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Deloitte Oil & Gas Mergers
and Acquisitions Report –
2015 Update
Adjusting to the new reality

Deloitte Center
for Energy Solutions



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Executive summary

Adjusting to the new reality

This paper discusses the merger and acquisition (M&A) market in the oil and gas industry in 2015, covering both what has happened so far and what appear to be the emerging trends for the rest of this year and into early 2016.

While the aggregate activity level, both in terms of number of transactions and overall value, recovered somewhat in the second quarter, relative to the first quarter of 2015, one large international deal accounted for all of this upturn—the announcement of the acquisition of BG Group (BG) by Royal Dutch Shell (Shell). This transaction was valued at around \$80 billion and is primarily designed to strategically grow a dominant position in global LNG and to bring Shell a larger presence in high-potential offshore fields in Brazil.¹

Without this transaction, overall M&A deal value was relatively low compared to the past several years. The industry appears to be in a holding pattern, while the implications and impacts of the oil price downturn play out. While expectations of a short-lived, low-price environment persisted through the end of 2014, acceptance of the lower pricing environment began to grow over the course of 2015, resulting in market participants retrenching, cutting costs, and delaying capital projects to conserve cash. In some cases, production has been accelerated to boost cash flows (and remaining hedged positions continue to provide support). In this period of uncertainty and adjustment, it has been easy for value gaps to persist, where potential sellers placed premium values on attractive assets, while potential buyers did not yet see the bargains they were anticipating. At the same time, lenders to the industry did not, to any great extent, seek radical corrective action during the spring redetermination of borrowing bases that might have increased the pressure on highly leveraged companies to sell assets. We have also seen examples of North American producers being able to tap into equity markets as an alternative to rolling over debt or raising new debt. This strategy helps sustain activity through the downturn without further weakening of balance sheets, but could be risky if the dilution effect depresses stock prices.

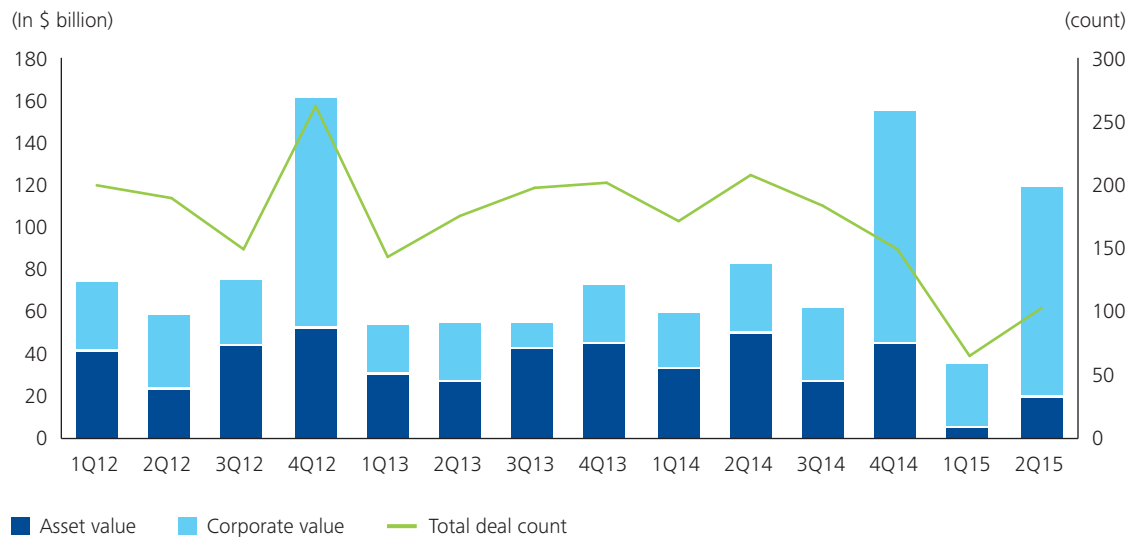


¹ The Financial Times Ltd., Shell says BG deal will produce 'billions' in savings, 19 July 2015. <http://www.ft.com/cms/s/0/81aa10ca-2c8b-11e5-8613-e7aedbb7bdb7.html#axzz3lFi5qp7s>

Going forward for the balance of this year and into next year, these factors may be changing, especially the availability of capital, likely creating a more fertile environment for deal-making than experienced so far this year. The longer the price downturn lasts, and, perhaps more importantly, the longer market participants think it will last, the more pressure builds from lenders for highly leveraged operators to shore up balance sheets with asset sales. Under this pressure, valuation gaps may erode, in which case buyers are likely to emerge, either from the ranks of companies with available cash and/or lower

leverage or from private equity sources, which see bargain opportunities. In this context, M&A activity will be poised to increase late in 2015 and early in 2016, particularly in the upstream and oilfield service sectors since these sectors are most exposed to lower crude oil prices. Historically, transaction data in recent years has shown that the fourth quarter has often been the strongest period of the year for M&A transactions. The convergence of factors described here indicates that this historical pattern will be repeated this year, and perhaps even to a greater extent than in previous years.

