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M&A in the oil & gas sector

FW discusses M&A in the oil & gas sector with Alicia Quesnel at Burnet, Duckworth & Palmer LLP, Norman Wisely at CMS Cameron McKenna Nabarro Olswang LLP, Justin T. Stolte at Latham & Watkins LLP, and Jim Hansen at Opportune Partners LLC. ■

Q&A:

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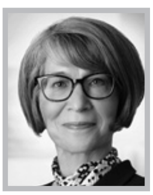
THE PANELLISTS



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FW: Reflecting on the last 12 months or so, what are some of the major trends you have witnessed in oil & gas M&A?

Quesnel: In Canadian oil & gas, M&A activity continues to focus on debt reduction, improving cash flow and unlocking market opportunities. Companies that have been active in the past 12 months have focused on consolidating their positions in certain liquids-rich resource plays, such as the Montney and Deep Basin, and several companies have taken steps to increase the weighting of natural gas in their asset base. Non-cash and alternative forms of consideration are playing a more prominent role, reflecting the lack of available capital and the financial stress that many companies are operating under. For example, 2020 saw an increase in cashless business combinations, or 'share-for-share' deals, sellers are more frequently reserving royalties out of the sale of their assets and parties are agreeing to contingent consideration payments should there be a return to growth when oil & gas prices strengthen.

Hansen: Within the past 12 months, the energy sector has gone through yet another dramatic transformation that began in 2019. The impact of both the coronavirus (COVID-19) and the Saudi Arabia-Russia oil-price war has caused companies to focus internally and externally on the key value driver in this environment: cost-cutting. Whereas in the past, synergies through cost-cutting measures were the third or fourth reason for going ahead with a merger behind increased growth, diversity of asset base and so forth, it is now the primary reason. This feeds the free cash flow (FCF) metric, which has quickly become the critical driver for generating shareholder returns or debt reduction and is central to the new investor sector paradigm. At the same time, companies are assessing the impact of $40 a barrel oil on oilfield economics. Estimates run as high as 50-75 percent of exploration & production (E&P) assets being inferior. This makes it challenging for acquirers to find willing targets with superior assets to accept all-stock offers at low premiums.

Stolte: Since mid-March 2020, oil & gas companies have faced unprecedented challenges created by the COVID-19 pandemic and the failure of OPEC+ to reach an agreement on oil production targets, which resulted in a significant decline in oil prices, and a knock-on reduction in global demand for hydrocarbons. Additional headwinds have been created by the continued push to decarbonise fuel sources, which has only intensified since the economic downturn began. These factors resulted in decreased M&A activity in 2020, especially during the first half of the year. Put simply, the economic downturn created too many uncertainties for companies to transact, whether it be because many companies had to shift their focus from growth to survival or due to misalignment on valuations. We did see an uptick in M&A activity in the US during the second half of 2020. Specifically, we have seen a number of strategic transactions in the upstream sector that have occurred in order to affect a much-needed consolidation across the industry, whether directly through mergers or indirectly through asset acquisitions that consolidate a basin or region. Many expect this consolidation to continue in 2021.

Wisely: As the oil price dropped at the start of 2020, many M&A processes were paused, or offers received deemed unacceptable, and existing processes between signing and completion were terminated or restructured by the parties. Little new M&A happened as many companies considered how COVID-19 and the oil price would play out. As the oil price has stabilised somewhat, in relative terms, we are again seeing an increase in sales processes being run and transactions beginning to move again, albeit slowly in many cases.

FW: How would you describe the current appetite for M&A? What factors are driving deals in today's market?

Hansen: In terms of M&A appetite, it is estimated that around 25 percent of E&P companies have the ability to reduce costs and debt, attract investors and remain independent. Another 25 percent are estimated to need to merge and create scale to meaningfully reduce costs – and they will become acquirers or targets. The final 50 percent are believed to have inferior assets at today's commodity prices and will have limited options going forward. M&A

options, opportunities and challenges will be frequently discussed by management and boards going forward. The most important factor driving deals is to create an 'investable' model incorporating lower corporate and field costs, low leverage, and FCF to distribute cash to shareholders. It seems this has been embraced by industry and equity research analysts who are quickly adopting this paradigm in price targets for public companies. Private companies, formerly able to sell for cash to public buyers to achieve growth, will find it very difficult to exit through a cash sale. Some private equity firms have elected to exchange private company stock for stock in public companies, allaying concerns over increased leverage. While the industry is rapidly embracing the paradigm, time will tell as to whether a wary investor base will be satisfied that, while changes are positive, it fulfils the 'investable' definition long term.

