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The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

Welcome to the August 2016 issue of Global Corporate Advisor.

In this issue, we discuss the effect of low oil prices on mergers and acquisitions in the oil and gas industry. As major players in the sector adjust to the new reality of low prices over a sustained period in face of supply-demand imbalance, many companies will witness shifts in strategy. We examine the role that M&A will play in reshaping the industry.

The second article addresses the many aspects of the valuation of non-profitable companies. Whether they are loss-making companies or those suffering temporary setbacks, an assessment of value is not only reliant on historical data but needs to take into account other factors.

In the fast-evolving economic climate affecting major economies, up-to-date knowledge of changing realties is necessary to maintain a competitive edge.

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The GCA team is here to respond to your needs relating to M&A transaction support, valuations and advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA, at *peter.varley@crowecw.co.uk.* Alternatively, please contact your local GCA team member to discuss your ideas.

Inside This Issue:

Oil and Gas M&A Strategies in a World of Low Oil Prices

By Justin Audcent, Perth

The collapse in oil prices almost two years ago was widely tipped to prompt a new wave of consolidation within the oil and gas industry, which has so far failed to materialize.

With the notable exception of Royal Dutch Shell's US$82bn takeover of BG Group, which closed in February 2016, M&A activity over this period has been decidedly muted. In fact, 2015 saw the lowest number of deals in a decade, and the total deal value of US$286 billion was almost 20% down on the previous year[1]. This is in stark contrast to the late 1990s, when structural changes within the industry and a sudden drop in oil prices triggered a number of mega-mergers between the major international oil companies (IOCs).

Despite a recovery from the lows of January/February 2016, WTI and Brent crude are continuing to trade at below $50 a barrel, as global supply continues to exceed demand. The US Energy Information Administration, in its Short Term Energy Outlook, does not anticipate equilibrium being restored – and crude oil inventories starting to reduce – until mid-2017. With the failure of talks aimed at securing commitments from OPEC producers to curtail production, even this time horizon is far from certain.

Not only does this supply-demand imbalance point to a more sustained period of low oil prices, but it is indicative of a structural change in the global oil and gas industry, in which the Middle East cartels are no longer able to control global supply and thus maintain high prices, in the face of increasing production from other regions – most notably with the rise of the US shale industry.

Combined with demand-side factors, such as the development of more fuel-efficient technology and a growing focus on renewable energy sources to meet emissions reduction targets, many economists are now forecasting a new era of low oil prices for the foreseeable future. If this is the new reality, how will the major oil and gas players adapt their strategy, and what role will M&A play in reshaping the industry?

The drivers of M&A are shifting

To date, the major IOCs have largely responded to a world of low oil prices with a renewed focus on cost containment and cash preservation. With restricted access to both the equity and debt markets, maintaining balance sheet strength has been seen as critical to riding out the cycle. For most, this has involved the deferral of discretionary capex, the reassessment of development projects, renegotiation of supply and service contracts, wide scale redundancies, and an increased focus on technology innovation and operational efficiencies.

Although a reduction in reserve valuations and downward revisions to forecast cash flows has restricted access to new debt facilities, existing lenders have, in many cases, been amenable to addressing potential debt service issues and covenant breaches by extending the maturity or renegotiating the terms of existing debt financing. In this generally supportive lending environment, many distressed companies have thus been able to avoid offloading assets at low valuations in a forced sale scenario.

This combination of factors has no doubt restricted M&A activity in the sector, limiting the number of distressed assets coming to market. The uncertainty around future oil prices has also presented significant challenges for M&A deals, with buyers and sellers often having widely different expectations, resulting in difficulty in reaching consensus on asset valuations.

While access to capital remains challenging within the sector, the expectation that the world of low oil prices may be here to stay is, at least, providing a clearer outlook for strategic decision-making and narrowing the gap on valuation expectations. Companies with a short-term focus on "riding out the cycle" will now need to consider a longer-term strategy to survive and prosper in this new market environment. Inevitably, not all will succeed.

The outlook for M&A

Keeping in mind ongoing funding requirements for development projects, shareholder pressure to maintain dividends and challenging conditions for raising new capital, IOCs will no doubt continue to review and rationalize their asset portfolios. Although the divestment of upstream assets may be seen as unattractive at current valuations, IOCs are nevertheless seeking to monetize non-core upstream assets in order to shore up their balance sheets and protect their portfolio of tier one assets. Several have announced formal divestment programs – including Chevron, which earlier this year announced the sale of certain Gulf of Mexico assets to privately-owned Cox Oil Offshore – and increased its target proceeds from asset sales to $15bn over the next two years.

