Q&A with Michael P. Darden, Michael R. King & Jeffrey S. Muñoz

Surveying the Oil & Gas Industry Landscape: Acquisitions, Divestitures and Joint Ventures

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In the rapidly evolving global oil and gas market, changes in composition of assets, financing, market players and types of transactions are among the many emerging industry trends. These topics were part of the discussion at "Drilling Through the Details of Acquisitions, Divestitures & JVs," a recent seminar hosted by Latham & Watkins' Oil & Gas Transactions Practice.

In this lw.com interview, Latham partners Michael Darden, Michael King and Jeffery Muñoz follow up on the seminar, discussing some of the key industry trends they are seeing in their day-to-day work and offering insight on the reasons behind these changes.

What changes are you seeing in the composition of assets (undeveloped acreage vs. producing assets) included in oil and gas transactions?

Muñoz: In the last year we have seen a lot more deals that are a mix between undeveloped acreage and producing properties. Over the past four or five years, it was mostly undeveloped acreage in the resources plays that were dominating the M&A area. But, over the last year or so I think that people are trying to market transactions where they have somewhat delineated their assets, and there is some production associated with the assets that are being sold. So you are seeing split transactions more and more these days with some developed and some undeveloped acreage. This causes a lot of differences in the documentation for the sale because you do actually see more production being sold. It is almost a throwback to before the shale plays when most M&A transactions were all producing properties, and you didn't really see that much of an M&A market for undeveloped acreage.

How are you seeing financing included in transactions, and why is financing being included? Does this change the way deals are negotiated?

King: I think it is safe to say that more and more these days we are seeing financing included as part of a transaction, and it does certainly change the way that the deals are negotiated. Sellers definitely do prefer cash buyers, and I think the main reason for that is sensible and quite obvious — they want certainty of closing. However, it is also the case that not all buyers are sitting around on big piles of cash that they are ready to deploy. In some cases, they do have the cash, but they want to use cheaper capital in the form of debt to pay for either some or all of the purchase price. That being said, it does take time to line up commitments for debt financing, and while there may be some preliminary work that is been done to that effect, the debt deal is usually not completely baked at the time that a bid is made. Sellers do understand this and they realize that the best value that may be achieved from buyer may be a buyer that isn't necessarily paying all cash, so they compromise between certainty of closing and getting the most value — it is a bit of a balancing act for them. Sellers do want to understand where financing is coming from, and they want to be able to assess the risk that the financing might not come through for a bidder. In an auction process sellers usually do ask for specifics on how the buyer is planning to pay the purchase price and whether there is going to be a financing contingency associated with the bid. In many cases, the bid instructions in an auction process will specify that bids with any financing contingencies will not be considered.

The same thing is true in a negotiated deal — the seller is usually very interested in knowing how the buyer is going to pay and they'll want to get some background and get comfortable that they think that the buyer really is going to be able to come up with the cash to close.

Occasionally, you do come across deals that have a true financing out. I worked on one at the end of last year, but it is extremely rare and the price that the buyer has to pay to get it (as far as other deal terms) is usually pretty steep.

The buyer is usually negotiating its debt commitment papers on a parallel track with the acquisition agreement. Both of those documents are generally signed simultaneously. Once the buyer gets its debt commitment papers, that is the first step, but there are a lot of additional things that need to happen in order to finalize the financing, and generally that does create an additional element in the documentation and negotiation of the acquisition agreement.

One of the big things that you have to address is any marketing period that is necessary for the lender to do its diligence and to syndicate the loan, which builds in some fixed period between signing and closing that may be longer than the parties would otherwise have if there was not a financing involved. It requires cooperation on the part of the seller to provide all the necessary information that the lender needs in order to diligence and syndicate the loan, which may include, among other things, preparation of reserve reports. The lenders are also going to insist on certain limitations of their liability in the acquisition agreement in the event that the deal goes off the rails, so obviously it does add an additional element to the negotiation of the transaction and will place additional burdens on the sellers.

In summary, it does affect the dynamics — it makes it a bit more complicated and creates more moving parts, but I think the market is now accustomed to this and they realize that this is just the way that many deals are going to be done.

Muñoz: There usually are a lot of additional stipulations on the sellers to assist in the financing and some of those might be ongoing, beyond the closing as well, particularly if the buyer is trying to finance this through public debt or a public offering associated with these assets that might end up requiring audits of the revenues and expenses associated with those assets. Often, this assistance will be ongoing for six, nine, 10 months after the closing occurs because the buyer might bridge the transaction using debt with the idea that they will take the bridge loan out with some type of public debt or public offering down the road.

Who are the new participants in the market? How are they changing the market?

King: We still have a lot of the traditional players involved in the mix like we did 10 or 15 years ago, including super majors and traditional independents, but they are not necessarily participating in the same percentage of the overall deal flow as they used to. Over the last five or six years, one of the new categories of participants in the US domestic market has been the international oil companies. They came in with the advent of the shale play and were a big part of the M&A boom and the joint ventures that occurred from 2008 and on in the shale resource plays.

