AlixPartners

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# IS M&A THE RIGHT ANSWER FOR CASH-SQUEEZED OILFIELD SERVICE INDUSTRY?

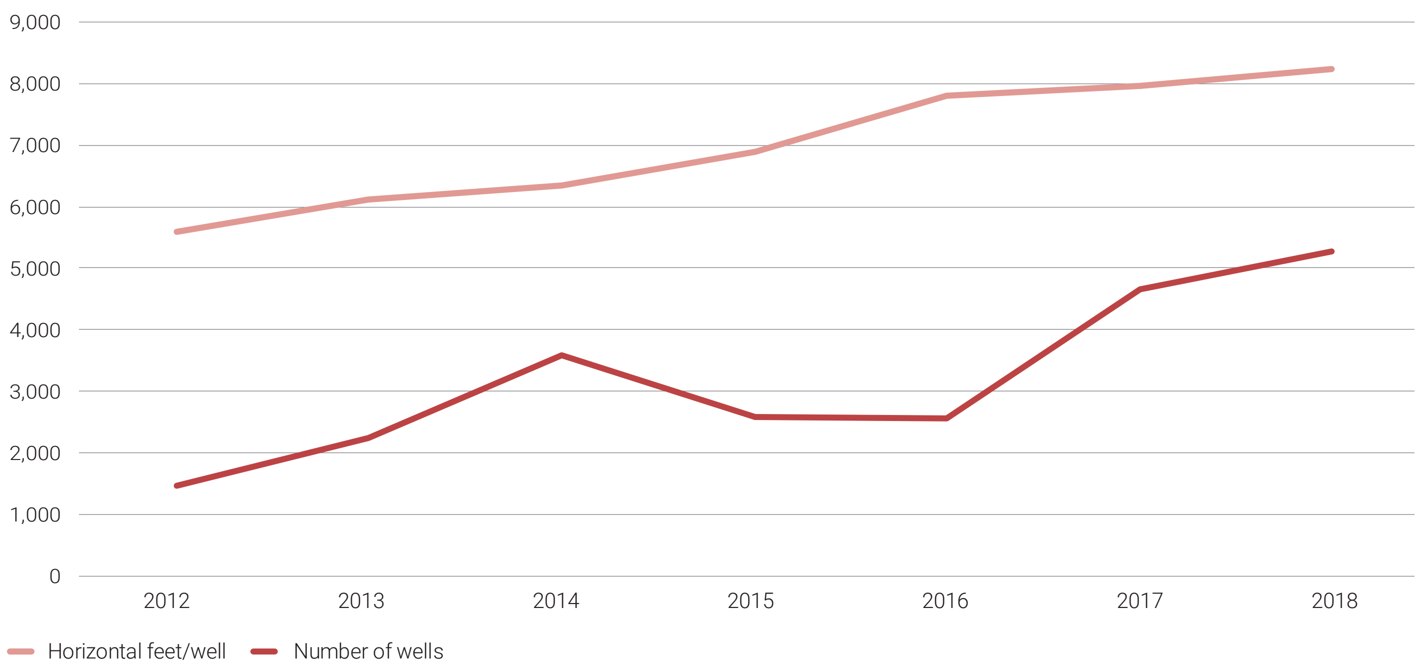
The Permian Basin is at the center of a strange conundrum. The region has been an impressive success story with advancements in hydraulic fracturing technology and horizontal drilling leading to unprecedented levels of oil production. Yet, investors backing oilfield services (OFS) companies are now balking as global oil prices linger in the mid $50/bbl range, and financial returns remain underwhelming for both OFS players and many of their exploration and production customers.

The period between 2012 and 2018 saw sizeable investments in equipment and technology by OFS players in the Permian Basin. Capital – raised largely through debt but also equity – was not a constraint. These investments significantly improved the efficiency of drilling and production (figures 1 and 2).

However, global oil production also increased simultaneously, which, in tandem with geopolitical and logistical issues, has kept oil prices from returning to the $100/bbl levels seen prior to 2014. With commodity prices tightening, the industry that had been relying on capital markets to fund investment through debt is struggling to generate sufficient cashflow to cover even its interest expenses. This dynamic, in turn, has severely limited investments in new technologies and resulted in downsizing and cutbacks by OFS players. Ironically, the current challenges are in many ways rooted in the incredible technical and productivity improvements made by the sector over the past 10 years, which has resulted in excess capacity and prices below reinvestment economics.