Stolte: The appetite for M&A has recently increased for US companies. One key factor behind these transactions is a need for companies, especially upstream companies, to consolidate their respective businesses, enabling them to maximise value through improved cost structures, largely by way of general and administrative (G&A) reductions. Over the last few years, oil & gas companies have been effective in improving the efficiency of their operations and reducing operating expenses. However, further reductions are needed in the current environment, forcing many companies to utilise consolidation as means of further improving economics through transactional synergies.

Wisely: The current appetite for deals is of increased optimism, certainly for buyers. Many sellers are looking to exit certain geographic areas, non-core assets or even the industry as a whole with the drive to energy transition. Buyers are opportunistic and looking for good deals.

Quesnel: After a relatively quiet few years, there appears to be an increased appetite for M&A in certain segments of the Canadian oil & gas industry. The focus is on value-creating rather than simply growth-creating consolidation. We have seen a strong appetite among Canadian oil & gas firms to free up cash flow, consolidate their positions in targeted areas, seek out operational synergies and sell off non-core assets. There has also been an increase in corporate M&A, with senior Canadian oil & gas companies acquiring or merging with firms that have complementary assets in order to unlock market opportunities, often at a discount. Finally, there has been an increase in private equity looking to capitalise on the low valuation, and possible undervaluation, of many Canadian oil & gas companies.

FW: Are you seeing different M&A strategies adopted since the coronavirus (COVID-19) crisis started to take effect?

Stolte: Acquirers can be more selective. At the outset of the crisis, most acquirers were in wait-and-see mode given the lack of predictability about the duration of the downturn. With the economy stabilising, acquirers are becoming more willing to transact, with many using the downturn to consolidate positions in an opportunistic manner. It is also worth noting that many industry participants are using the downturn as a springboard to making investments in "clean energy" – for example, a number of private equity sponsors successfully formed special purpose acquisition companies (SPACs) in 2020, with funds raised specifically for clean energy investments.

Quesnel: Government support for abandonment and reclamation activities, such as Alberta's Site Rehabilitation Program, has made funding available to oilfield service companies to complete site closure work. These programmes were introduced as a response to the COVID-19 pandemic and have helped oilfield service companies maintain operations throughout the COVID-19 crisis. From an M&A perspective, this has likely led to fewer business combinations and distressed sales in the services sector than might have otherwise been expected. Transacting parties are more commonly relying on contingent consideration mechanisms, agreeing to purchase price adjustments on the basis of production and commodity pricing thresholds or other triggers, such as increasing proven reserves of the assets involved in the transaction. These arrangements are beneficial to vendors operating under a mandate to divest assets because they provide the opportunity to attract buyers that may not have been interested and, potentially, benefit from an increase to the purchase price.

> **"WHILE THE ECONOMIC DOWNTURN CONTINUES AND HOPE FOR A RECOVERY HAS LIFTED OIL FUTURES IN THE SECOND HALF OF 2021, EXCESS CAPACITY REMAINS AN OVERHANG."**
>
> JIM HANSEN
> Opportune Partners LLC

Wisely: We are seeing an increase in distressed and opportunistic M&A. Some, but by no means all, buyers are taking aggressive approaches to transactions where they consider the counterparty may be in financial difficulties as a result of the crisis.

Hansen: Successful M&A has always been an extremely difficult and time-consuming process. Starting with management approval and progressing through board and shareholder approval can often take months. Historically, personnel decisions such as the chief financial officer, chief executive and board members are generally highly contested and negotiated face-to-face. COVID-19 has hampered this interaction. However, most chief executives are highly tech savvy and are at large corporations. They are familiar with conducting remote meetings on important subjects. Further, while highly competitive, the industry is also cordial where executives often interact on a professional and personal basis. Therefore, while face-to-face time may be limited by COVID-19, executives are generally already familiar with both the professional track record of potential merger partners and also the personal connections that have already been made.

FW: In what ways are deal dynamics likely to evolve as the economic downturn continues? What impact do you expect this to have on buyer and seller valuations?

Wisely: Buyers and sellers will find it hard to land valuations while there is a volatile oil price and future uncertainty, which certainly exists at present, notwithstanding some increased stability during the final quarter of 2020. Contingent or deferred consideration structures are increasingly normal to allow valuation gaps to be plugged – there, if the company or asset being acquired does not make sufficient return, the buyer pays less. These structures can be simple, such as oil price or production volumes as the contingent consideration measure, or much more complicated, such as net profit interest arrangements and royalty structures.

