational efficiency, and 17% whose focus was on maintaining stability. This is the highest percentage of respondents citing growth as their top priority since April 2011.

Percent of companies focused on growth



The companies focused on growth tend to prioritize lower-risk organic strategies that are within their comfort zone. Rather than pursuing ambitious, transformational deals, they are hoping to deliver growth through better execution in existing markets, developing new products and markets through the exploitation of technology, identifying new sales channels, and changing the current mix of products and services.

What is the primary focus of your company's organic growth?

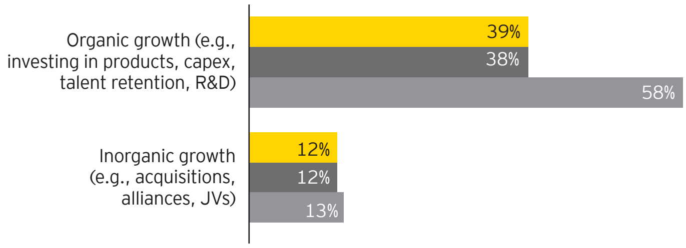


The appetite for organic growth reflects this broader pro-growth trend, but the oil and gas respondents' intentions with regard to excess cash point to some lingering caution. Only 39% of the oil and gas respondents plan to deploy excess cash toward organic growth, up from 38% in October 2012, but well below the 58% in April 2012. Deploying cash to inorganic growth remained at 12%, slightly down from 13% in the April 2012 survey.

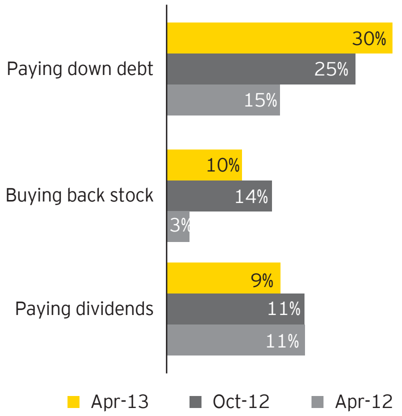
Returning cash to stakeholders — both shareholders and creditors — is now the priority for 49% of the oil and gas respondents, down slightly from 50% in October but up from less than 30% in the April 2012 survey. Thirty percent of oil and gas respondents expect that paying down debt will be their primary focus for excess cash over the next 12 months, up from 25% in October and 15% in the April 2012 survey. A focus on paying dividends declined slightly, and a focus on buying back stock also declined. This provides further evidence that companies are focusing their attention on deleveraging and strengthening their balance sheets against a backdrop of ongoing uncertainty.

If you have excess cash to deploy, which of the following will be your focus over the next 12 months?

Growth slows ...



... as cash is returned to stakeholders



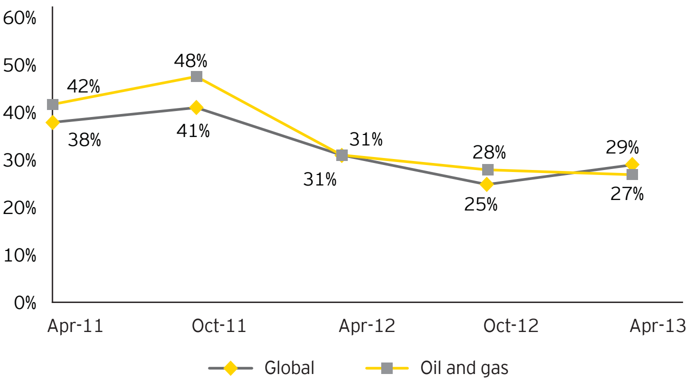
Mergers and acquisitions outlook

Appetite for M&A declines

Amid uncertainty about the global economic outlook, oil and gas companies are still wary of acquisitions and their perceived risks. Just 27% of respondents now expect to pursue acquisitions over the next 12 months, down from 28% in October 2012 and 31% a year ago. It is not just a lack of confidence in the business environment that is holding companies back – many are also concerned about the gap between their valuation of potential acquisitions and the prices sought by sellers. For many companies, the intent around M&A has declined. Five years after the financial crisis, many executives are still waiting for a sustained recovery before taking action.

