2017 Spotlight on Oil and Gas Upstream Activity

A confluence of factors, including rising global demand and recently announced production cutbacks by OPEC, is expected to provide a tailwind for the currently rebounding oil and gas industry. Should that forecast hold, sidelined corporate and private equity investors will want to ready themselves to get back in the game. In this *Investment Spotlight*, L.E.K. Consulting explains how the market's current pace of recovery points to potentially attractive growth opportunities for well-positioned companies.

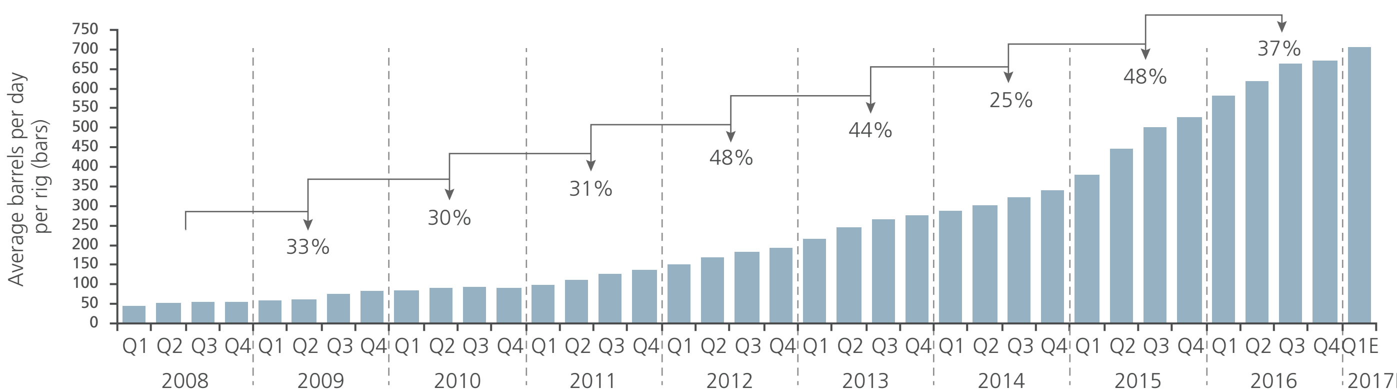
Crude awakening

Since reaching an all-time high of $155 per barrel in early 2008, pricing of West Texas Intermediate (WTI) crude has fluctuated wildly, at one point losing two-thirds of its value in a single six-month stretch (also in 2008). The industry suffered a similar setback beginning in mid-2014, with crude ultimately hitting a 15-year low of $29 in 2016 before recouping some of its losses a year later. While evidence of rising demand helped buoy the market, macro-induced price volatility is likely to remain a factor going forward.

Nonetheless, with OPEC nations opting to reduce crude output during the first half of 2017 (and possibly extending the cuts through the end of the year), observers see modest price growth going forward, with some eyeing a $60-per-barrel price target by year's end, despite ongoing market gyrations.

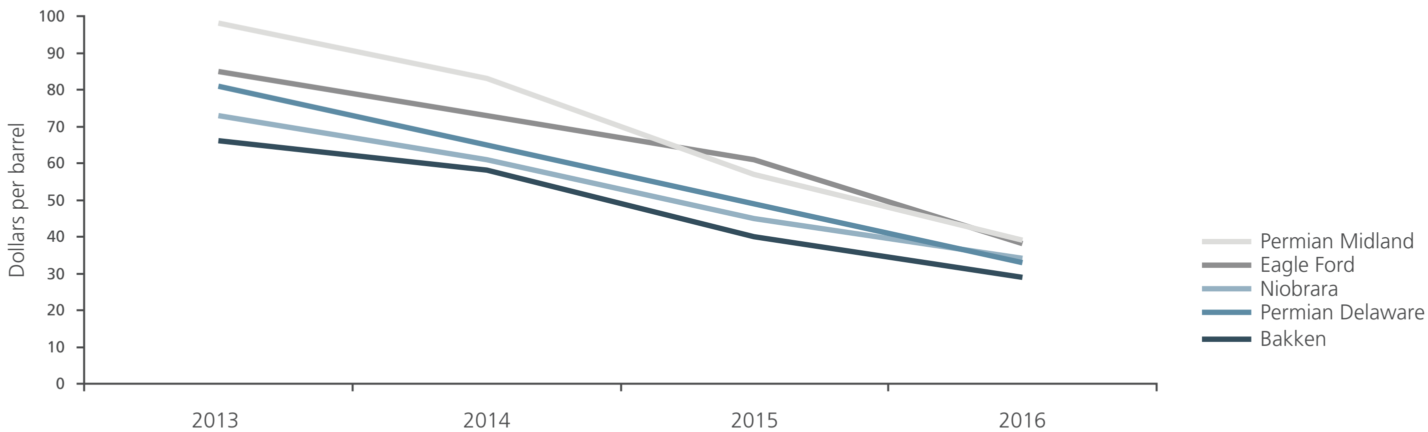
There are other positive signs as well. In its recent E&P survey, Barclays called for a 32% year-over-year improvement in North American upstream spending. Meanwhile, oil and gas sector employment continued to stabilize throughout much of 2016 before closing the year slightly to the upside.