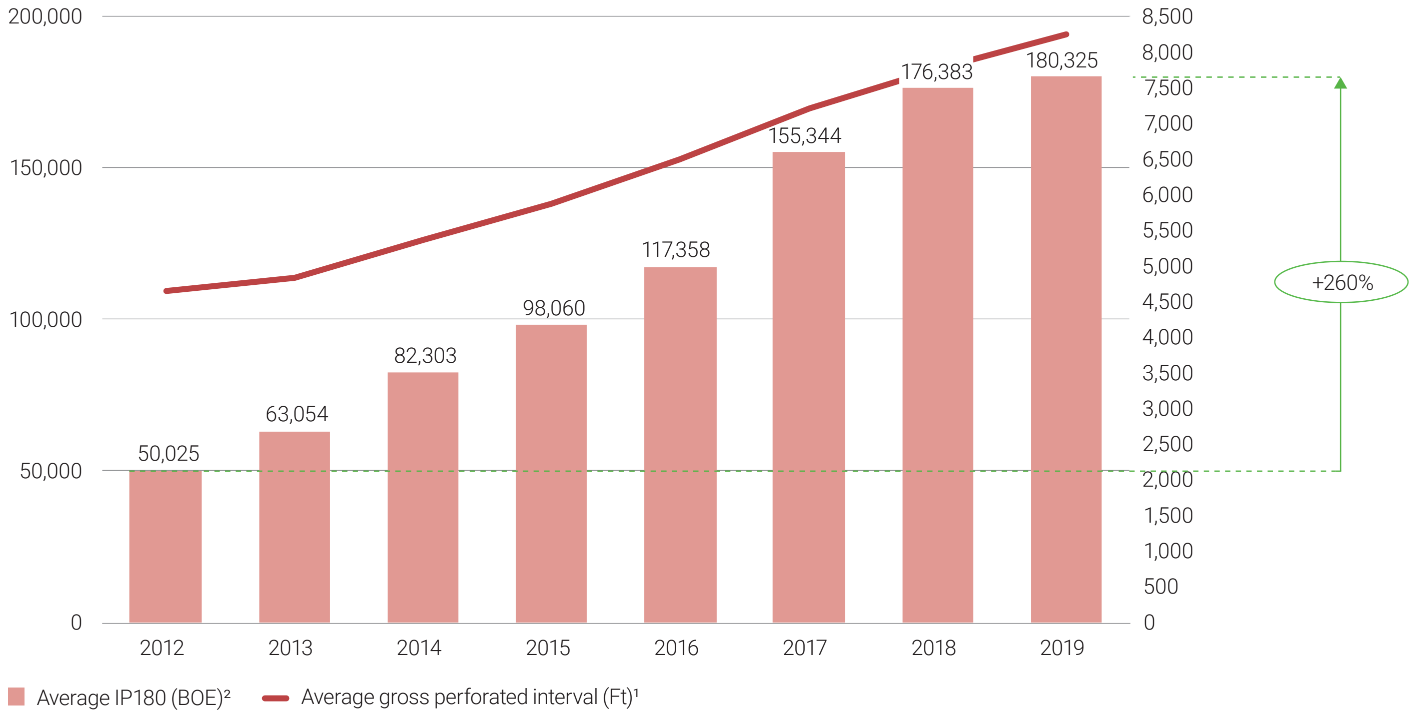
**FIGURE 1: THE PERMIAN BASIN HAS SEEN A SIGNIFICANT INCREASE IN THE NUMBER OF WELLS AND THE HORIZONTAL FEET DRILLED PER WELL**

Average per year shown




Source: DrillingInfo, AlixPartners analysis

**FIGURE 2: INITIAL PRODUCTION AMONG PERMIAN WELLS HAS INCREASED SIGNIFICANTLY AS OPERATORS CONTINUE DRILLING AND FRACTURING LONGER HORIZONTAL SECTIONS**




Source: EIA, AlixPartners analysis

While mergers and acquisitions (M&A) activity offers one potential solution to improve profitability and cashflow, OFS companies must remain cautious about this approach and look closely at what factors within a prospective deal are likely to drive this incremental cashflow.