Figure 1. Oil and gas M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

Note: M&A activity examined in this report is based on data from PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015. The data represents acquisitions, mergers, and swaps with deal values greater than \$10 million, including transactions with no disclosure on reserves and/or production. Our analysis has excluded transactions with no announced value as well as transactions between affiliated companies, to provide a more accurate picture of M&A activity in the industry.

Industry overview

M&A activity slows despite continued low oil prices

2015 has been a year of adjustment for much of the oil and gas industry, both in North America and globally, and it is likely that continued adjustment will be needed for some time to come. M&A activity is one option to adjust to the new business environment, but, so far at least, it seems that organic adjustments to cost structures and activity levels have been prioritized over portfolio actions achieved through the M&A market.

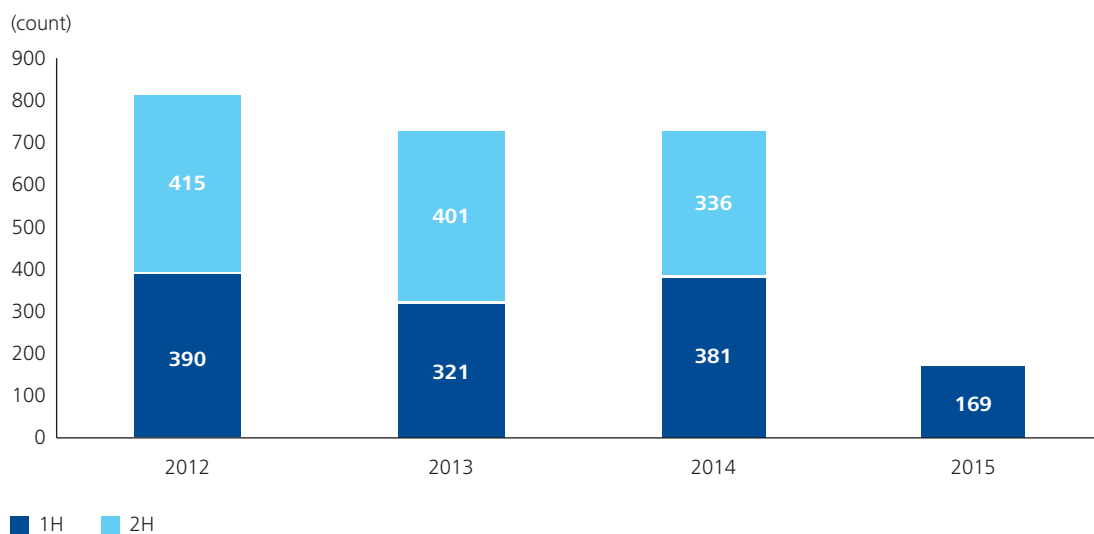
The backdrop to oil and gas industry activity this year has, of course, been dominated by the sharp drop and continued weakness in oil prices, from a level of over \$100 per barrel through mid-year 2014, to below half that level around mid-year and into the third quarter of 2015. Such a precipitous drop in oil prices has been predominantly a function of global supply growth exceeding global demand growth for the past few years, and then OPEC declining to follow historical practice by cutting its production to firm up the price environment. With the growth in non-OPEC production from multiple sources, dominated by US tight oil and Canadian oil sands, and with increases in production from Iraq, offshore Brazil and Russia, supplemented by the prospect of the return of Iran to global markets, core OPEC members led by Saudi Arabia and the other Middle East

producers have made a strategic decision to attempt to defend market share rather than price.

The impacts of this lower oil price world have been primarily felt in the upstream and oilfield service sectors of the industry, where reduced cash flows and balance sheet stress have led to an urgent focus on cost cutting and concentration of activity only on top tier assets. Activity levels and cash flows for the midstream sector have been largely unaffected in the short term, as throughputs in midstream facilities have remained robust, although longer term there may be a contraction in new investment opportunities for pipeline and processing facilities as a consequence of the current upstream environment. In the downstream, refining and marketing operators are financially doing well, as lower feedstock costs allow higher refining and marketing margins, for the moment at least.