Downstream asset values have held up well, with refining, marketing and retail margins benefiting from low input prices. Even though margins may come under greater pressure in a sustained low oil price scenario, there is a window of opportunity, which is likely to see further downstream divestments. Midstream assets such as pipelines, which provide more stable cash flow, generally underpinned by long term contracts, also continue to be attractive to investors seeking infrastructure-type assets and returns.

In one example of the above, following the acquisition of BG Group, Shell announced in March 2016 that these areas will be the initial focus of its $30bn divestment program, appointing Lazard to lead the portfolio review and identify specific non-core assets for sale.

Buyers with the financial capacity to pursue acquisitions may find attractive opportunities to acquire assets at historically low valuations and, with a reduced field of buyers and the potential for forced asset sales, many such deals are likely to be concluded behind closed doors, rather than through a formal sale process. In this environment, prospective buyers will be well advised to identify target assets which fit their portfolio and be proactive in making approaches.

However, IOCs will be highly selective in pursuing acquisitions, with boards and shareholders being reluctant to take on additional risk or major development capex commitments. Since most are likely to be pursuing their own divestment programs, acquisitions which are not cash flow positive in the short term will need to have an exceptional strategic case.

Investment in higher cost upstream assets and undeveloped fields will be more speculative in this market, with future returns dependent on a longer-term recovery in oil prices. Investors prepared to take a contrarian approach to the industry may include NOCs and sovereign wealth funds that have access to capital and are able to take a long-term investment view. Although investment by NOCs, particularly from China, has slowed over the last few years, NOCs may well become more active, seeing this as an opportunity to secure assets at low cost and hold them for long-term energy security or other geopolitical purposes, as part of a diversified global asset portfolio.

Oilfield services

Despite the high-profile US$28bn merger between Halliburton and Baker Hughes being abandoned in May 2016 following opposition from anti-trust regulators in the US and Europe, the oilfield services segment remains ripe for further consolidation. With operators cutting back on exploration spend, deferring development projects, and renegotiating – or terminating – contracts with service providers, oilfield services companies are facing a particularly challenging combination of lower asset utilization and reduced margins. Most have responded quickly with restructuring programs, rationalizing their operations, mothballing assets and implementing redundancy programs, in order to reduce capacity and cut costs. However, mounting financial pressures are leading to distress, particularly for smaller, niche players. Although the segment is diverse, those with a high fixed cost base are particularly at risk, as are companies heavily exposed to exploration and development activities. These include the companies involved in seismic and drilling activities, as well as those involved in engineering and construction, which depend on an ongoing pipeline of new development projects.

To date, potential buyers have largely focused on internal restructuring and have therefore not been in a position to pursue acquisition opportunities – the number of deals in the segment was down 70% in 2015.

However, many of these niche companies will present attractive targets for larger, more diversified oilfield service companies who have the financial and organizational capacity to integrate them as part of a global, diversified service offering, while cutting out duplicated management structures and overhead costs. Mid-sized global players in particular – with gaps in their service offering or global coverage, and fewer regulatory hurdles than the major players – have a clear opportunity to acquire bolt-ons at historically low valuations, while the major players will continue to be interested in new technologies and niche capability which can be leveraged through their existing global operations.

Larger and mid-sized companies should also be actively evaluating potential merger partners or major acquisitions, both as a defensive strategy and to increase competitiveness and grow shareholder value through the delivery of substantial revenue, technology and cost synergies. A case in point is the $14bn merger of Technip SA and FMC Technologies, announced in May 2016, which will bring together their complementary capabilities in project management, engineering, construction and subsea systems.

Private equity funds have been active investors for some time in the oilfield services segment, particularly in relation to asset maintenance and other businesses supplying or servicing producing assets. With valuations of portfolio companies taking a hit in the current environment, their response will depend on their reading of the future outlook for the sector. Some non-specialist funds may shift their investment focus to other sectors and may consider exiting existing investments. However, we expect others to see an opportunity to invest in bolt-on acquisitions at a low point in the cycle – effectively averaging down their entry price while building scale and capability and achieving revenue and cost synergies to deliver growth in both profitability and an eventual exit multiple. This may be a bold strategy, but has the potential to deliver strong returns for underlying investors.