### IN THIS MARKET, INCREMENTAL VALUE VIA M&A MAY MATERIALIZE IF:

**A** the combination is positioned to accrue market power,

**B** the deal brings new capabilities together that deliver a set of services at a lower effective cost, or

**C** enough excess capacity is retired from current active duty to potentially change the supply and demand dynamic.

In the lower 48, with the current capacity and oil price outlook, situations that may result in the incremental value outlined above appear to be very limited.

1. Gross Perforated Interval is the productive section of the wellbore. In horizontal wells, it is approximately the length of the horizontal section and corresponds to the section that is perforated and fractured
2. IP180 denotes the initial production over the first 180 days of oil, gas, and natural gas liquids, measured in barrels of oil equivalent per well

AlixPartners conducted an analysis that compared the benefits of capturing operating as well as selling, general and administrative expense synergies from a hypothetical consolidation of seven pureplay companies in the hydraulic fracturing sector to the benefits of each company improving its own performance to that of best-in-class player levels *(figure 3; see summary on page 5 for additional details)*. It is worth noting that the seven companies analyzed together have more than $1.2 billion in long-term debt maturing between 2021 and 2023, which puts them at risk given current cashflows from operations.

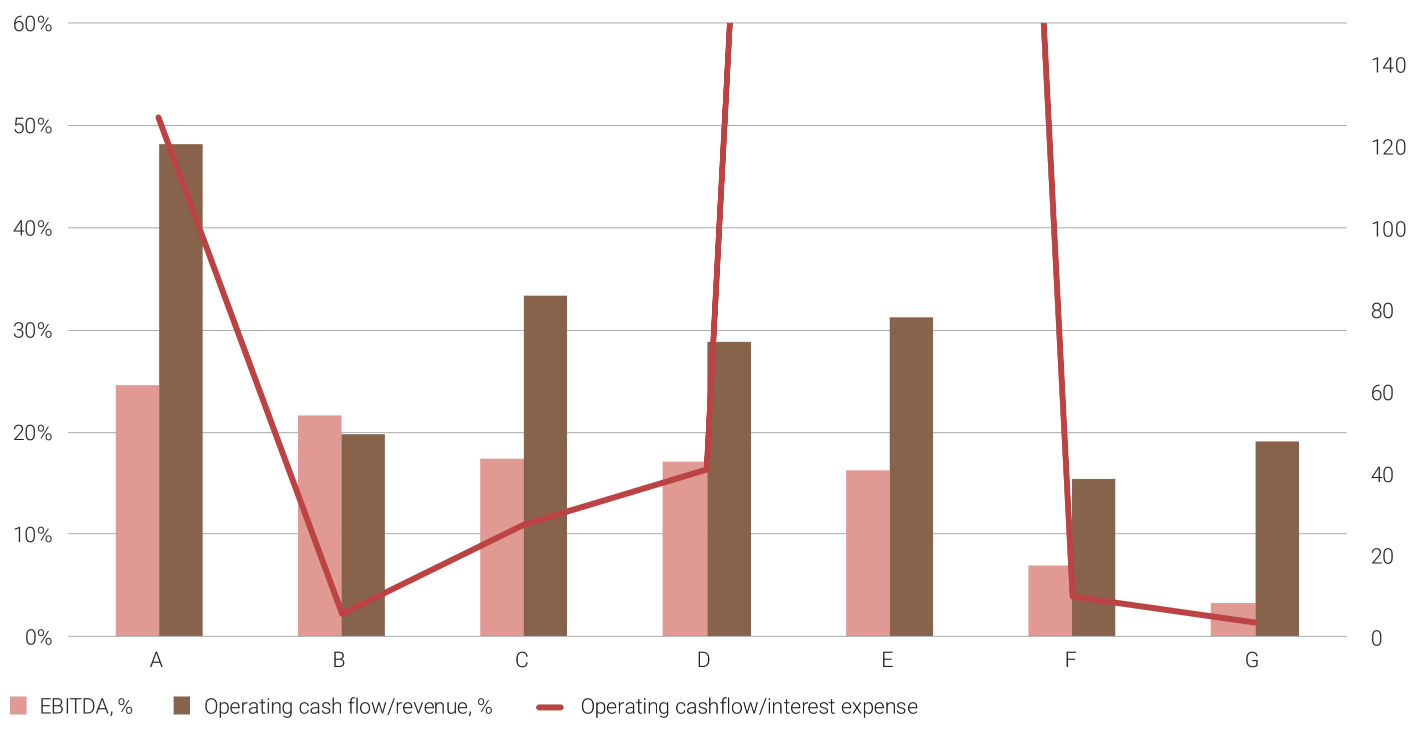
The results were surprising as the analysis pointed to a higher benefit from individual companies improving their own performance than the likely benefits derived from M&A synergies alone. In general, the collective benefits of each individual company improving to best-in-class level in the sector generated close to $0.75 billion in incremental cash flow. However, applying prevailing demonstrated synergies in typical M&A transactions to the sector generated only around $0.3 billion in incremental cashflow. The difference was significant – around $0.5 billion in cashflow or approximately $2.5 billion in enterprise value, using prevailing multiples from companies improving their own performance rather than through capturing M&A synergies.