Figure 1
U.S. quarterly oil productivity* (2008-2017E)



Note: *Based on the rig-weighted average across the following key regions: Bakken, Niobrara, Eagle Ford, Permian, Haynesville and Marcellus
Source: EIA drilling productivity report (March 2017); L.E.K. research and analysis

Figure 2
North American key shale players drilling break-even prices (2013-2016)



Source: Rystad Energy; NASWellCube; L.E.K. analysis

Well-oiled

Operating in a sub-$50 world has forced producers to become better at managing costs while focusing on enhanced efficiency and productivity. From 2015 to 2016, for instance, global directional drilling costs per active rig declined 12%, while hydraulic fracturing costs were almost 14% lower year to year. Oil companies can now drill multiple wells just 20 feet apart using the same pad, thereby saving on crew/equipment transport costs. Accordingly, the median number of barrels per rig rose more than 40% during each of the past eight years (see Figure 1). At the same time, the number of active North American rigs continues to rise, including a 45% increase year over year during the first quarter alone. Analysts see domestic production continuing its upward trajectory, as U.S. drillers are set to bring additional rigs online.

As a result of these productivity and cost improvements, crude derived from the shale-rich Eagle Ford, Bakken and Permian basins, for example, can be extracted at a much lower cost, resulting in a significantly reduced break-even point for companies such as Chevron and Exxon (as little as $40 a barrel, according to some estimates — see Figure 2). Not surprisingly, domestic producers have rapidly increased investments in shale-based drilling, which is expected to approach $10 billion by year's end, according to Bloomberg. Bottom line: Over the near term, E&P firms are likely to remain profitable and, in turn, maintain their current rate of drilling activity growth.

Trump card

The leadership change in Washington also bears watching. Many observers believe that the new administration's pro-business, anti-regulatory stance will help oil extend its gains, particularly if such policies further reduce drilling costs. Potential EPA adjustments could promote increased oil and gas usage — for example, the EPA is set to reopen its midterm review of federal CAFE (Corporate Average Fuel Economy) standards, which may help mitigate currently projected decreases in domestic fuel consumption. And if that isn't enough, oil exploration firms could also realize an estimated $10 billion in annual tax savings if the administration's call for reduced corporate taxation becomes law.

Getting ready for a crude comeback

- OPEC cutbacks have helped tilt the expected supply/demand balance back in favor of modest price growth
- North American E&P activity continues to trend upward despite lower short-term per-barrel pricing
- Ongoing production innovation/efficiency has allowed current players to become more capital-efficient
- Possible pro-energy moves by the Trump administration could have a positive impact on the industry

Barreling forward

The prospect for ongoing price stability, along with an increase in North American E&P activities, makes this an opportune time to re-enter the oil and gas segment, particularly with expectations for limited downside along with significant upside opportunity in the forecast. The distressed assets of the recent past have been replaced by higher-quality issues, featuring companies with a more disciplined approach to spending that have in turn thrived on innovation-borne efficiencies, allowing them to maintain profitability even in a reduced-price environment. This change in market fundamentals has been reflected in the number of deals struck of late — according to PwC, during 2017, the Q1 oil and gas deal value reached $73 billion, a 160% year-over-year increase, on the strength of 53 announced deals, a 36% jump in deal volume during the same period. Additionally, transactional volume in domestic drilling, as well as oil field services and equipment (OFSE), effectively doubled during 2016's fourth quarter compared with the same period a year earlier, including a twelvefold rise in transactional value.

The strengthening fundamentals within oil and gas make a convincing case for investors currently positioning for a sector re-entry. For those already on board who've patiently waited out the most recent downturn, take heart: The turnaround may finally be on the way.

L.E.K. Consulting's Industrials practice continually monitors industry trends and identifies attractive opportunities for private equity and corporate investors. Matt Korsch and Eric Navales, Managing Directors at L.E.K. Consulting prepared this Investment Spotlight. Please contact Matt or Eric at industrials@lek.com for more information.