Do you expect your company to pursue acquisitions in the next 12 months?

Expectations to pursue an acquisition

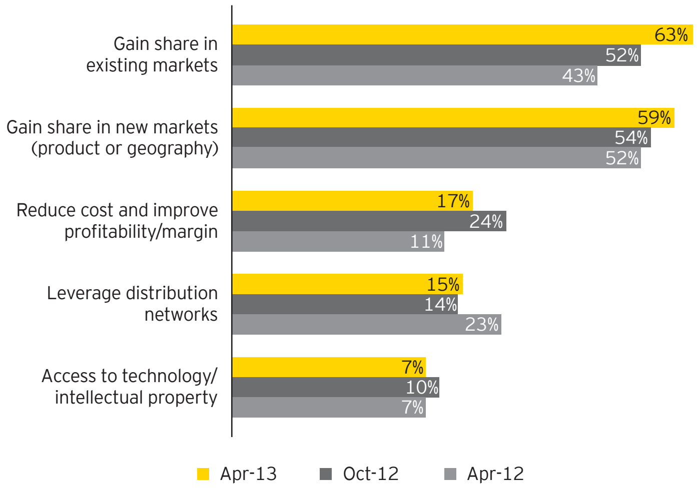


That conservatism aside, oil and gas respondents expect that global M&A deal volumes will increase over the next 12 months, with 72% expecting volumes to at least modestly improve. Expectations of the larger global sample were broadly similar. At the local level, oil and gas respondents were slightly less optimistic, with 58% expecting volumes to at least be modestly better.

Notably however, oil and gas respondents are slightly more optimistic about the acquisition environment than is the global sample, and oil and gas respondents generally had more confidence than the broader sample in terms of positive views on the number of deals, the quality of deals and the likelihood of closing deals. Nevertheless, confidence levels are generally increasing, both for oil and gas respondents as well as for the broader sample.

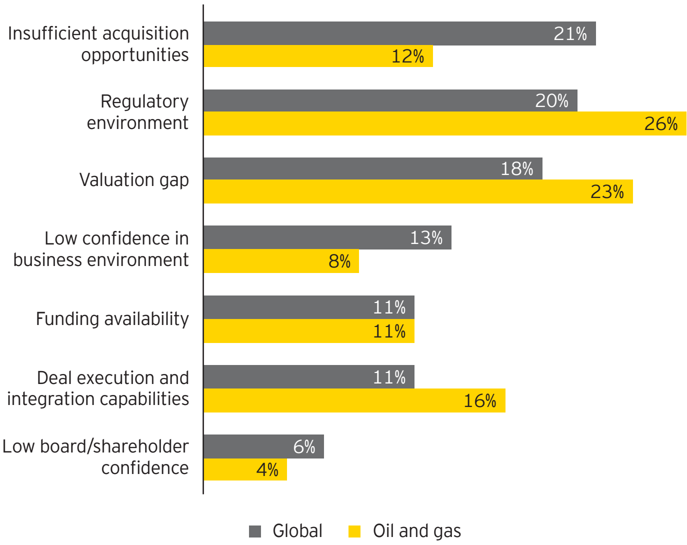
In terms of the drivers of acquisition activity, increasing market share, both in existing markets and in new markets, dominated the responses, for both the broader global sample and the oil and gas companies. Particularly for the oil and gas respondents, the market share drivers have been increasing in relative importance.

