L.E.K.

EXECUTIVE INSIGHTS VOLUME XV, ISSUE 24

After the Shale Rush: How the Slowing of the U.S. Oil and Gas Boom is Forcing Oilfield Suppliers to Raise their Game

Over the last five years, we have witnessed an extraordinary boom in the U.S. oil and gas industry. It was sparked by a technological revolution. Dramatic advances in horizontal drilling and hydraulic fracturing ("fracking") have enabled companies to extract vast quantities of oil and gas from shale, where it previously eluded their economic reach. As a result, drilling activity in areas like North Dakota's Bakken Formation and Eagle Ford in Texas has surged by about 20% in each of the past five years.

This oilfield gold rush has had a profound economic impact, with UBS predicting in September that the U.S. could become the world's largest oil producer by 2020. At the epicenter of the boom, the wealth creation has been so rapid that the cover of the *New York Times Magazine* recently hailed North Dakota as "The luckiest place on earth."

Amid this bonanza, companies that did not even exist five years ago now generate hundreds of millions of dollars in revenues. The race to bring thousands of new wells online has also enriched countless suppliers of oilfield equipment and services. Demand has been so intense that their customers – oilfield service companies such as Baker Hughes, Halliburton and Schlumberger – have, on many occasions, willingly paid premium prices to secure access to vital supplies.

But the halcyon days of the U.S. oilfield boom are ending. As the sector matures, industry analysts expect overall drilling activity in the U.S. to grow about 2.1% annually through 2018. This downshift to a more moderate rate of growth has important implications for vendors of oilfield equipment and services. Weaker firms will struggle. Yet opportunities still abound for companies that adopt the right strategies to navigate this challenging terrain.

L.E.K. has taken a deep look at these trends and their implications, surveying about 230 decision makers in North America's onshore drilling sector. This includes CEOs, CFOs, well-site supervisors, procurement advisers, and many other industry insiders. We interviewed them to find out how leading companies are repositioning themselves to succeed in this rapidly-changing environment.

Managing Costs and Enhancing Efficiency Become the Keys to Success

One important finding of our survey was that customers for oilfield products and services are altering their purchasing priorities now that growth is slowing. In recent years, opportunities for exploration and production were expanding so quickly that companies happily paid premium prices for services and

After the Shale Rush: How the Slowing of the U.S. Oil and Gas Boom is Forcing Oilfield Suppliers to Raise their Game was written by **Chris Kenney** and **Chris Rule**, Managing Directors in L.E.K. Consulting's Chicago office. Key research support was provided by Maria Gacek, a Basic Industries Specialist in L.E.K. Consulting's Chicago office. For more information, contact energy@lek.com.

equipment. Their priority was to ensure that these were readily available and reliable, since they were anxious to avoid costly delays in their operations.

Now, that emphasis is changing, with an increasing focus on managing costs (see Figure 1). The CFO of one oil and gas services company told us: "It's true across the industry that pricing has gone down for service companies. We used to just raise our price if our costs went up, and oil companies would accept it. Now they aren't. So we have to challenge our cost structure with our vendors."

