Spotlight on Oil and Gas Upstream Activity

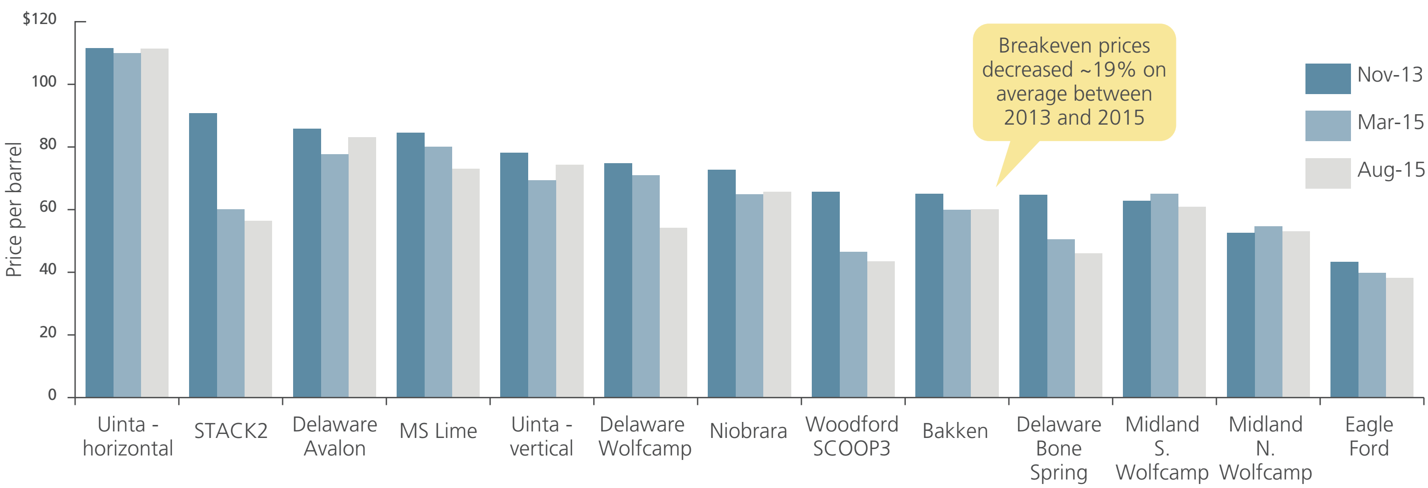
L.E.K. Consulting's Industrials sector continually monitors industry trends and identifies attractive opportunities for private equity and corporate investors.

Following the steep decline in crude oil prices in late 2014, and with continued downward pressure in 2015, there have been many questions regarding future drilling activity and the outlook for investment within the oil and gas sector. Advances in technology and unconventional drilling techniques have propelled the U.S. to its present role as a much more meaningful producer of oil and natural gas. Meanwhile, increased supply from the Middle East coupled with slowing demand in certain segments of the world economy has caused significant price pressure. In this new environment, many investors and companies are trying to determine whether there are still opportunities to pursue.

Through our work in this sector, we have developed unique perspectives and insights that can help our clients work through this evolving landscape. Consider the following:

- The industry has been more focused on productivity and production is not declining significantly as everyone is wringing costs out of supply chain and retreating to prime acreage
- Supply and production dynamics continue to squeeze pricing downward — a dynamic that is not expected to ease in the near term

Figure 1
WTI oil breakeven price by U.S. basin (2013-15)[1]



Note: [1]Breakeven prices based on 30% IRR and long-term, normalized natural gas price of $4 / MMBtu, assumes income taxes are 100% deferred; [2]STACK = Sooner Trend (oil field, Anadarko (basin), Canadian and Kingfisher (counties); 3SCOOP = South-Central Oklahoma Oil Province
Source: UBS, L.E.K. analysis

