THE M&A ADVISOR

THE M&A ADVISOR SYMPOSIUM REPORT

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Energy in 2014 - A Powerful Surge In Global Expansion

At The M&A Advisor's 12th Annual Mergers and Acquisitions Summit in New York late last year, Thomas Yagel, Director, S&P Capital IQ led a panel of experts in an enlightening discussion about investment trends in the energy market with a spotlight on shale oil, natural gas and renewables.

In an exclusive assembly of industry experts, academics and media, both trends and strategies for investment in the rapidly changing energy space were addressed including:

- What's holding M&A deals back in oil
- The impact of environmental activism on M&A
- The future of renewable energy sources
- Midstream and downstream opportunities

It is anticipated by some industry watchers that 2014 will see a significant return to M&A activity in the energy sector. In this report, industry veterans explore the range of opportunities and challenges in this volatile sector.

Featuring

Thomas Yagel
Director
S&P Capital IQ

Shaia Hosseinzadeh
Principal
WL Ross & Co., LLC

G. Cook Jordan
Co-Founder, Managing Principal
Jordan, Knauff & Company

Richard Peterson
Director, Global Markets Intelligence Group
S&P Capital IQ

Presented by

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EXECUTIVE SUMMARY

The energy market is still digesting the acquisitions from the oil price high of 2008-2009, but by the end of 2014, we could see a return to M&A transactions in the oil and gas markets. Shale oil has the potential to reshape U.S. industry in a way that couldn't be imagined just five years ago. Shale oil development creates significant investment opportunities particularly in midstream and downstream operations. Natural gas prices have risen in recent months, but prices are still lower in the U.S. than in most of the world, creating economically-viable opportunities to export natural gas particularly to Asia.

INTRODUCTION

At the 2013 M&A Advisor Summit in New York, Thomas Yagel, Director, S&P Capital IQ led a panel of experts who provided a detailed assessment of investment trends in the energy market including shale oil, natural gas and renewables.

The symposium session participants included:

Thomas Yagel, Director, S&P Capital IQ (Moderator)
Shaia Hosseinzadeh, Principal WL Ross & Co., LLC
G. Cook Jordan, Co-Founder, Managing Principal, Jordan, Knauff & Company
Richard Peterson, Director, Global Markets Intelligence Group, S&P Capital IQ

In the session, panelists discussed the reasons why M&A activity has lagged in the energy market and provided insight into the investment opportunities created by the development of shale oil and natural gas in the upstream, midstream and downstream markets.

The topics discussed included:

- Shale oil and the implications for investment
- What's holding M&A deals back in oil?
- 2014 outlook for natural gas
- The impact of environmental activism
- Midstream and downstream opportunities
- The role of renewables

The conversation started with each panelist providing some perspective on the energy sector and the recent M&A environment. Shaia Hosseinzadeh, Principal at WL Ross & Co., LLC, cited key facts on shale oil and the implications for investment. “In the past 50 years, no other factor has the potential to reshape American industry as much as shale oil. The amount of shale oil discovered in the U.S. is the equivalent of two Saudi Arabias. North Dakota alone has the capacity to produce 2 million barrels of oil a day from shale. Kuwait currently produces 2.6 million barrels.”

“The shale paradigm is more capital intensive; however. It costs $2-5 million to drill a traditional oil well. Shale wells require $5-15 million in capital. There are an estimated 60,000 potential shale oil drilling locations and it will require $200 billion annually in capital expenditures to get that oil. This is notable because the entire operating cash flow of the oil and gas industry is less than $100 billion before capital expenditures.”

“So when you look at the value chain and what it means for investors, there is a tremendous opportunity for M&A.”

> “In the past 50 years, no other factor has the potential to reshape American industry as much as shale oil.”
> *– Shaia Hosseinzadeh*

Cook Jordan is a Co-Founder, Managing Principal, Jordan, Knauff & Company, an investment bank that focuses on the energy sector. He noted a number of ironies with the shale market that create a push and pull between those who seek to develop these resources and those who are concerned about the potential environmental costs. “The Monterrey shale in California is potentially the most prolific of all the shale formations. It is located in the state that needs revenue, but it is also one of the greenest states.”