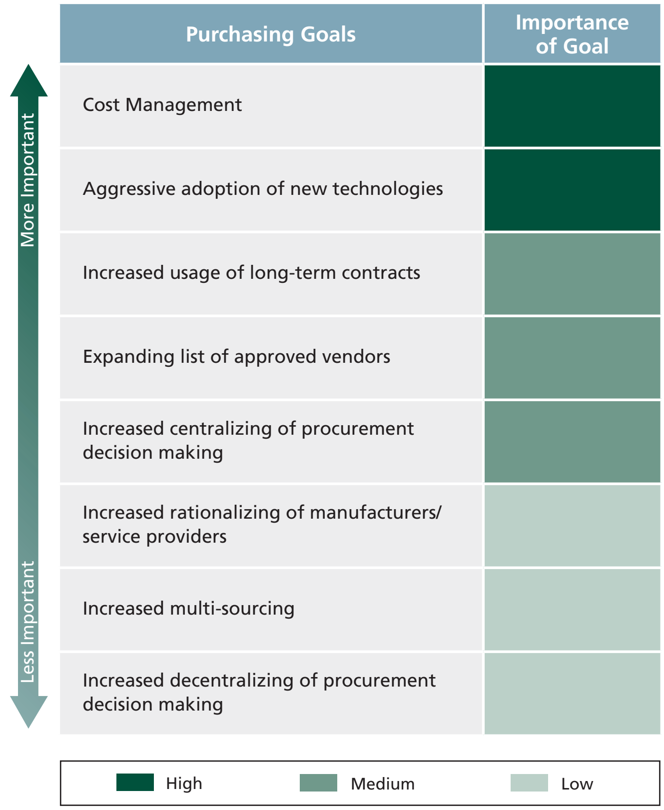
Across the industry, we are seeing this heightened emphasis on cost control. As growth in drilling activity slows, oilfield service companies are intent on removing any excess from their cost structure, partly by changing the way they procure equipment and services. For example, our survey shows they are making more effective use of vendor contracts to obtain volume discounts and secure steady supplies of materials and services. "If we feel like we've beaten down the price, we try to get them to hold down that price for 12 months, two years, or more," says one executive. "You want to lock it in."

Like other industry insiders, he also sees a growing drive to professionalize the purchasing process to avoid costly surprises: "There is increased focus on getting advance agreements, agreeing on what the price is and what the service levels are. Previously, if you didn't get these agreements, you would budget on certain assumptions and your vendors would surprise you by under-delivering on quantity and/or quality." That kind of inefficiency is harder to tolerate now that growth is more constrained.

We are also seeing a pronounced shift within oilfield service companies toward more centralized procurement – another way to wring efficiencies out of the supply chain and manage costs. Over 60% of our survey respondents indicate that they have already centralized procurement decision making or are planning to do so. "We're becoming much more centralized to control costs," says an executive at a leading service company. Management still listens to local employees on the ground, he says, but centralized decision makers have brought much more rigor to the company's purchasing process.

Figure 1

Company Purchasing Goals – Oilfield Products & Services



Note: Contains a subset of all purchasing goals asked in the survey; *Please rate how important each of the following goals are for your company when it comes to purchasing [products/services] on a scale of 1 to 7, where 7= very important and 1= not at all important;* High: >50% of respondents answered 6 or 7, Medium: 30-50% of respondents answered 6 or 7, Low: <30% of respondents answered 6 or 7

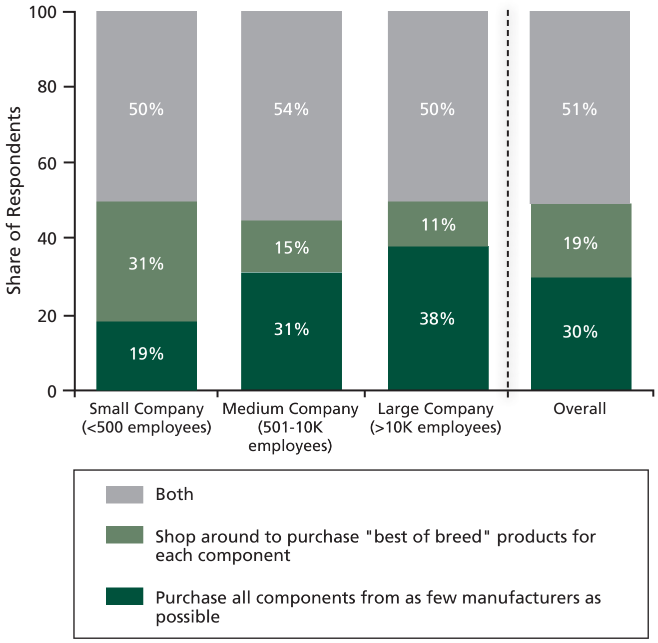
Source: L.E.K. oilfield survey & analysis

In this drive to enhance efficiency, oilfield service companies are also placing greater emphasis on standardizing their purchasing processes and monitoring vendors' performance. A field supervisor for a multinational oilfield service company says, "Our suppliers have to be on the approved vendors list, which requires an evaluation by our quality department. Once you're on it, the quality department tracks your performance, and vendors need to live up to our standards, or else they will be removed from the approved vendors list."