> **WITH THE ECONOMY STABILISING, ACQUIRERS ARE BECOMING MORE WILLING TO TRANSACT, WITH MANY USING THE DOWNTURN TO CONSOLIDATE POSITIONS IN AN OPPORTUNISTIC MANNER.**
>
> JUSTIN T. STOLTE
> Latham & Watkins LLP

Hansen: Industry supply and demand conditions are being adjusted almost every day. Only recently, the Organization of the Petroleum Exporting Countries (OPEC) announced the possibility of deferring an additional 2 million barrels of oil supply anticipated in January due to COVID-19 concerns. While the economic downturn continues and hope for a recovery has lifted oil futures in the second half of 2021, excess capacity remains an overhang. Saudi and Russian excess capacity is estimated at 8 million barrels-per-day, and it is clear that the production increase in April 2020 was meant to severely handicap US production growth. Thus, expect low oil prices to keep valuations in check.

Quesnel: The current economic downturn has exacerbated the negative investor sentiment that has surrounded oil & gas and we expect that insolvency risks will continue to shape deal dynamics. Cashless and nominal cash consideration deals will continue to mark the M&A landscape. Regulators will play an increasingly active role in assessing the corporate health of transacting companies and approving transactions. Lenders and co-owners will more closely scrutinise deals and withhold consent if they consider the risks too high. Purchasers will focus on opportunities to consolidate their holdings in key resource plays to achieve operational, capital, land and facility synergies, and highly leveraged companies will focus on reducing their debt and providing their shareholders with growth opportunities through mergers and other business combinations. Buyers and sellers will continue to disagree on valuations; however, there is now a willingness to consider alternatives with potential upside for sellers, such as contingent consideration and royalty reservations, as a means to bridge valuation differences.

Stolte: As many might expect, deal dynamics today are leaning to the benefit of acquirers, evidenced, in many cases, by decreased prices paid by acquirers for companies and assets. In volatile markets like today's, it can be difficult to make projections on the performance of an acquired business or asset, creating a significant risk that an acquirer will overpay, or that a seller will not receive adequate consideration, on a deal. To help reduce this risk and bridge valuation divides, acquirers are increasingly using contingent payment structures, which have been a more frequently used tool since the last downturn in 2014. When using a contingent payment mechanism, the acquirer pays a base purchase price at a transaction's closing, and makes one or more contingent post-closing payments to the seller upon the occurrence of certain events or the satisfaction of certain predefined performance. If these events do not occur or the metrics are not satisfied, the acquirer does not make the contingent payments to the seller.

FW: What general advice would you give to parties on negotiating, structuring, financing and closing oil & gas deals in today's market? What key areas need to be considered?

Hansen: On M&A deals, it has become clear that recent successful deals are all stock-for-stock deals at low premiums with substantial cost savings and low post-deal leverage. It appears that one of the key selling points to a target is that a 'go-it-alone' strategy today is not going to attract investors unless the target can accomplish cost cuts and leverage targets independently. Acquirers should focus their pitch to targets on the difficulty in surviving in a no growth, capital-constrained, environmental, social and governance (ESG)-focused environment, with renewables looming in the distance. Without scale, facing these challenges will be daunting. On the acquisitions & divestitures (A&D) front, it seems buyers will have to reduce return hurdle rates to close more deals. Sellers have been buffeted by the loss of proved undeveloped reserves (PUD), drilled but uncompleted wells (DUCs) and acreage value. Making matters worse, they are not able to receive value at minimum levels such as proved developed producing (PDP) PV10. Buyers are demanding higher discounts, but many sellers have decided not to sell, potentially waiting for higher prices.

Quesnel: Important considerations in the current M&A market are timing and delay – transactions are taking longer to complete than they did in the past. Factors that contribute to delays in closing include increased regulatory scrutiny of licence transfers, longer waiting periods to become eligible to operate assets, and lenders and co-owners withholding consent to certain transfers. We now expect licence transfers to take at least 30 days to receive regulatory approval. In addition, a growing number of industry participants in western Canada are filing statements of concern and withholding their consent to transfers. These practices can delay closing even more, particularly where the completion of the transaction is contingent on all transfers receiving regulatory and third-party approval. Transacting parties have adapted to the changing deal landscape by asking regulators to pre-approve their licence transfers as a pre-condition to closing and parties are also agreeing to close in escrow, subject to the resolution of these delaying factors.