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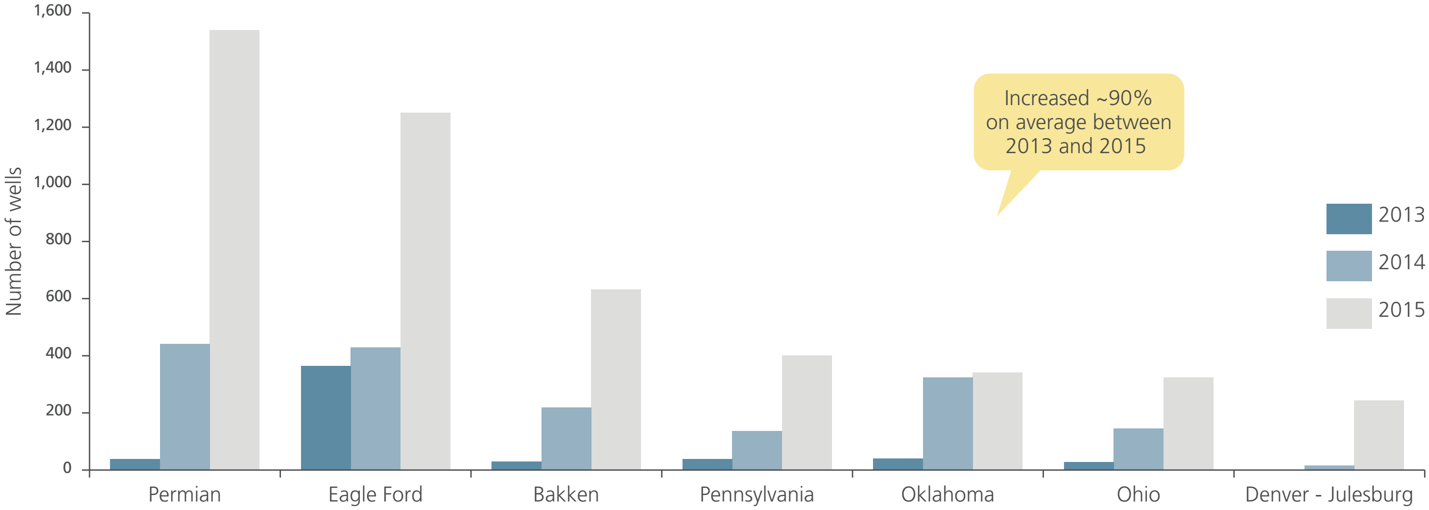
Figure 2
Drilled but uncompleted well inventory by U.S. basin (2013-15)



Note: Inventory as of February for each year
Source: Bloomberg Intelligence, L.E.K. analysis

- Drilled but uncompleted wells and dynamics of U.S. production suggest that as prices firm up, activity will rebound quickly; but this considerable inventory will also work to dampen price increases

Continued price pressure in the near term to midterm

In the current pricing environment, it is not unusual for providers of upstream services and equipment to see a 30-40% decline in their revenues. Despite diminishing activity, however, production has not experienced a significant drop because exploration and production (E&P) firms are now focusing on developing only the best wells in the most productive areas. Along with other strategies — using longer laterals, adding more wells per drilling pad and developing increased knowledge of the basins — targeting the most favorable locations is boosting the average productivity of the wells still being drilled.

At the same time, drillers are asking suppliers to share in the price pain by slashing their prices as well. As a result, input costs for the materials, tools and equipment to develop a well are down more than 20%. By successfully managing costs, and with less work overall, drillers now can work with their choice of top suppliers for each product or service.

All these factors improve well economics, meaning there are still basins in the U.S. where the marginal cost of drilling supports continued activity (see Figure 1).

The dynamics impacting prices are not likely to change in the near term, and we expect to see consolidation in the oil field equipment and service space. In addition, rather than complete a well, which accounts for approximately 65% of the total production cost, a driller can choose to leave the well uncompleted to save that additional cost. This trend is leading to an increased backlog of unfracked wells — additional supply that could quickly be brought online at the first sign of improving prices, which could further delay pricing recovery (see Figure 2).

Benefits to private equity investors

For companies considering an investment in the oil and gas sector a few themes stand out:

- While in the long term we see substantial investment opportunities in this space, at this time the quality of assets available is pretty meager; the investment opportunity in the short term is likely in distressed assets instead
- Unless distressed assets is your area of focus, we suggest waiting well into 2016 or beyond for quality oil field equipment and service companies to become available for investment
- With the focus on cost cutting, we anticipate some tempering of margins into the mid- to longer term

Contact

Please contact industrials@lek.com for more information.

About L.E.K. Consulting

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