At the same time, the market economy in the U.S. helps speed the production of hydrocarbons. “Consulting firms estimate that by 2025, the U.S. will be largest supplier of hydrocarbon on earth – bigger than Russia, bigger than Saudi Arabia. What will accelerate the [commercialization] process is that approximately 90% of all transactions that involve hydrocarbons are done in private transactions. This benefits the U.S. relative to other nations because our oil and gas assets are privately-owned and not state-owned. This will speed investment and transactions.”

Richard Peterson, Director, Global Markets Intelligence Group, S&P Capital IQ, provided data on M&A activity and valuations in the energy markets. “Merger activity has been robust in 2013, in no small part fueled by cheap money, willing buyers and available resources. However, M&A activity in energy and utilities has lagged other sectors. We’ve had two consecutive down years in M&A in the U.S. from a peak in 2011.”

Exxon's 2009 acquisition of XTO for $40 billion, the largest M&A transaction in the U.S. energy sector, occurred shortly after 2008's peak oil prices. Peterson explains, "Since then, Exxon's shares have gained 48%. Shares of the S&P 500 have gained over 60% over the same period. So for Exxon shareholders, this transaction has not been a great return."

Peterson noted that the U.S. energy industry has been affected by poor financials. Profitability has declined on a year-to-year basis for most of 2013 and revenues have declined since Q3 2012. "These negative trends have definitely hurt deal flow." He pointed to a recent survey indicating that deal flow in energy is being hampered by "an inability to find assets that can bring revenue and profits." He went on to say that his firm does not see deal activity picking up until the second half of 2014.

According to Hosseinzadeh, there have been two distinct periods in the energy M&A market since 2005. The first, 2005-2008, he characterizes as the "land grab." This was the time when there was widespread recognition that shale could be commercialized using fracking and horizontal drilling. During those three years, the acquisition and divestiture tripled on the acquisition side with lots of midcap independents putting their stakes into the ground on shale.

"Deal flow in energy is being hampered by an inability to find assets that can bring revenues and profits."
– Richard Peterson

Larger corporates got into the shale market in 2009. At the time of the Exxon/XTO transaction, natural gas was at $7. Hosseinzadeh notes, "Now we are at $4.45. So a lot of the value in the acquisition assumptions no longer holds true. There is buyer's remorse because those deals were structured on very preferential terms to the sellers – minimal governance on what's being drilled – carried interest payment went from buyer to operator – so there's an adverse selection problem."

According to Hosseinzadeh, "Half of all the deals done during that period are not economical to drill in the current price environment." At the same time, "For the other half of the deals that are economical to drill, the buyers' share prices have lagged considerably, so the buyers lack the liquidity to do the drilling."

Hosseinzadeh summed up the current M&A environment. "It will be a time of great inward-reflection. The E&P companies have more land than ever and can earn 20-40% returns on drilling – so most of their capital will likely go to drilling in 2014. That leaves very limited capital to do M&A."

However, he does see a move towards portfolio optimizations. "A lot of activist investors are agitating for companies to focus and refocus their portfolios and go from acquisition to actual [well] development. We believe these two reasons explain why the M&A market has been so anemic for the past two years."

Yagel posed the next question to Cook Jordan. “Natural gas prices have risen 18% in the past month or so. What is the implication of that for 2014?”

Jordan noted that the key components to understanding prices in the gas market are the export market and rig count. “Rig count is coming down and the belief is that there will be too few rigs in the near future and the industry won’t be able to bring the supply of new rigs on fast enough to match demand. Therefore, we don’t expect gas prices in 2014 to hit the same lows as we saw in 2013.”

Jordan commented that his firm also heard of a vast number of uneconomical deals out in the natural gas space. “However, the cure for low prices is low prices. Low prices will eventually attract more demand and market prices will increase.” Based on current export market estimates, “Gas is where it should be.”