The first couple of quarters therefore stand in sharp contrast to the same period in 2014, when oil prices were high, capital investment was proceeding at a very robust level, and the global market in all segments seemed to be functioning at a level which had fully adapted to a reality of \$100 per barrel oil prices.

Figure 2. 2015 Global oil and gas M&A deal activity slows



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

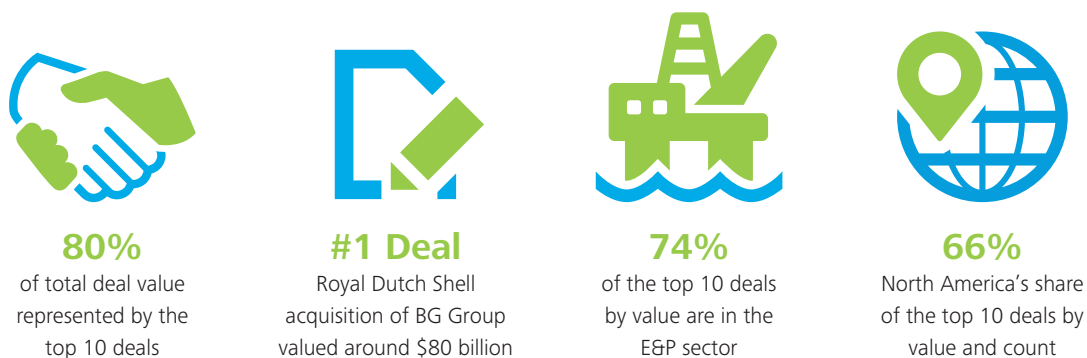
So how has the M&A market fared in this transition to a new business environment for oil and gas? The data on the number and value of deals announced in the first eight months of this year show, somewhat surprisingly, a fairly modest level of new deal activity, particularly when the impact of one global-scale deal—the acquisition of BG by Shell—is excluded. In fact, if the two major oilfield services deals—the combination of Halliburton/Baker Hughes and Schlumberger/Cameron—were also excluded, there would be a consistent downward trend in deal value since the second quarter of 2014, coincident with the decline in oil prices. To some extent, this trend is counter-intuitive, particularly if we recall that the great consolidation of the major oil companies with a series of mega-mergers occurred at a time of low oil prices in which the search for scale and efficiency were seen as critical for long-term survival.

A number of factors could contribute to explaining the relatively low level of deal activity seen so far in this downturn. First, the psychology of the market saw many participants anticipating that the price downturn would be relatively short-lived, such that short-term activity and cost adjustments would be sufficient to ride out a limited period of reduced cash flow. Second, many upstream players,

particularly US-based independent producers, had hedging programs in place, which afforded a degree of protection to cash flows over much of 2015. Third, many debt holders have been willing to continue extending debt coverage under existing conditions, again in the anticipation of a market upturn, which would likely result in a return to anticipated debt repayment schedules. As these factors are only expected to favorably impact companies for a limited amount of time and companies will likely be under increasing pressure to rationalize assets in their portfolio and respond to the requirements of debt holders, there is likely to be an increase in M&A momentum across the sector over the balance of 2015 and into early 2016. The exploration and production (E&P) sector would likely be at the forefront of such an upturn, since cash flows in this sector are most affected by low oil prices.

Of course, tax considerations can be a key enabler or inhibitor of M&A activity in specific cases, as companies look to incorporate optimization of their tax exposure as an integral part of their assessments of deal valuation and strategic fit. While perhaps not a prime driver in itself, tax considerations can play an important role in making or breaking potential deals across all sectors.

Figure 3. Top 10 oil and gas M&A deals



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015



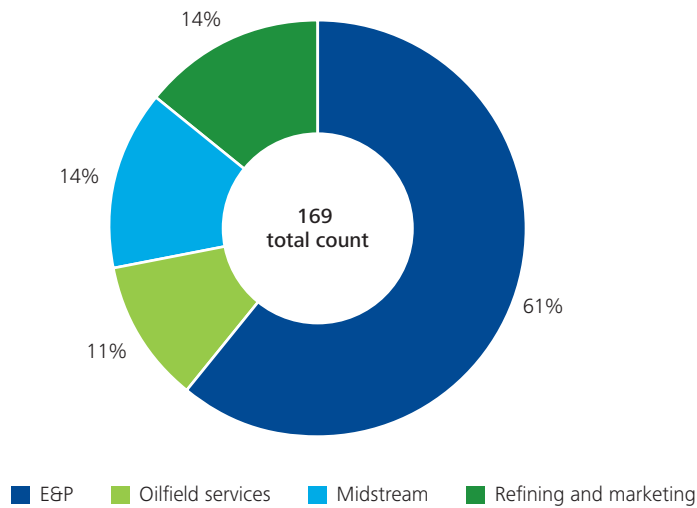
M&A trends across the sectors

Activity remains low

M&A activity across the main oil and gas sectors has varied in intensity over the first part of 2015. In general, second quarter activity was stronger than the first quarter.