Of late, probably the most notable newcomer has been private equity — whether it is private equity participating directly or through equity investments and portfolio companies, they have had an enormous impact on the M&A market. They have a lot of money that they are looking to put into the upstream and midstream space. The model for private equity is much different than the traditional upstream industry participant. Whereas the old model was to hold and accumulate acreage positions and always be a buyer and never a seller, private equity looks to come in, buy an asset, prove up an undeveloped asset to increase the acreage value or make an asset with existing production more efficient to make it more valuable — essentially to create additional value as quickly as possible, and then proceed to an exit event where they flip the property and sell it to somebody else. Private equity funds typically have a fixed life, and they can’t have their investments out there indefinitely — they need to monetize their investments to create value for their limited partner investors. Further, the management teams for these entities are typically incentivized to flip assets as quickly as they can because their incentive interests are worth more if they can realize a return on the capital that the private equity sponsor has invested sooner rather than later. What we are seeing is management teams completing two, sometimes three, sometimes even more cycles. This creates a more active M&A market across the board than we had prior to the emergence of private equity as a significant player in the upstream space.

Muñoz: The idea that the private equity firms are looking for an exit does drive the types of assets that the private equity firms are looking at as well. In a lot of situations they are either going to be looking to do an IPO, or nowadays they may also be looking to MLP some of these assets, or potentially just selling the whole asset base. It does cause them to look at the transactions a bit differently because they are thinking about what will work with an MLP, or what the dropdown story will be with respect to the assets. So they are a different participant and they do have different goals associated with the assets that they are acquiring.

Have you seen any change in the split between asset deals and share deals? If so, what is causing it?

Darden: We've continued to see more asset deals, generally. We haven't seen a big split except when you start talking about private equity. With private equity in many cases you will see that they are using special purpose vehicles, and therefore the entity is sold as opposed to the assets. To me, it is not a big change. We are still seeing a lot of asset deals. We saw very few share deals historically, so we are seeing a few more than we did. Not a huge trend, but a very fact-specific one with respect to private equity.

Muñoz: The one area where I do think that you see more equity deals are in the midstream space, as opposed to the upstream space. For whatever reason, historically, I think people have set up a lot of their gathering assets and other midstream type assets into separate companies. They do tend to try to sell the company as opposed to just the asset, possibly because of the potential difficulty of obtaining consents with respect to all of rights-of-ways associated with the pipelines, obtaining new permits and things of that nature. You do see a bit more of that in the midstream area than you do in the upstream, but I still don't see it as being a vastly greater amount of equity deals versus asset deals.

King: The reason we typically do see an equity deal in the upstream space is because there is something very specific that is driving it. For example, in some deals you have rights and consents that affect the assets and that would be triggered in a sale of the asset but wouldn't be triggered in a sale of the equity interests of the owner of the assets.

The other reason is tax related. I recently worked on a deal where ultimately what the buyer is buying is assets, but the transaction is being structured such that the buyer is initially acquiring equity and will subsequently withdraw from the entity in which it is buying the interest. The structure allows the seller to avoid paying certain capital gains taxes within the state in which it is organized. So generally, there is a very specific reason that people use equity structures in upstream deals.

Darden: You tend to see the ownership of midstream assets done through LLCs that are jointly owned by more than one party, so when it comes time for somebody to sell their interests, they can't sell assets directly. They have to sell their interests in that LLC. I've seen several deals recently where we have been selling somebody's interest in the upstream as an asset deal, but their interest in the midstream assets that are related to those upstream assets are held in an LLC that they own jointly with someone else. In that scenario, they can't sell assets, they have to sell their LLC interests. So the underlying facts and your goals determine what you are going to do.

Have you seen any change in the split between upstream transactions and midstream transactions? If so, what is causing it?

Darden: You have to go back to the state of the industry three or four years ago when you had the tremendous success of the shale plays and a real lack of takeaway capacity. That situation created business opportunities for midstream companies. There were a lot of midstream companies that got started and developed assets in these plays. Those assets are starting to change hands now. This is not at the expense of upstream deals. In my view, there are quite a few midstream deals because of the fact that to be a midstream company is now a very successful stand-alone business model.

Muñoz: I think some of it is driven by the fact that there wasn't a lot of infrastructure where the shale plays were first discovered, and, in a number of cases, the upstream company was required to build out its own midstream assets. There weren't a lot of midstream companies at that point willing to take the kind of exploratory risk associated with building out some of the gathering and processing assets that provide for the exploration & production (E&P) companies, so the E&P companies were doing it themselves. Again, because of the MLP structures out there that provide such a cost of capital advantage over non-MLP companies in order to finance midstream assets and with so many new pure play midstream companies forming, it gave an avenue for the upstream companies to monetize these gathering systems and other midstream assets that they had built. Quite frankly, the rates of return for exploratory activities versus midstream activities are so much greater. I think that most E&P companies want to continue to use their dollars to put holes in the ground through the drill bit versus building out gathering systems, so although they might incur the cost and bear the risks upfront, they are always looking to monetize those assets whenever they can. The number of midstream companies out there now is making it very easy for E&P companies to monetize their assets. You do see a lot of transactions, but I don't think we are seeing a drop-off in the E&P side of it; it’s more that there is just growth in the sector in total.

Darden: It is surprising to me how many upstream deals we do that have a midstream component; that is, where there is a gathering system being sold as well. The other thing you can't discount in terms of midstream is that it is the perfect MLP model. Midstream businesses were the first to be converted to MLPs, so you see a lot of activity in the midstream business related to MLPs.

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