The discussion then turned to the M&A markets for oil and gas – a tale of two cities. Hosseinzadeh noted that with oil going from $80 to $90, “there are a lot of stories that work.” The key is having currency to do deals. He pointed to the emergence of both private equity and upstream MLPs as significant, if somewhat unexpected, sources of capital in the E&P market. “We believe that the private equity firms have $40 billion in ‘dry powder’ to invest. With leverage, that equals $80 billion of buying power.”

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> – *Shaia Hosseinzadeh*

There are 11 publicly-traded MLPs (Master Limited Partnerships) in the U.S. with a market capitalization of approximately $20 billion. According to Hosseinzadeh, the MLPs and private equity funds have accounted for more than half of the deal flow in 2013. “If we can justify deals at $90 oil and if the IPO markets and the public markets continue to buy that story, there is probably some baseline demand.”

Natural gas, however, is another story. “It’s been the stepchild in the fossil fuel family for sometime, and I believe it will continue to be until you can see gas supporting prices north of $4.50. Otherwise, companies will have a difficult time getting deals past their boards.”

Peterson concurred that higher natural gas prices may help M&A, but primarily because it will improve the top and bottom lines for those energy companies. Separately, he commented on movements by activist investors, “Activist investors compelled Hess to sell off properties in Indonesia; however, the resources are not being redeployed into acquisitions, but rather the resources are being used for share buybacks and other forms of financial engineering.”

Jordan spoke about activism at a grassroots level. “In Vermont, the major newspapers devote a lot of ink to the struggle to ban fracking. Environmental

activism is a real dynamic across the country. Above the grassroots efforts, however, are the powerful lobbying efforts of the various segments of the energy market – refiners, processors, etc. – all of whom are pushing legislation."

"We all have impressions about how the environment will be affected and it comes down to this: Do we trust the engineering and geologic minds of the scientists who say they can drill successfully without disturbing water in an aquifer? I am a believer in the technology and the minds that control it and believe that it can be done successfully."

Yagel then asked Peterson about cash on the balance sheet as driver of M&A. Peterson noted that based on S&P Capital IQ data, there is about $180 billion in cash for the energy sector, but that as a whole, the sector has been really stagnant in terms of dealmaking – particularly for the top 12 companies that account for nearly 80% of the cash. He noted more interest from foreign buyers and pointed to Chesapeake's sale of several Oklahoma properties to Sinotec – a Chinese firm.

> "I am a believer in the technology and the minds that control it and believe it can be done successfully."
> *– Cook Jordan*

The conversation next moved from upstream to opportunities in midstream and downstream. Here, the panelists believe that there is a wide range of opportunities. Hosseinzadeh cited railroads as an immediate beneficiary of shale oil development in the midstream space, "When we look at shale, the producing hubs are no longer near the refining and consuming hubs. So, shale oil, that is produced in North Dakota, has to be transported to refiners on either the east or gulf coast. Railroads charge $10-15 a barrel to transport this oil because there is no pipeline capacity. "He also pointed to an arbitrage opportunity for companies that can refine WTI (West Texas Intermediate) crude into diesel. "WTI trades at a 10-15% discount to Brent crude. Refiners can buy feedstock at this discount, refine it into diesel and resell it into Europe at a sizeable profit."

Another opportunity is selling and transporting LPG (liquefied petroleum gas) to other countries. LPG is a by-product of drilling and the U.S. is the largest and cheapest supplier of LPG in the world. Demand for LPG is emerging markets driven, where it is used for cooking and heating, and secular growth in the Brazil and India creates higher demand.

Panama is working to widen the canal, so that it can accommodate larger ships. This is a potential boon for shipping companies, because they will be able to cut their voyage from the east coast to Asia in half. The question, however, will be how much Panama charges ships that use the widened canal. Hosseinzadeh believes that the biggest beneficiary, however, be the LNG (liquefied natural gas) trade.