A bigger role for financial investors

With the exception of the oilfield services sector, the oil and gas industry has not traditionally been a target for private equity investment, due to high capex requirements, development risk and oil price volatility creating a high degree of uncertainty around the amount and timing of returns. However, this is changing with a number of firms, including Carlyle Group and Blackstone, establishing funds to invest in upstream assets. Some estimates put the amount of available capital at over $80bn.

For investors with a long term investment horizon and flexibility around exit timing, the current market presents a rare opportunity to buy in at a low point in the cycle. Plus, with oil prices showing some recovery in recent months, financial investors may start to have more confidence around asset values. Nonetheless, activity is likely to be focused on producing or close-to-production assets, with such investors reluctant to take on substantial development risk. One such notable deal saw Brookfield Asset Management and Macquarie Capital join forces in establishing Quadrant Energy to acquire certain Australian oil and gas assets of Apache Energy for $2.1bn in 2015 – taking the opportunity to acquire producing assets with strong cash flow underpinned by domestic gas contracts.

Infrastructure funds and pension funds remain interested in pipelines and other infrastructure assets, providing lower, but stable long-term returns, and the divestment of further downstream assets by the IOCs may present a further source of opportunities for financial investors.

Conclusion

With consensus views now anticipating a world of lower oil prices for the foreseeable future, a focus on preserving cash and riding out the cycle no longer appears a viable short-term strategy. Consequently, operators and service providers alike are being forced to reassess their asset portfolios and operating models. In this new environment, an increase in M&A activity is likely to be driven by sellers – whether as a proactive strategy to deleverage the balance sheet and protect their tier one assets, or in a forced sale situation, with lenders becoming less accommodating as they adjust their own exposure thresholds to the sector.

For all participants, it has become increasingly important to have a clear M&A strategy in response to the market outlook, as well as the flexibility to move quickly in response to opportunities coming to market.

Notwithstanding the opportunity to do so at a low point in the cycle, most IOCs will remain cautious, focusing their attention on assets which bring clear strategic value and avoiding higher cost production or development assets.

So which buyers will be prepared to take a contrarian approach, buying up higher risk assets at low valuations? Investors unconstrained by the short-term need to generate returns for lenders and shareholders are best placed in this regard. This may well provide opportunities for the NOCs to diversify their asset base and secure future supply. Additionally, private equity – and other investors able and willing to adopt a countercyclical investment strategy and take a long-term view of the market – will have an opportunity to build their own asset portfolios.

[1] M&A deal data compiled by Derrick Petroleum Services.

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Valuation of Non-profitable Companies

By Roger Tiest, Antwerp

This article will cover both loss-making companies and companies that have not been able (yet or any more) to conduct operations in a sufficiently profitable manner. In some cases, the value of companies has to do with factors other than mere operations. Their value may be linked to infrastructure, geographical location, tradition, company name or brand, as well as associated factors concerning image and market entrance. In such cases, company value will depend on the potential business value of any one of these specific elements as perceived by new owners. Thus, valuation will focus on the perceived valuable elements, whereas the remaining assets and liabilities will be valued in terms of their liquidation value or the value associated with second-hand use of equipment and materials.

In other cases, lack of profitability may be temporary in situations such as company start-up or company restructuring. One should be aware that bankruptcies and financial troubles not only result from underperformance by companies or from a lack of competing goods and services, but can also be attributed to spectacularly successful operations or innovative product offerings that far exceed market expectations due to the high needs of financing.

1. Loss-making companies

1.1. Principles

Classic valuation approaches will quickly yield low or even negative values by relying on historical data, because these methods multiply negative results by a number that corresponds to a period of specified years. Often, a challenge might be to have sufficiently reliable budgeted figures knowing that the current business model results in losses.

When it comes to dealing with historical losses it is not only a question of documenting reliable operational budgets for companies that have not (yet) succeeded in offering profitable goods and services to the market, but one also needs to raise questions about the true business economic value of company assets. Companies often tend to be loss-making because their way of doing business does not allow for profitable business. In such cases, it may be useful to revalue the infrastructure along with all equipment and machinery in terms of their contribution to (potential) company profitability. In this way, it is possible to accept a basic valuation rule, i.e. book value of operational equipment is only worth its value if it contributes to operations in such a way that it at least recovers associated annual depreciations. This would result in a company being valued at the equity value taking into account the reevaluation of the infrastructure, equipment and machinery.