Stolte: These are unprecedented times, and it should be recognised that there is not a playbook or manual to address all of the uncertainties and risks that may arise from this downturn. As such, creativity and flexibility are key. If industry participants can be flexible, there are a number of creative structures that can be utilised to ensure that transactions get signed, financed and closed. Equally important, industry participants are increasingly mindful of ESG and related climate concerns, and thus, are more inclined to find ways to address these issues in a way that is beneficial to all stakeholders.

Wisely: The best advice for any party is to be prepared. The oil price, COVID-19 and the like have demonstrated there can be significant changes in the period during and after negotiation of any deal and dealing with all possible scenarios will be key to a successful transaction. Does the buyer have the right to terminate the deal in the event of a material adverse event? What if co-venturers or third parties with consent rights do not approve the transaction? Dealing with the various 'what ifs' will give the parties increased certainty around when a deal should complete or is required to be restructured.

FW: Could you highlight some of the risk-related issues that need to be addressed when undertaking an M&A transaction in the oil & gas sector? How can acquirers manage those risks to enhance future value?

Wisely: The main risk is around valuation. Other risks are around buyers taking on uncertain and significant future decommissioning liabilities, and many deals in mature areas, such as the UK and Norway, are structured such that the seller will retain certain liabilities around paying decommissioning costs. Financing is often an issue for buyers, with traditional lenders more reluctant to lend to the industry for volatility and ESG reasons. Novel financing structures are often also then required, for example through innovative pre-paid hydrocarbon offtake arrangements, vendor loans or use of significant deferred

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NORMAN WISELY
CMS Cameron McKenna Nabarro Olswang LLP

or contingent consideration structures. Ensuring the buyer has sufficient tax losses to minimise tax exposure on any transaction is also key, either itself or through the transaction structure.

Stolte: At a basic level, we are attempting to avoid post-closing surprises when effecting a transaction, whether it be from the seller's or the acquirer's perspective. Common risks relate to closing certainty, value leakage and the allocation of liabilities. The parties can manage these risks in a variety of ways, with perhaps the most important being to ensure that the definitive transaction documents reflect their mutual understanding and agreement on deal terms, and anticipating, and then addressing, uncertainties that may arise in the course of a transaction.

Quesnel: Regulatory risk continues to impact transactions involving companies with low liability management ratings (LMR) or lack of operational experience, and regulators are starting to reject licence transfers if they feel a transaction poses too much risk. This is particularly relevant when neither the vendor nor the purchaser is willing or able to pay the deposit required to maintain an LMR above the minimum regulatory threshold. Transacting companies can mitigate these risks by closing in escrow, which provides some assurance that the purchase price will only be paid when the necessary approvals have been received and makes it easier to unwind a transfer if the regulator withholds approval.

Hansen: The biggest risk in an M&A transaction is post-deal execution. Expectations on any number of improvements will exist. Primary among them will be cost-cutting synergies at the corporate and field level and realisation of production and FCF estimates. An experienced M&A team will conduct deep due diligence and have a high degree of confidence on appropriate post-deal staffing. For shale players, the proper spacing of parent and child wells has become increasingly important in production projections. A highly seasoned competent management team is necessary to evaluate drilling options. Negative variance to estimates will have long-term consequences for the new company.

> **COMPANIES THAT HAVE STRONG BALANCE SHEETS CAN EXERT SIGNIFICANT INFLUENCE OVER DEAL TERMS, PARTICULARLY WHEN THE COUNTERPARTY IS DISTRESSED OR SEEKING TO DIVEST FROM THE REGION. BUT THERE ARE LIMITS TO THEIR NEGOTIATING POWER.**
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> ALICIA QUESNEL
> Burnet, Duckworth & Palmer LLP

FW: In what ways has the disruption and uncertainty surrounding COVID-19 impacted the distressed M&A landscape for oil & gas deals? In what ways are cash-rich buyers leveraging their position to obtain more favourable transaction terms?

Stolte: Many acquirers are attempting to get more favourable terms in how they structure the consideration to be paid as part of a transaction, often in asks for lower upfront payments or alternatives to cash payments, and the use of contingent payment mechanisms. Certainly, a seller would like to be paid as much, or all, of a transaction's consideration at closing, and in cash, but in a distressed market, an acquirer can more defensibly make an argument that a portion of a transaction's consideration should be payable only upon the satisfaction of certain performance criteria, or the occurrence of certain specified events, after the closing of the transaction. Similarly, sellers today may be more willing, in certain circumstances, to receive alternatives to cash consideration, such as stock of the acquirer.