A somewhat surprising point for the audience was that the economics for shipping LNG overseas was so favorable. An audience member asked why more wasn't being exported. Hosseinzadeh parsed the economics for LNG export. "China and Asia are biggest markets for export. Currently China gets two-thirds of its LNG from Qatar and Australia – with a small portion coming via pipeline from Russia. China believes it has a strategic interest in diversifying its energy sources. It's always been a suppliers' market in Japan, and post-Fukushima, that's even more true."

"Spot price for natural gas in Asia is in the high-teens. With gas in the U.S. at $4-5/mcf., and the cost of liquefying, transporting and regasification at $10-12/mcf., leaves anywhere from $3-7/mcf. of margin. The reason the U.S. hasn't exported more natural gas stems from regulatory constraints where gas could not be exported to non-Foreign Trade Agreement (FTA) countries until a few months ago. Exports have also been opposed by groups concerned about rise in the cost of natural gas in the U.S."

"The price you are going to get for your power is set by natural gas. When natural gas was $12/mcf, you looked brilliant if you had a wind farm."
– *Shaia Hosseinzadeh*

The session ended with a discussion on the outlook for renewable energy. The panel was generally not optimistic on the outlook for renewables in 2014 -- largely on price. Jordan characterized 2014 as, "a state of flux in renewables. If you look at pure economics, renewables such as solar, wind and hydro vs. hydrocarbon – hydrocarbon is generally cheaper."

However, two things may boost short-term demand for renewables in the next few years. The first is legislation. In the U.S. many states have legislation that dictates what percentage of energy must come from renewables by y a certain year. The second driver in the U.S. is the tax policy. The tax incentive is dropping from 30% to 10% in 2016, so there may be a rush for companies to adopt renewables (even at the current high price) in order to reap the tax benefit.

Peterson also sees the outlook for renewable transactions as somewhat limited. "Berkshire Hathaway's Mid-America Energy recently made a commitment to wind turbines in Iowa – something outside of its core operations – but that may be an aberration rather than the direction going forward. We don't see [renewables] as ongoing or strong component of M&A world based on current prices."

Hosseinzadeh commented that the real deterrence to investing in renewables is the price of natural gas, "The price you are going to get for your power is set by natural gas. When natural gas was $12/mcf, you looked brilliant if you had a wind farm, because the price of gas was 3-5 times the price of gas when the turbines were built and once the turbines are built, the cost to produce energy is negligible. The problem now is that the price of gas has come down but the cost of building turbines has not."

All panelists pointed to the inability to store renewable energy as the real wild card for the space. There was one comment from the audience suggesting that the solution was to hybridize energy production – use gas turbines when the conditions for solar or wind were inadequate. By hybridizing production, the average total cost of energy could come down.

In summary, the outlook for M&A in the energy space in 2014 depends on whether one is looking at oil or natural gas. On the oil front, there is a tremendous need for new capital to develop the country's shale resources. At the same time, there is an important opportunity in the midstream and downstream operations to transport and refine oil. Natural gas opportunities for 2014 are more about taking advantage of the U.S.'s position as a low-cost producer of natural gas (particularly LNG and LPG) and transporting the product to high-demand countries in Asia, where the price of gas is 3-5x higher than in the U.S. M&A activity in the U.S. is likely to be modest for the next few years as companies use capital to drill wells on property purchased during the "land grab" years of 2005-2008 as opposed to acquiring additional properties. Legislation and grassroots activism support continued development of renewable energy, but with such a huge positive change to the U.S. fossil fuel position in the past few years, the economics continue to favor hydrocarbons over renewables.