What are the main drivers of your company's planned acquisition activity? (select two)

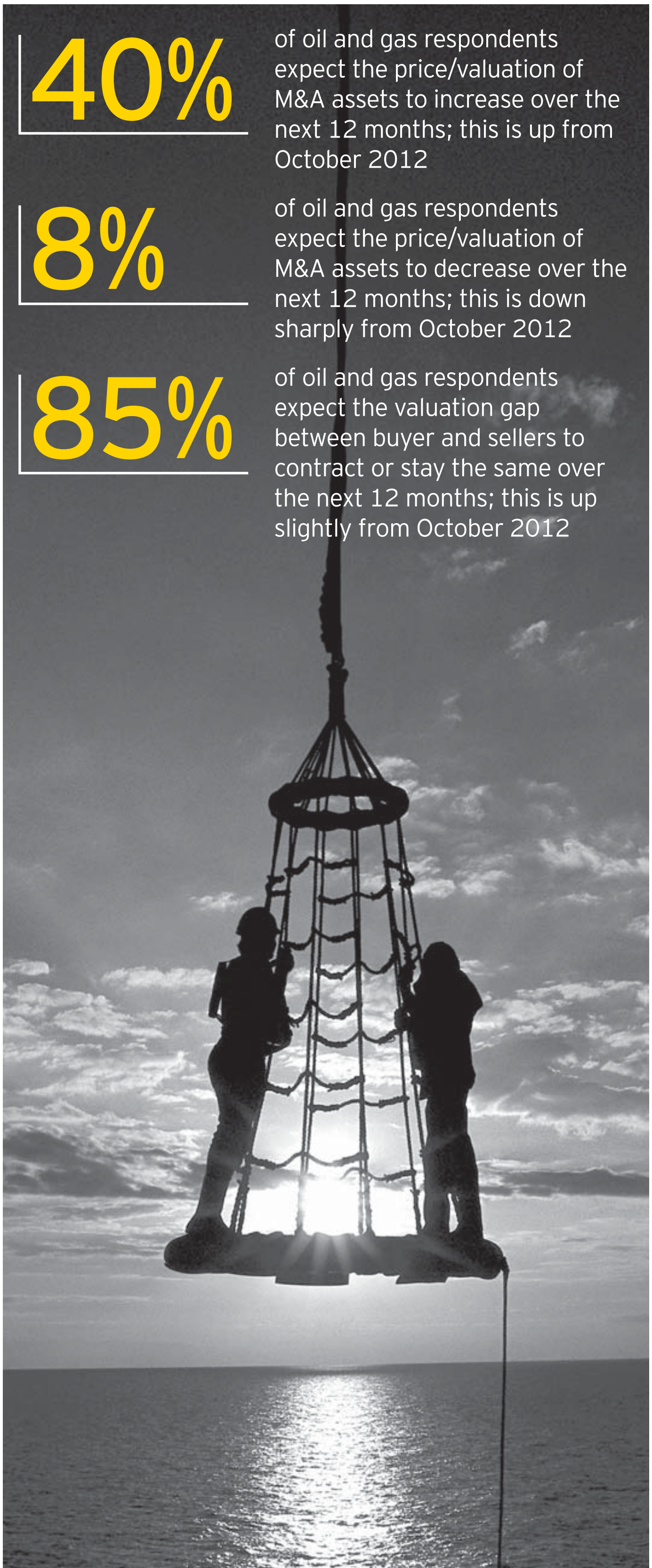


In terms of deterrents to acquisitions, our oil and gas respondents are more likely to be deterred by the regulatory environment, by the potential valuation gap, and by deal execution and integration challenges than are respondents in the broader global sample. Conversely, the broader sample was more likely to be deterred by insufficient acquisition opportunities and by low confidence in the business environment.

What is the primary reason for not pursuing an acquisition in the next 12 months?