Quesnel: COVID-19 has exacerbated many of the challenges facing Canadian oil & gas companies. As a result, companies that have strong balance sheets can exert significant influence over deal terms, particularly when the counterparty is distressed or seeking to divest from the region. But there are limits to their negotiating power. Lenders generally require that borrowers receive their consent before entering transactions and a struggling company's lenders may not accept unreasonable terms if they believe that retaining assets and maintaining operations will better preserve the vendor's value. Unsurprisingly, there has also been an increase in restructuring transactions as companies of all sizes reorganise to survive the economic downturn. Long-term marketing contracts predicated on higher commodity pricing and production volumes than those we are currently seeing have posed a unique challenge throughout the pandemic, and these agreements are frequently renegotiated as part of restructuring transactions – often to the benefit of the acquiring company.

Hansen: On a granular level, the biggest impact on M&A deals surrounding COVID-19 is the disruption to the due diligence process. Physical inspection of properties, for example, has been challenged, leading to longer lead time in deal closings, as well as to changes in representations and warranties. From a larger perspective, the uncertainty regarding a return in pre-pandemic oil demand levels continues to be a major overhang to the A&D market. While traditional wisdom dictates that the asset sale market slows during periods of rapidly escalating or declining commodity prices, the A&D market remains frozen even with relative price stabilisation. The distribution of effective vaccines to the population appears to be just around the corner, but with rising cases, forecasted oil prices seem range bound within a $40 to $50 a barrel level for the near term. Sellers wishing for higher prices may have to wait until well into 2022.

Wisely: There are fewer buyers now in the marketplace, generally speaking, and fewer still with significant cash reserves, so cash-rich potential buyers are succeeding in obtaining more favourable transaction terms than was the case over the past few years, with the market turning increasingly into a 'buyers' market'.

FW: Looking ahead, how do you expect oil & gas M&A activity to unfold over the coming months? What major trends do you predict will dominate the industry?

Hansen: While many suggest consolidation will continue over the coming months, resulting in as few as 10 very large E&P companies, others are suggesting that the prime companies in key basins have been picked off. Certainly, being a low-cost producer in a sector with excess capacity will keep focus on combinations reducing costs and improving supply chain efficiencies. Other factors that will become more critical as management and boards weigh their options include the move to mature assets with slow decline curves. Additionally, research analysts are now including metrics detailing compensation, diversity of boards and a whole set of ESG measures. These will now enter into consideration as merger candidates are chosen, in addition to an emphasis on the new company generating improved FCF.

Wisely: We will likely see more of the same – an increase in activity. Many majors, particularly in Europe, are increasingly looking at divesting non-core oil & gas assets or assets in certain geographies to further invest in core areas or the energy transition. Some private equity entrants are looking to exit following their investment cycle but are not finding that easy in all cases, with listing increasingly not an option – the likes of Chrysaor resorted to a reverse takeover of Premier Oil plc, a listed entity in the UK, to achieve that aim. For opportunistic independents focused on oil & gas, and private equity entrants, there will be opportunities to find and undertake attractive deals.

Quesnel: We expect the trend of consolidation in the Canadian oil & gas industry to continue in the coming months, primarily in the form of corporate M&A. At the same time, we expect producers to focus their attention and resources on core assets. Combined, these trends will likely result in a leaner industry that is dominated by larger companies and is organised around specific resource plays and complementary operations. In the mid-term, we expect that some of the uncertainty that has surrounded export capacity from western Canada over the past five years will be resolved. While some regulatory and permitting challenges remain, three oil pipeline expansions – the Trans Mountain Pipeline expansion, the Enbridge Line 3 Replacement and the Keystone XL Pipeline – are currently underway. On the natural gas side, Coastal GasLink and the NGTL expansion are proceeding. As these pipeline projects come online, Canadian oil & gas producers will benefit from increased export capacity and access to higher-priced, tidewater, commodity markets.

Stolte: Most of us expect there to be an uptick in activity levels in 2021 as the economy further stabilises and the pace of the energy transition increases. Specifically, consolidation in the US upstream space will likely continue and many expect that restructurings, both in-court and out-of-court, in the US will continue and, in connection with these restructurings, there will be a number of quality asset packages or companies sold to opportunistic acquirers. At the same time, investments in the clean energy space are expected to increase, likely at an increasing pace. ■