To watch candid interview with industry stalwart on "Energy in 2014 - A Powerful Surge In Global Expansion" click on the photo below

Rich Peterson
Director, Global Markets
Intelligence Group
S&P Capital IQ

Thomas Yagel
Director
S&P Capital IQ

Shaia Hosseinzadeh
Principal
WL Ross & Co., LLC

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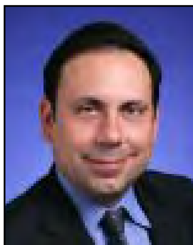
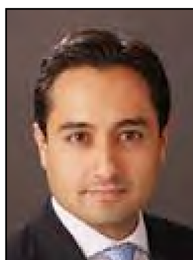
FACULTY PROFILES

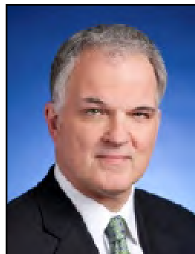


Thomas Yagel is Director, the North American Application Specialist Credit Team at S&P Capital IQ. Since first joining S&P Capital IQ in 2006, Thomas has held several analytical and client development positions. As part of the Application Specialist team he is currently involved in innovating new offerings and solutions that reach across asset and product categories, writing research that highlights the power of S&P Capital IQ capabilities and actively participating in analytical and consultative sales engagements. Thomas has an extensive background in finance covering both fixed income and equity markets with significant work in risk and valuation capabilities. With 15 years of industry experience, Thomas has held positions focusing on consulting, project management, software development and product design. Thomas holds an MBA with honors in finance and accounting from New York University Stern School of Business and a B.S. in physics from the University of Virginia.



Shaia Hosseinzadeh is a Principal at WL Ross. Shaia is responsible for originating, structuring and executing private equity transactions. He manages principal investments in various sectors, including natural resources. Hosseinzadeh has more than 13 years of experience in mergers and acquisitions, capital raises, and private equity investments. He has led or participated in more than 45 transactions with a combined aggregate value of over $35 billion. Prior to joining WL Ross, he spent five years at Apollo Investment Management and six years at Credit Suisse in the Investment Banking Division and the Leveraged Finance Group. Hosseinzadeh holds an M.Sc. in economics and philosophy and a B.Sc. in economics from the London School of Economics.

Cook Jordan is a Co-Founder and Managing Principal of Jordan, Knauff & Company. Prior to the founding of Jordan, Knauff & Company, Mr. Jordan served as the General Partner-in-charge of the Chicago, Illinois, office of C.I.D. Equity Partners, a leading provider of venture capital and mezzanine financing to high growth companies. Before joining C.I.D. in 1998, he was a Principal and Manager of the Chicago, Illinois, office of C3 Holdings, L.L.C., a private merchant bank that specialized in acquisitions and industry consolidations. From 1988 to 1996, Mr. Jordan served as Manager of Venture Capital with Allstate Venture Capital, the $600 million venture capital investment division of the Allstate Insurance Company (NYSE: ALL), headquartered in Northbrook, Illinois. Mr. Jordan began his career in 1975 at the Kansas City, Missouri, office of Merrill Lynch, where he became a Commodity Specialist focused on commercial and industrial commodity trading programs. In 1981, he joined George T. Cook Company, a broker and processor of railroad and industrial scrap metals with operations in Kansas City, Missouri, and Shreveport, Louisiana. After managing the company's processing operations for two years, he organized a leveraged buyout and became the company's President and Chief Executive Officer. Mr. Jordan is a graduate of Georgetown University (B.S.B.A. - Finance).



Richard Peterson is a Director with the Global Markets Intelligence group at S&P Capital IQ. In his current role, Richard provides in-depth evaluation of capital markets activity from M&A transactions, IPO issuance and fixed-income underwriting. Also, he provides commentary for CUSIP Global Services' CUSIP Trends, a monthly compilation of new securities identifier trends. Previously he served as Chief Market Strategist at Securities Data Company and Senior Research Analyst at Thomson Reuters Propriety Research. Richard is the author of Inside IPOs (McGraw-Hill) and has frequently appeared on CNBC as well as being quoted in The Wall Street Journal, Financial Times, The New York Times and Barron's. He has written an IPO column for CNET.com. Richard earned a J.D. degree from Rutgers Law School and B.A. from Rutgers University.