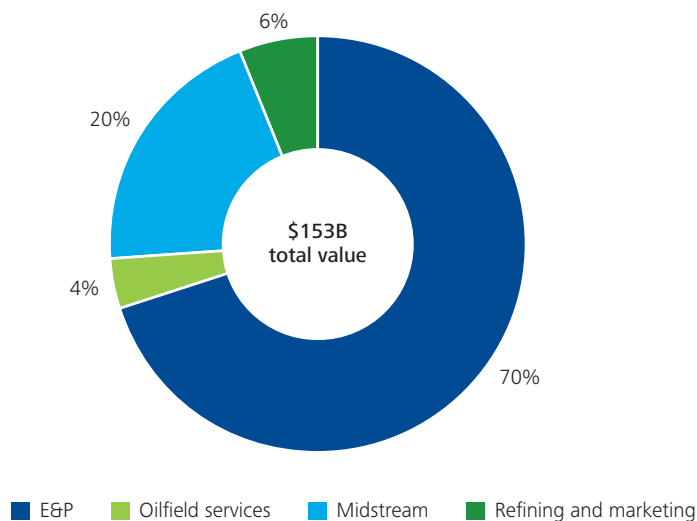
However, even with that, excluding the Shell/BG deal, M&A activity was at a relatively low level compared to any quarter over the last three years.

Figure 4. Global M&A–E&P maintains M&A dominance by deal count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

Figure 5. Global M&A–E&P maintains M&A dominance by deal value (billions)



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

Exploration and production

Wait and see mode continues



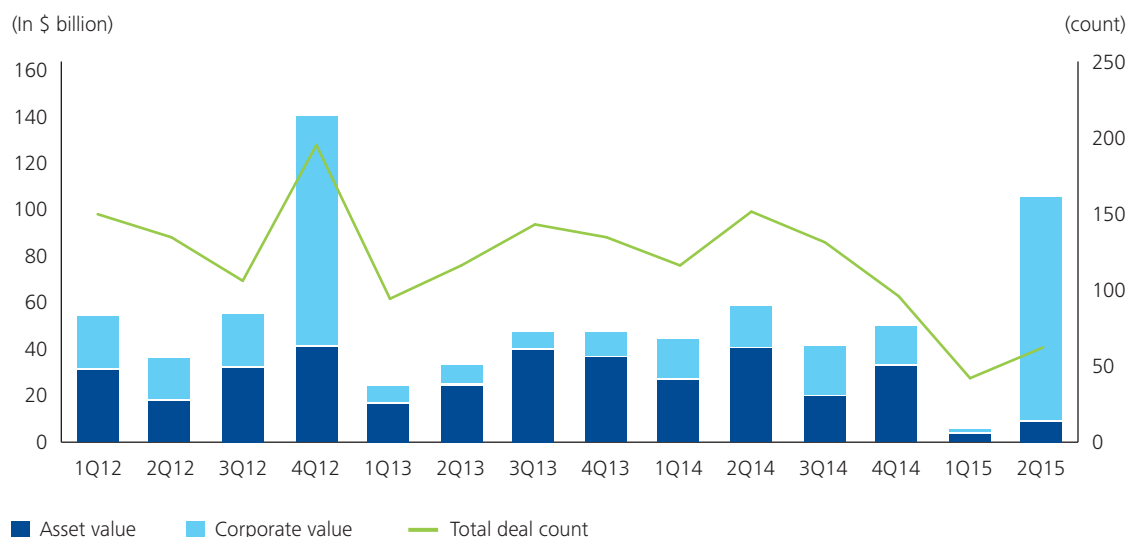
2015 Q2 deal value up with one deal accounting for 80% of the total

Although the overall value of E&P upstream deals shows a sharp upturn in the second quarter of 2015, over half of overall deal value is attributed to the announced acquisition of BG by Shell. Without this deal, overall upstream second quarter activity would have been about half the level of the fourth quarter of 2014, which is certainly a recovery from the first quarter, but still supports the perception that the sector was largely in a wait-and-see mode, focusing on cost-cutting and high-grade drilling prospect inventories rather than actively pursuing inorganic rationalization. The next largest corporate deal involved the acquisition of Rosetta Resources by Noble Energy, which was primarily driven by Noble Energy's desire to strengthen its portfolio in the onshore US unconventional arena, in particular the Eagle Ford play in South Texas.²

North America was clearly the geography where deal activity was most prevalent, even at an overall reduced level. Structurally, the number of players in the US and Canada opens up greater opportunities for upstream deals than in other parts of the world, so it is to be expected that this is the most active region, even in an overall depressed market.

