

The oilfield services industry is in the midst of a perfect storm for M&A activity.

energy **OPPORTUNITIES** abound

BY J.B. DOLLISON



The oilfield services (OFS) industry represents one of the most vibrant M&A markets within the energy sector. All indications point to continued activity, but the real question is: How long will the party last? The answer lies in the fundamentals of the industries served by OFS companies.

As background, OFS businesses, broadly defined, provide support for the extraction, production, transportation and processing of oil and gas. In North America, it is a \$110 billion industry. It has many attributes for an active M&A environment: It is highly fragmented with more than 11,000 businesses; it lacks concentration among competitors; many companies are publicly traded; and both strategic and financial buyers are flush with either cash or appreciating stock shares to be used as consideration in changes of control.

The industry is growing rapidly due to new extraction technologies associated with horizontal drilling and fracturing techniques. These methods are facilitating the exploration and production of hydrocarbons in tight horizontal rock formations known as shale plays. In fact, so much oil and gas is being discovered and produced that the Energy Information Agency believes the United States could meet 100 percent of its liquid fuel needs from North American sources by 2024.

This is great news for the OFS industry and it has created the perfect storm for M&A activity. Not surprisingly, valuations are attractive and transactions plentiful in the industry, as illustrated by charts 1 and 2 in the accompanying chart gallery.

Revenues in the OFS industry, however, have historically followed the price of crude oil, a commodity notorious for its cyclicity (see chart 3 in gallery). As a result, investors naturally question the outlook for acquired companies, an obviously important variable in determining valuation metrics (or whether or not to buy an asset). Surprisingly, the answer varies if one examines businesses associated with natural gas vs. crude oil.

First, let's examine the natural gas segment of the energy industry. Prior to the fracking boom in shale plays, natural gas supply in the United States was rapidly dwindling, with prices vacillating depending on seasonal demands. At the time, various plans were formulated to import natural gas to the United States in liquid form (LNG) and build new, large facilities to accommodate its storage.



Tap to view
chart gallery



Fast forwarding to the present, massive quantities of natural gas have been discovered and are being extracted from shale plays in Texas, North Dakota and Pennsylvania. So much natural gas is available that current estimates are that domestic reserves could last another 100 years at current usage levels.

With rapidly growing supply and historically limited demand, gas prices have predictably declined relative to alternatives like coal, crude oil and renewables. Reduced prices naturally provide less economic incentive for continued exploration and production (and associated OFS services) that increase supply. A good illustration of this economic reality is the decline in active rigs drilling for gas (see chart 4 in gallery) that resulted from the reduction of natural gas prices in 2011.

If ample supply is available, how can demand increase for natural gas? Aside from converting retail heating customers from other energy sources, one obvious answer is to supplant the use of coal in generating power, with the added benefit of reducing carbon emissions. Other options include using natural gas instead of crude oil derivatives to manufacture certain chemicals and to power vehicles. And, finally, we have the option to export these molecules as LNG to other countries—a controversial, but currently legal, alternative.



To take advantage of this plentiful commodity and its price advantage, gas conversion efforts are in full swing domestically. Pipelines are being engineered, fitted, laid and inspected from ground sources to plants. Manufacturing facilities are being configured to accommodate new fuels and feed stocks. Facilities that dispense natural gas as a fuel source for vehicles are being constructed, and sophisticated **LNG facilities** for export are being permitted, designed and built.

Given this activity, it is easy to see a virtuous cycle for OFS businesses in the gas segment as low prices and plentiful supply lead to conversion efforts. As demand increases due to these investments, it is conceivable that prices for the commodity will increase, leading to further exploration and production. Accordingly, OFS businesses in the gas sector arguably could be in for a long run bull market that would portend well for M&A activity.

Now let's turn our attention to OFS businesses focused on crude oil. From the supply perspective, like natural gas, U.S. production of crude oil has increased dramatically. The United States is now extracting as much oil as it did in the 1970s, surpassing the production of Norway and possibly of Russia. However, two major factors affect the dynamics of the U.S. market that are different from natural gas: a legal ban in exporting crude oil and light sweet crude refining capacity.

First, the background. As supplies declined in the 1970s, the United States established prohibitions on exporting its own production while simultaneously importing more crude oil. Thus began five decades of optimizing U.S. refining capacity to accommodate imported oil that was generally more viscous than the light crude produced domestically. This effort was particularly pronounced in the Gulf Coast, where the United States maintains more than half of its refining capacity and imports heavy crudes from South America.

As shale plays began producing more oil, the domestic price of light crude (reflected as West Texas Intermediate, or WTI) naturally declined relative to its world equivalent (known as “Brent”) — a phenomenon that would normally lead to increased exports. However, with legal restrictions for exporting U.S. crude, domestic production can only be refined as finished products such as gasoline for export. Consequently, domestic supplies have been rapidly absorbing U.S. light crude refining capacity. In fact, so little excess refining capacity is currently available for domestic crude supplies that both the International Energy Agency and Goldman Sachs have published reports warning of constraints for U.S. oil output growth. Without international outlets for domestic crude or an increase in domestic refining capacity for light sweet crude (both of which would require major legislative changes), it is conceivable that prices for domestic crude could decline precipitously assuming continued increases in production.

This is potentially troubling news for OFS companies in the oil sector, especially since most businesses are associated with the extraction, transportation or storage of crude (i.e., increasing the supply, not the demand, for the product). Obviously, businesses that assist in alleviating refining bottlenecks for light crude could benefit, but drilling operations and other important growth segments might see decreased demand for services. Therefore, even though overall M&A activity is strong, we believe that potential storm clouds are brewing for OFS businesses in the oil sector. //

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