While the study did not go into how each company may improve its efficiencies, the magnitude of the chasm between top and bottom performers was indicative of the opportunities available within many of the companies to make meaningful cashflow improvements. Levers range from pricing optimization, market participation decisions, material cost improvements, labor cost reductions, and back-office cost efficiencies. Although OFS companies have tried to focus on leaner operations, our analysis indicated that more can be done to broadly improve the cost structure and profitability at many OFS companies, including addressing the age-old operating models that may not suit the new reality of sub-$100 oil and razor-thin operating margins.

With the current oil price outlook, constraints on cash, and higher investor expectations, OFS companies should take a hard look at every available lever to improve their internal efficiencies – especially companies whose performance lags the top competitors in their respective sectors. While M&A executed well can create benefits and bottom-line improvements in a fragmented market, looking inwardly and improving performance may be a more prudent approach in light of challenging market conditions and to better prepare for the next boom – whatever form that may take.

Investors – strategic or in private equity – should take a deep and hard look at any M&A opportunities that are available. Would they truly add value? Even in cases where M&A could be the right solution, investors should also focus on operational improvements for additional value creation.

**FIGURE 3: COMPARATIVE OPERATING PERFORMANCE OF THE SEVEN COMPANIES**




Source: S&P CapIQ, AlixPartners analysis

# SUMMARY OF DATA AND ASSUMPTIONS IN ALIXPARTNERS RESEARCH

## The seven companies are nearly pure-play hydraulic fracturing companies

**AVERAGE FINANCIAL PROFILE OF THE COMPANIES IN OUR ANALYSIS (BETWEEN Q4 2018 AND Q3 2019 IN $ MILLION)**

| | |
|---|---|
| **REVENUE** | $1,361 |
| **COS** | -$1,062 |
| **SG&A** | -$73 |
| **EBITDA** | $226 |
| **OPERATING CASH FLOW** | -$18 |
| **CAPEX** | -$208 |
| **LONG-TERM DEBT** | -$260 |
| **INTEREST EXPENSE** | -$25 |

Interesting to note that the operating cashflow of this 'average company' does not cover its annual interest expense.

## The mega merger scenario assumed

1. No topline synergies (i.e. no incremental revenue from added scope or pricing improvements).
2. Industry average targets (based on published synergy targets by recent OFS mergers) for labor, materials, services, and overlapping selling, general and administrative expenses (SG&A) (i.e. no synergies assumed for SG&A in non-overlapping basins/regions).

## Efficiency improvement in individual companies assumed

1. No topline changes – assumed that each company can keep its revenue share.
2. 80th best percentile performance of key metrics (such as labor, materials, services, SG&A as percent of revenues) and the resulting proforma profit and loss.
3. No assumed changes to capital expenditure or debt obligations (i.e. no added interest expense, etc.).
4. Essentially a top quartile performer in the industry.

Date sources: CapIQ, company financials, and analyst reports; AlixPartners benchmarks and analysis

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## ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.