Over the next six months or so, circumstances would seem to favor greater pressure on some E&P companies to execute asset sales or even corporate consolidations in the face of increasing strains on cash flows and balance sheets. As previously mentioned, hedging positions, which had provided positive cash flows, are now rolling off and cannot be replaced by equivalent positions in the forward markets. Add to this the likely increase in asset impairment charges each quarter and the reduction in proved reserves—both a function of lower oil prices—and the probability that debt redeterminations will raise borrowing costs and/or accelerate repayments, and the build-up in pressure to rapidly sell assets could be severe. Some companies, particularly those that are very highly leveraged, may even be forced into bankruptcy, releasing assets onto the market as part of post-bankruptcy restructuring. The tightrope on which some of the industry participants have been precariously balancing over the past several months has been supported by companies aggressively attempting to maintain cash flow by cutting costs, completing projects already in progress, and drilling in areas with the best prospects for immediate returns, while financial institutions have not been eager to

Figure 6. E&P M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

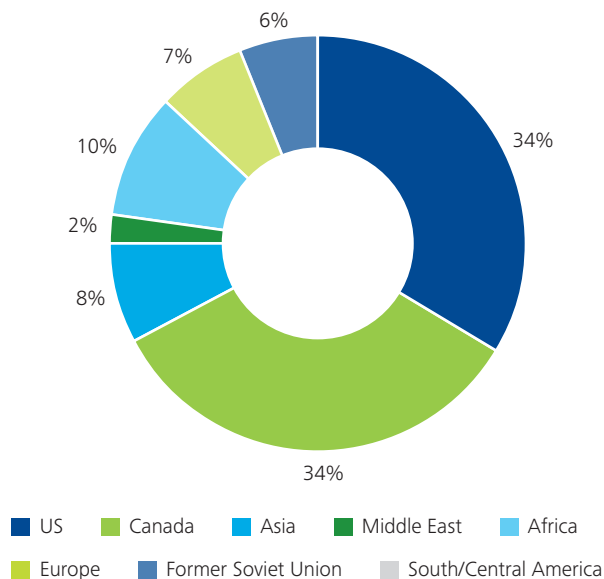
² Noble Energy Press Release, Noble Energy Closes Acquisition of Rosetta Resources, July 20, 2015. <http://investors.nobleenergyinc.com/releasedetail.cfm?ReleaseID=922879>

force companies into foreclosure and be left with distress-value asset disposals. But the longer the downturn lasts, the higher the risk that more of the companies walking this tightrope will lose their balance.

For potential acquiring companies, the above combination of circumstances is likely a factor which thus far has delayed asset or corporate purchases. Many potential acquirers expect valuations to decline further as pressure

on distressed companies increases, and higher quality assets become available. For all these reasons, the volume of E&P M&A transactions could accelerate over the balance of 2015 and into early 2016, with both corporate buyers and private equity investors in the market securing good assets at bargain valuations, ahead of an upturn in oil markets, whenever that occurs.

Figure 7. 2015 1H E&P deal count by region



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

Oilfield services

Companies continue to refocus—activity remains quiet

52%

Deals by count

71%

Deals by value

(1H 2015 vs. 2014)