In extreme situations, we may value company equity in terms of its liquidation value. This will be the case if new owners only show an interest in goods, services, and available expertise while disregarding the current company infrastructure. In such cases, shareholders' equity value will consist of revenues resulting from a liquidation-based valuation from which all related restructuring costs have been subtracted. This value can potentially be increased by an assessment of goods, services and expertise using cost prices that are based on reconstruction budgets or replacement values. This could be the case if such items would only be economically useful in a revised activity. In other words: in an approach of 'make or buy'.

If equity value is considered irrelevant, one may use the methods of infinite series of profits or real cash flow. However, it is not unimaginable to set high risk levels for such companies, in part because new owners often have to make special arrangements for getting the company out of its present situation and transforming itself into a business vehicle capable of conducting profitable operations. High risk levels will also lead to increased discount rates, which might limit the infinite series to a very short and transparent time period.

1.2. Tax losses

In some countries company losses may fiscally be transferred completely at the moment of acquisition. These losses are defined as losses that originated as a consequence of accepted fiscal costs associated with taxable income. They will be expressed as positive latency to the advantage of the current company owners. We may include this in the revalued shareholders' equity or incorporate this in part as tax advantages in future operational budgets.

One may argue whether current or new owners are to be credited for this fiscal latency and, if so, to what extent? Taking the point of view of new owners, one may argue that recovery of losses is only possible because new owners have succeeded in conducting profitable operations, where current owners have failed to do so. Alternatively, this fiscal advantage at least triggers a discussion about the associated opportunity value. This consideration frequently leads to a consensus between both new and current owners.

It will be quite different if loss-making situations are attributed to financially unfeasible (but potentially successful) stories of current owners, and if loss recoveries are just a matter of financing to get a company out of a situation of underfunding so as to achieve a more healthy financial structure. In such cases, we will often regard fiscal latency as partially or fully acquired rights by current owners either as compensation for bearing risks or as potential loss recovery, and thus, active latencies.

1.3. Negative shareholders' equity

In the case of some loss-making companies, we may be confronted with accumulated losses that actually result in negative shareholders' equity.
First of all, it needs to be emphasized that this often constitutes an accounting presentation as opposed to a presentation that is based on economic values. This may revolve around accounting values of buildings and premises and financial fixed assets, which are no reflection of their economic value. This might also be explained by the fact that assets such as intangible fixed assets or commercial assets are not reflected accounting-wise.

Negative shareholders' equity may feature in two different ways when applying profits or cash flows:

- positive fiscal latency as explained previously, and/or

- alternatively, only as a financial position of underfunding, in which case financial contributions are required. Such financial contributions will serve as starting points for cash flow planning. The financial cost of those contributions will be included in the budget that serves for the evaluation. This financial contribution itself will also lower the value of the company as it is required for developing its business plan.

Negative shareholders' equity in a purely accounting sense does not feature in company valuations. It is not a value that is (to be) taken into account. It is not even used for other calculations of return value or cash flow value. Strictly speaking in terms of accountancy, negative shareholders' equity only means that current owners have spent or lost their investment capital. However, this does not constitute an economic value assessment. It is not even an evaluation in a purely financial sense. After all, company liquidation may lead to positive equity repayments to shareholders.

Negative shareholders' equity in itself, unless incorporated in financial and, especially, cash flow based budgets, will not be part of the basic dataset used for company valuation. Therefore, company value will never be lower than its liquidation value. Of course, in some cases, debts and liquidation costs may exceed the liquidation value of company assets.

2. Asset stripping

In case of unprofitable or insufficiently profitable companies, we should not ignore the opportunities and realities of asset stripping. Specifically, this means a company takeover for the purpose of eventually selling off useful and valuable elements or transferring these elements to other companies that may be part of the conglomerate of new owners. The approach is similar to liquidation valuation.

The value may consist of an operational usage value for these assets as perceived by new owners. The selling price of an asset, such as a piece of equipment or an automated process control system, may be equal or lower as compared to its operational usage value for an (acquiring) operational unit. Circumstances will determine the nature of the particular valuation practice to apply.

Transfer of shares implies acquiring the company as a legal entity including all of its associated rights and commitments. Although settlements and bankruptcies often result from asset-stripping initiatives, it should be noted that this technique does not go unnoticed and certainly does not mean that new shareholders can simply disregard all commitments that are associated with the liquidated company.

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