Service companies are also simplifying their supply chains by using fewer vendors. This streamlining provides greater efficiency and reduces costs. "We used to use a different vendor for every location," says a senior executive for an oil and gas services company. "Everyone was doing their own thing.

Figure 2

How Do You Purchase Oilfield Products?



Source: L.E.K. oilfield survey & analysis

Some were overpaying." An executive at another firm says, "It's far more efficient" to "leverage one relationship" with a supplier that provides "seven different things" than "to manage seven different relationships where there are no efficiencies." Dealing with a vendor that sells a broad array of products is also appealing because it's easier to negotiate lower prices, he says, asking them to "give us a little better deal on sucker rods if we buy a few more casings."

Smaller vendors are finding themselves at a competitive disadvantage, since they can't provide this wide range of products and services. Some will go out of business; others are already being snapped up in a wave of mergers and acquisitions. National Oilwell Varco, the world's leading supplier of equipment to the oil and gas industry, has made about 30 acquisitions since 2008, turning itself into a one-stop-shop for everything from well tools to blowout preventers. Likewise, in July, GE Oil & Gas completed a $3.3 billion acquisition of Lufkin Industries, broadening its offering of artificial lifts for extracting oil and gas.

Another powerful trend also poses a mounting threat to suppliers of oilfield products and services: In many cases, their customers are also becoming their rivals. Oilfield service leaders like Schlumberger, Halliburton and Baker Hughes have made a concerted effort in recent years to capture a greater share of spending on oil and gas wells by "in-sourcing" various businesses, instead of contracting them out. This generally occurs in high-margin or critical areas with an expectation of robust long-term growth. For example, Halliburton and Schlumberger have both positioned themselves to compete in the lucrative business of water management for oil and gas development.

In-sourcing is also driven by service companies' desire to gain greater control over their supply chain to cut costs and reduce risk. By in-sourcing, they can ensure plentiful, affordable access to critical resources. For example, Pioneer Natural Resources acquired Carmeuse Industrial Sands last year, in-sourcing its supply of sand for use in the fracking process. Many other companies are also embracing this trend. "I see us in-sourcing more in the future," says the director of global logistics at a major service company. "We want more control… We're trying to eliminate some of the volatility in the system."

Implications

L.E.K. believes these trends will continue to have a transformative impact on the oil and gas sector, causing disruption but also providing growth opportunities. To adapt, suppliers of oilfield equipment and services must understand the strategic implications of these changes, positioning themselves to profit, not perish.

Suppliers that are not among the leaders in their field should move aggressively to improve their competitive position – or risk becoming increasingly marginalized. Given that customers are looking for broader solutions from a smaller group of vendors, suppliers should actively pursue opportunities to expand their offerings. For vendors that are targeting new customers or looking to sell additional offerings to existing customers, there is mounting pressure to move quickly – the barriers to entry are rising, since customers are already seeking to broaden their relationships with existing partners, instead of entering relationships with new vendors.

In a period of slower growth, it will also be crucial for suppliers to drive down costs and boost their own efficiency. As demand moderates, customers will continue to push their suppliers for lower prices and greater accountability.

The winners in this challenging environment will be highly efficient companies with an appropriate breadth of offerings and an ability to meet customers' increasingly exacting demands. Third-and-fourth-tier companies will struggle to achieve the requisite scale and professionalism. During the boom years, when a rising tide lifted all boats, investors could profit handsomely by betting on smaller, more speculative companies. But as drilling activity slows and the industry shakes out, investors would be wise to avoid these marginal players, focusing instead on first-and-second-tier companies that are larger, more productive, and more clearly differentiated from the pack.

The industry's headiest days may be over, but there is still plenty of growth to come, albeit at a less frenzied pace. Companies that adjust to this new era will not only survive, but thrive.

For further information contact:

Boston
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

International Offices:
Bangkok
Beijing
Chennai
London
Melbourne
Milan
Mumbai
Munich
New Delhi
Paris
São Paulo
Seoul
Shanghai
Singapore
Sydney
Tokyo
Wroclaw