North America deal values represent 98% of the total

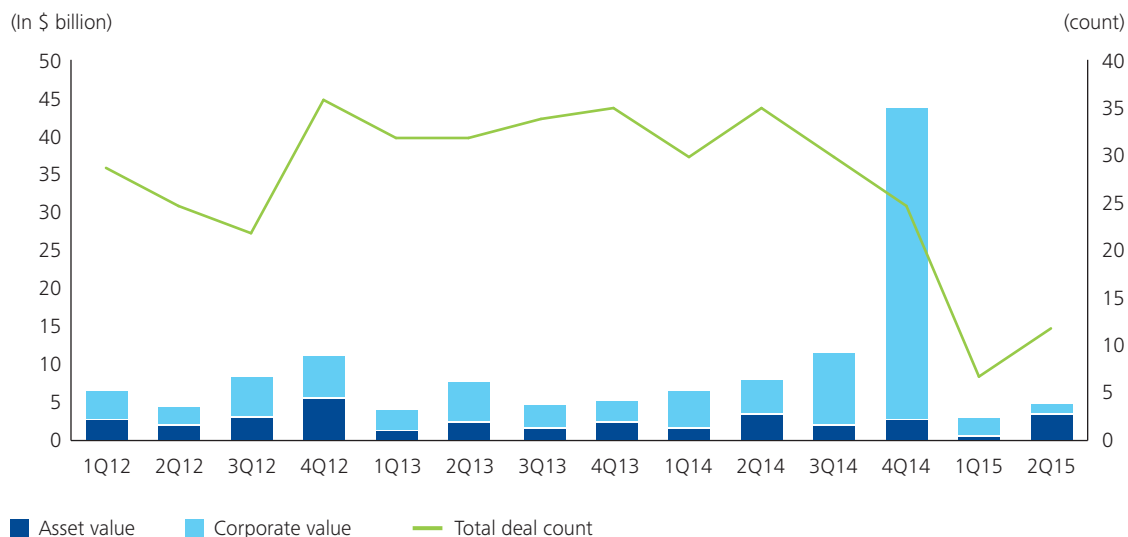
Oilfield service companies have borne the brunt of the reductions in activity and costs targeted by the E&P sector since the oil price downturn began in mid-2014. There has been intense and urgent pressure on service companies to cut costs; reduce capacity; rationalize portfolios, both geographically and by service line; and renegotiate contracts with customers and suppliers. At mid-year 2015, the North American rig count was less than half of mid-year 2014. Revenues at the largest oilfield services companies were down more than 25 percent from 2014 with greater declines suffered by companies focused on the North American drilling market. In the midst of this turmoil, M&A activity can provide opportunity for companies to sharpen their focus on those business areas, which can provide more sustained profitability.

Oilfield service deal activity in the second quarter of 2015 was in fact dominated by one asset deal, of a financial nature, in which Petrobras spun off a number of offshore platforms to Standard Chartered Bank for a deal value of

\$3 billion. This transaction dwarfed the remainder of M&A activity in what was a relatively quiet quarter for the oilfield service sector.

Looking forward, rationalization in the sector will likely continue, with oilfield service companies refocusing on their most robust service lines and geographies, giving the opportunity for deal making in both assets and business lines. Coming out of the pending large transactions between Halliburton and Baker Hughes, mid-tier and smaller companies may look to pick up divested service lines and take advantage of an opportunity to acquire the technology and related intellectual property. There may even be a mini-wave of consolidation among mid-size players looking to bolster their scale and competitiveness. This low oil price environment may also drive innovation in techniques and/or joint ventures and combinations to drive innovation, such as the announced merger of Schlumberger and Cameron.³

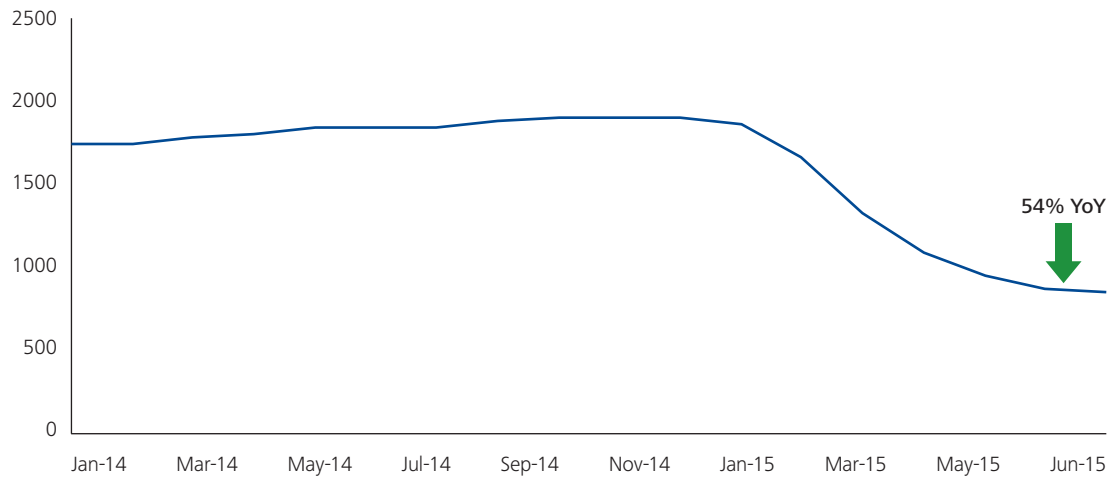
Figure 8. Oilfield service M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

³ Schlumberger.com, Schlumberger Announces Agreement to Acquire Cameron, August 25, 2015. http://www.slb.com/news/press_releases/2015/2015_0826_slb_cameron.aspx

Figure 9. US total rig count



Source: Baker Hughes (August 2015)

Midstream

Signs point to interest in consolidation



Deals by count



Deals by value

(1H 2015 vs. 2014)

Top 10 deals account for 93% of total deal value

In the midstream sector, the number of deals consummated or announced in the second quarter was slightly above the first quarter of the year, and trending above the same period in 2014, although most deals were quite low in value. The two most notable transactions were the spin-off by Hess of a 50 percent share of its Bakken midstream operations and the acquisition of more gathering and processing assets by Enterprise from Pioneer and Reliance, both transactions valued in the \$2 billion range.