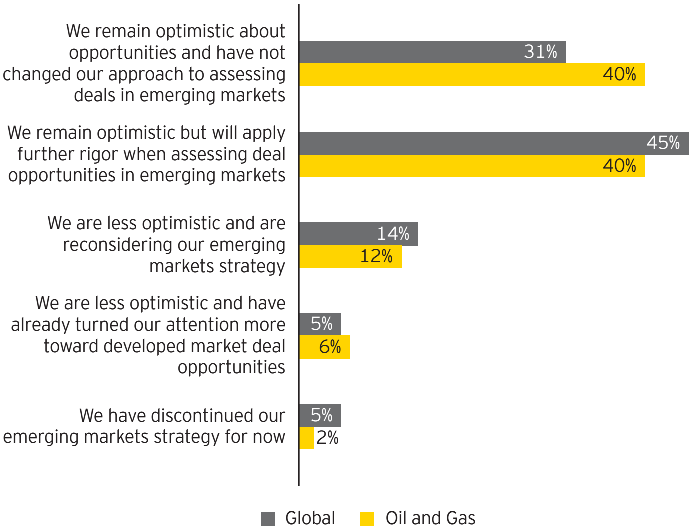


Among those oil and gas companies that do expect to engage in M&A, deal sizes remain fairly small, reflecting an ongoing aversion to risky, transformational transactions. More than 88% say that they will do deals worth less than US$500m, and 22% say they will do deals under US$50m. This suggests that, where deals are being considered, they will extend existing businesses and fill strategic gaps, deals that are typically termed, bolt-on



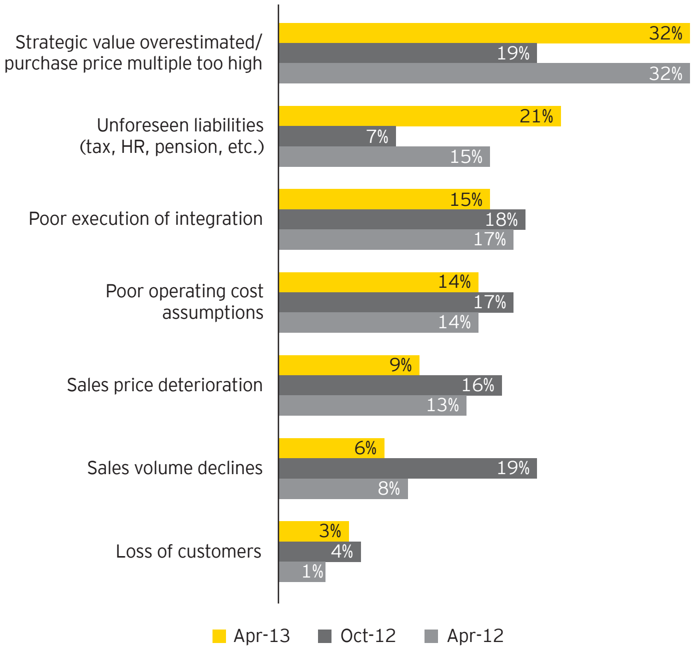
acquisitions. Optimism around acquisitions in emerging markets remains relatively high, both for our broader sample and for our oil and gas respondents, but companies are exerting more caution, particularly in those areas where growth has slowed. Notably, political risk and regulatory risk are the principal obstacles to emerging market deals, particularly for oil and gas companies.

Which statement best describes your approach to M&A in those emerging markets that are experiencing slower growth?



Among companies that have recently completed acquisitions, overestimating strategic value was the leading reason for deals not meeting expectations, both for the broader sample and for oil and gas companies.

For acquisitions recently completed, what was the most significant issue that contributed to deals not meeting expectations?

