INSIGHTS FROM BDO'S NATURAL RESOURCES PRACTICE

POWER PLAYS: U.S. OIL & GAS LEADS THE GLOBAL MID-MARKET

Digital Transformation Initiatives Could Create New M&A Wave, Revamp Drilling Risk

Quality over quantity is the message the mid-market U.S. energy sector sent through its 2018 deal activity. Though the number of deals was less than in 2017, they packed a stronger punch: Mid-market energy companies recorded 191 deals totaling $22.8 billion in 2018, compared to 207 deals totaling $21 billion in 2017, according to analysis from BDO's Global Natural Resources team.

The volume of mid-market deal activity, meanwhile, was largely concentrated in the first half of the year, but the fourth quarter saw the most value, with M&A totaling $6.91 billion.

QUARTERLY DEAL BREAKDOWNS

2018	# of Deals	Total Deal Value (Billions)
Q1	57	$5.88
Q2	49	$4.59
Q3	44	$5.42
Q4	41	$6.91

Looking to the upcoming year and beyond, the industry's new pricing paradigm—the result of a fundamental shift in supply and demand dynamics— plus the rapid growth of renewables and accelerating technology advancements will continue to reshape the industry. These factors will make digital transformation a priority—and even a potential driver of future M&A.

MID-MARKET ENERGY'S GROWING DIGITAL RESOLVE

According to the ***2019 BDO Middle Market Digital Transformation Survey***, 40 percent of mid-market natural resources companies say developing a digital transformation strategy is their company's most important digital priority. Their second-highest digital priority is investing in innovative digital capabilities for anticipated business needs—indicating they have their eye on creating new business efficiencies.

More than half (52 percent) of respondents say they even plan to finance such digital transformation investments through a sale or divestiture of assets. As the energy company of the future's success hinges on using digital transformation to boost operational efficiencies that drive revenue and profitability, the push to fund such digital initiatives could fuel M&A activity in 2019 and beyond.

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DIGITAL INVESTMENTS' ROI POTENTIAL IN ENERGY (NEXT 3 YEARS)

	Increase by 10%+	Increase by 1-9%	No Impact	Decrease (Due to Under-Investment or Poor Execution)
Anticipated Impact on Revenue	48%	40%	8%	4%
Anticipated Impact on Profitability	36%	40%	20%	4%

In fact, we believe digitization and technological advancements could nearly eliminate exploration risk for all oil and gas drilling and could propel the U.S. industry to achieve a drilling success rate above 95 percent.

> *"Reflecting on this period of transition, BDO's Global Natural Resources team is looking towards the future to help oil and gas companies anticipate and plan for the challenges and opportunities ahead. We believe that to prepare for success in 2020 and beyond, oil and gas companies must strive to become 'Lean, Green, Digital' machines."*
>
> – ***BDO's Energy 2020 Vision: Oil & Gas***

LOOKING BEYOND THE MID-MARKET

Outside the mid-market, 2018's deal frenzy was largely concentrated in the latter half of the year, which featured several megadeals. Among the largest was a $23.3 billion merger between Marathon Petroleum Corporation and Andeavor that closed in October and combined the companies' midstream and refining assets.

The Marathon-Andeavor deal followed on the heels of a record-shattering third quarter. According to **Drillinginfo**, the third quarter was the most active period for U.S. oil and gas deals since 2012. Most notably, BP acquired BHP's onshore oil and gas assets in the Permian, Eagle Ford, Haynesville, and Fayetteville for $10.8 billion. Consistent with prior years, both the rampant growth of the U.S. shale industry and demand for infrastructure attracted investors and dealmakers' attention and drove a significant slice of the years' transactions.

In 2019, we expect deal activity in the U.S. energy industry to be shaped by three overarching trends:

2019 PREDICTIONS FOR M&A IN THE U.S. ENERGY SECTOR

- Deal value will grow, with efficiency in Permian operations a key driver, as mid-market organizations look to punch above their weight.
- Demand for energy infrastructure will accelerate M&A in the U.S. midstream sector.
- Pressure to innovate and cut costs will be a key driver of deal activity.