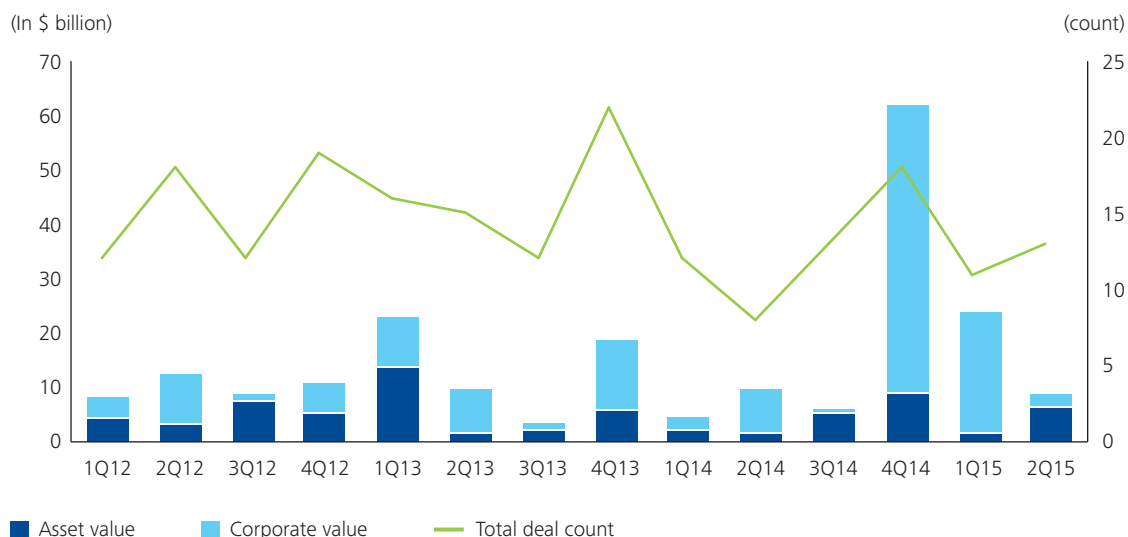
However, as 2015 progresses, there are continued signs of interest in consolidation in the sector, notably among master limited partnerships (MLPs). This follows the second quarter closing of Energy Transfer's pending acquisition of Regency Energy Partners for approximately \$18 billion, a deal that dominated transactions announced in this sector in the first quarter of 2015.

At least one other large transaction was also recently announced, involving the acquisition of Mark West Energy Partners by Marathon Petroleum's MLP, MPLX LP, a deal worth over \$15 billion. Mark West has an extensive infrastructure footprint and has been behind some of the major expansions of natural gas pipelines and processing out of the Marcellus shale. Marathon Petroleum appears to

be building synergies here between midstream capabilities and its downstream refining assets to unlock value further up the value chain. It will be interesting to see if this heralds a new trend in deals between midstream and downstream companies.

The M&A outlook for midstream deals appears strong, with opportunities for further consolidation and rationalization around assets, asset types, and geographical footprints; reevaluation of MLP structures and their long-term sustainability as some of the larger entities find it more challenging to grow; and development of new markets (for example, building out cross-border infrastructure into Mexico as that country becomes more integrated with the US in a liberalizing business environment). As the uncertainty around the upstream investment climate subsists, it is also possible that there will be delays or downgrades in the opportunity set for building our new midstream infrastructure capacity in North America. With this uncertainty around new investment, it is more likely that consolidation and asset rationalization become more prominent features of the midstream sector, adding momentum to the current wave of M&A activity for the next year or so.