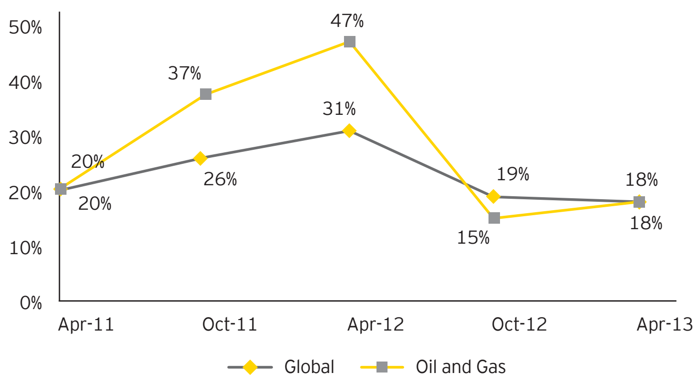


Divesting activity shifts down as well

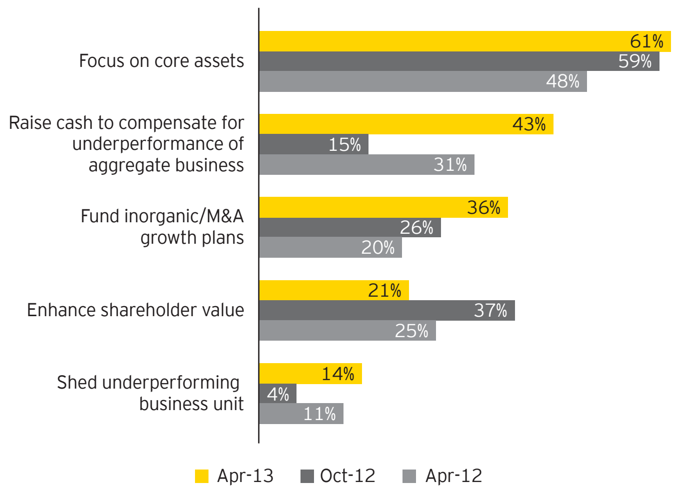
There has also been a sharp decline in the number of companies planning to make divestments in the next 12 months, particularly so in the case of oil and gas respondents. Many companies have gone through the process of optimizing their portfolios and offloading those assets that did not fit their overall strategic objectives.

Do you expect your company to divest assets in the next 12 months?

Expectations to divest



What are the main drivers of your company's planned divestment activity? (select two)



Optimization moves to the forefront

Following an active period of divestment activity over the past 18 months, oil and gas companies have now shifted their focus to optimizing capital allocation and improving performance. For oil and gas companies expecting to make divestments over the next year, a spin-off or IPO of an existing business unit was seen as the most-likely form of divestment, followed by the outright sale of an existing unit.

For our oil and gas respondents, the most-often cited deterrents to making divestitures were the inability to realize the price/value expectations (i.e., the "valuation gap"), fears of disruptions to core business activities, and some execution concerns.

Viewpoint

A possible inflection point in asset valuations

One factor contributing to the ongoing slowdown in deal-making is a perceived gap in asset valuations between buyers and sellers. Companies pursuing divestments are seeking high valuations for their assets, while potential buyers are primed for discounts and reluctant to pay a premium.

However, we may now be nearing equilibrium between what buyers will pay and what sellers will accept. This equilibrium is vital, signaling the deal markets are at an inflection point and ready to rebound. The pendulum is primed to swing the other way – toward growing prices by buyers and more-profitable exits for sellers. This also suggests a comeback in market fundamentals, corporate health and a stable foundation for deal-making.

With 40% of respondents expecting M&A assets to increase in value over the next 12 months (and only 8% calling for a decrease), companies should consider taking advantage of this inflection point now.