COMPETITION IN THE PERMIAN TO DRIVE M&A TO NEW HEIGHTS

The Permian is still the sweetheart of the U.S. oil and gas industry. The basin stretches 75,000 square miles and offers E&P companies dramatically lower break-even prices compared to other drilling areas. According to **GlobalData Energy**, break-even oil prices in the Permian are as low as $21 per barrel.

M&A activity in the region has ebbed and flowed in recent years, but in 2019, we're predicting a comeback. Consolidation in the Permian has already started to pick up over the last year. In early 2018, Concho Resources **acquired** RSP Permian for the significant sum of $9.5 billion. The combined entity is now the largest shale producer in the region with 27 rigs and 640,000 acres under their control.

When it was inked, industry experts viewed the Concho-RSP deal as a reawakening of Permian-centric deals. In the months that followed, market expectations have held true. Diamondback Energy staked claims in the Permian shortly thereafter, purchasing Energen Corporation for $9.2 billion and expanding their presence in the Permian.

Permian megadeals are on track to accelerate in 2019. We expect the value of deals to rise substantially as companies look to increase their presence in the basin and remain competitive with the new Permian behemoths.

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DEMAND FOR NEW ENERGY INFRASTRUCTURE WILL ATTRACT MORE INVESTORS AND DEALMAKERS IN 2019

The largest hurdle to the U.S. oil and gas sector's growth is the nation's insufficient energy infrastructure. The U.S. shale boom, which catapulted the U.S. onto the map as a global energy supplier, has led to increased demand for infrastructure across all commodity types, including natural gas, crude oil and natural gas liquids. Production levels are starting to surpass infrastructure capacity.

At the midpoint of 2018, natural gas pipelines in the Permian Basin were at 98 percent capacity. The bottleneck caused by a lack of takeaway capacity is expected to continue. By late 2019, the International Energy Agency (IEA) forecasts crude oil production in the southern U.S. shale belt will exceed takeaway capacity by as much as 290,000 barrels per day.

With limited avenues to transport commodities out of the Permian, some producers are slowing down their drilling activity. As a result, the number of drilled but uncompleted (DUC) wells is rising. At the U.S. Energy Information Agency's (EIA) October count, there were 3,866 DUCs in the Permian Basin alone.

Continued growth of U.S. oil and gas production hinges on strengthening energy infrastructure. To finance infrastructure projects, we predict an uptick in M&A activity among midstream players. The $23.3 billion Marathon-Andeavor merger is likely the first in a longer succession of midstream deals.

PRESSURE TO INNOVATE AND CUT COSTS WILL BE A KEY DRIVER OF DEAL ACTIVITY

Across the globe, energy companies are under intense pressure to streamline costs. Investors' scrutiny and demand that companies "live within their means" initially tempered deal activity. Companies prioritized delivery returns and avoided costly acquisitions that would weigh heavily on their balance sheets.

Companies share a common goal of achieving operational efficiency—minimizing expenditures and maximizing production. But a strategy that only focuses on trimming expenditures may overlook growth opportunities and is not sustainable long-term. Recognizing this reality, U.S. energy companies are starting to change course. The quickest route to establishing more efficient operations is integrating new technology to improve drilling processes, which requires a considerable upfront investment.

In 2019, U.S. energy companies will look beyond their own enterprises to innovate. Instead of building new technology internally, we predict many players will pursue add-on acquisitions to integrate already established digitized and data analytics processes into their own operations.

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People who know Natural Resources, know BDO.

CONTACT:

CLARK SACKSCHEWSKY
National Natural Resources Practice Leader
713-548-0899 / csackschewsky@bdo.com

TOM RAMOS
Managing Director, Valuations & Business Analytics
713-576-3463 / tramos@bdo.com

BRAD ROSS
Transaction Advisory Services Managing Director
713-548-0821 / bross@bdo.com

NIKOLAS REIGLEMAN
Assurance Partner
713-561-6531 / nreigleman@bdo.com

ALAN STEVENS
Assurance Partner
214-665-0786 / astevens@bdo.com

STEPHEN SONENSHINE
Transaction Advisory Services Partner
404-979-7198 / ssonenshine@bdo.com

BDO'S NATURAL RESOURCES INDUSTRY PRACTICE

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