Figure 10. Midstream M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

Refining and marketing

Second quarter shows increased activity

62%
Deals by count

23%
Deals by value

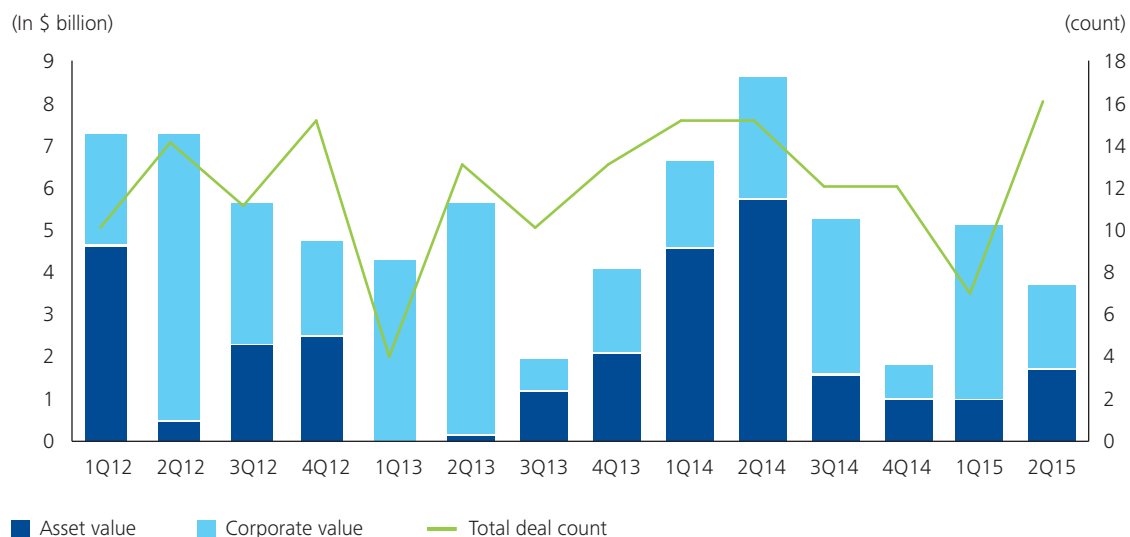
(1H 2015 vs. 2014)

52% of refining and marketing deals are in the retailing and marketing subsector

In the refining and marketing sector, global deal activity increased in the second quarter, compared to the first quarter of 2015 in terms of number of transactions, but total deal value declined. In the aggregate, activity in the first half of 2015 was lower than activity in the first half of 2014. Transactions have been dominated by portfolio actions in the storage and retail businesses, both globally and in North America, with major integrated operating contractors like Exxon and Shell continuing their long-term strategy of reducing exposure to fuels distribution and marketing business, usually seen as complex and low-margin relative to other segments of the value chain. An example of this is the sale of Chalmette Refining LLC (co-owned by Exxon and Petróleos de Venezuela) to independent oil refiner PBF.

While the recent oil market environment has bolstered downstream margins, companies that wish to slim down or exit the refining and marketing business, or rationalize their geographically diverse presence, may have an ongoing opportunity to divest assets at attractive valuations to locally stronger competitors or to companies with a strategic imperative to build more scale in the downstream sector.

Figure 11. Refining and marketing M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global Mergers & Acquisitions Database as of 12 July 2015

Summary

Increase in M&A activity on the horizon

In summary, the rapid downturn in oil prices since the second quarter of 2014 has led many companies, particularly in the upstream and oilfield services sectors, to embark on rapid adjustments of their cost base, their operational and development portfolios, and their activity focus. However, over the first half of 2015, several factors have held back the level of M&A activity which might have been expected.

Expectations that the downturn would be of relatively short duration encouraged companies to focus on internal, organic responses, such as cost-cutting, dropping rigs and renegotiating service contracts, delaying large new capital programs, deferring completions, and reducing new drilling. Many companies had also protected their cash flows into late 2015 with hedging programs at higher oil prices. These factors assisted in limiting impacts arising from the spring borrowing base redetermination season. All these conditions together contributed to mitigating pressure to raise cash by disposing of assets. Valuation gaps persisted between buyers and sellers, with sellers still expecting premiums for good assets, while buyers were less interested in the lower quality assets being offered.

All these mitigating factors are weakening as we move towards the fourth quarter of 2015. Oil prices have failed to revive, even dipping further in August, and industry consensus has moved to expectations of a longer downturn, perhaps lasting through most of 2016. The immediate steps involving organic cost-cutting and drilling focus have been taken, while structurally more sustainable measures will take longer. Forward hedges with prices well above 2015 levels are rapidly rolling off and cannot be replaced with positions at equivalent oil prices. As a result, balance sheet stress is increasing, particularly for the more highly leveraged companies. Borrowing redeterminations, asset and reserve impairments, enduring cash flow pressures, and weakening balance sheets will all contribute to a likely shift in focus to the M&A market to raise cash and protect longer term viability. Valuation gaps also appear to be closing, such that buyers who have been able to retain cash and/or more sustainable leverage will feel justified in purchasing assets, which fit their portfolio. This trend has started over the summer of 2015, with a number of significant deals announced or expected. It appears there will be more to come.

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