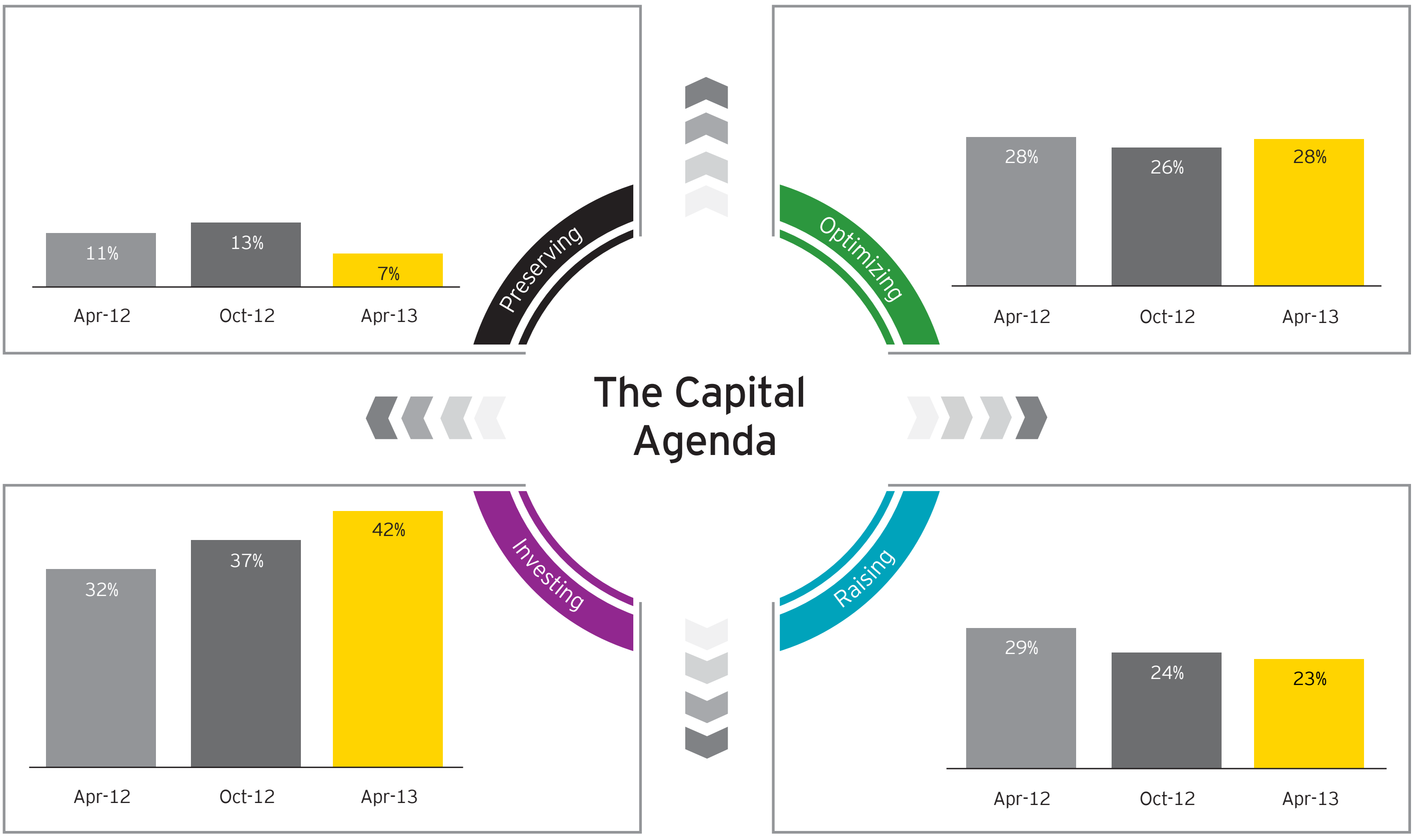
Capital Agenda

Oil and gas companies shift focus slightly; investing still tops the Agenda

Our latest Barometer survey shows a slight shift in the focus of the oil and gas Capital Agenda over the last six months. "Investing" capital is still the dominant dimension for the Agenda, and it increased in importance from the October 2012 survey.

"Optimizing" capital ranked second on the Capital Agenda, also up slightly from the last survey. "Raising" capital had moved up rather strongly on the Agenda in the April 2012 survey but has slid back slightly since then. "Preserving" capital also decreased slightly in importance in our latest survey, and it remained the least important part of the oil and gas Capital Agenda.

What statement best describes your organization's focus over the next 12 months?



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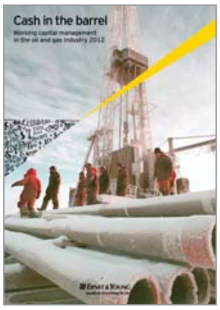
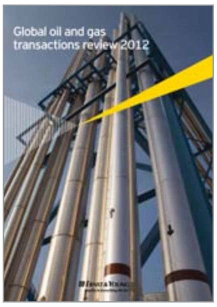
A quarterly update of our O&G Eye Index and analysis of the performance of the AIM listed O&G companies.



Cash in the barrel

Cash in the barrel 2012 is the latest in a series of working capital management reports published by Ernst & Young.



Global oil and gas transactions review 2012

In this report, we look back at some of the main trends in oil and gas deal activity over 2012 and explore the outlook for transactions in the sector in 2013.

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