

Oil & Gas Practice

OFSE quarterly: Revenue edges up, but margins stay under pressure

It was another tough quarter for the oil-field-services-and-equipment (OFSE) sector. Oil prices again declined, the possibility of global recession weighed down on demand, and OFSE revenues saw only marginal improvement. Offshore and gas sectors provided some silver lining.

by Nikhil Ati



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Key events shaping the second quarter of 2019

Global political unrest. May saw tensions rising in the Middle East, threatening supply passing through the Strait of Hormuz, a major choke point in the global crude and products supply chain. Despite several skirmishes, there has been little supply disruption and even lesser impact on oil prices. Measured response from other regional producers so far has helped. The US sanctions, however, have proved effective, cutting Iranian oil exports to about 450,000 barrels per day (b/d) in July from 1.7 million b/d in March. Elsewhere in the region, there has been disruption to supply, such as in Libya, where the ongoing civil war has resulted in temporary shut-ins, including at the country's biggest field (El Sharara at 290,000 b/d) in July, and in Algeria, where political turmoil has also seen output fall. Venezuela continues to be another key battleground; while the United States has toughened its stance after extending sanction waivers for Schlumberger, Halliburton, and Baker Hughes until October 25, Russia has indicated willingness to step in and help. At the time of writing this article, tensions continued to rise in the Middle East following attacks on Saudi Aramco's oil facility.

Economic concerns threaten demand growth. A continuing rise in trade tensions between the United States and China, Brexit uncertainty, weakening Chinese industrial output, and an anticipated global recession, as indicated in actions taken by central banks across the world, has led to lowering of global demand expectations.

The Organization of Petroleum Exporting Countries (OPEC)/non-OPEC supply deal was rolled over in early July extending 1.2 million b/d cuts until March 2020. Continued tight adherence to the deal helped support prices throughout Q2, with little room for any slippage. Early in Q3, further cuts are being discussed (and likely needed) to support oil prices.

Sector consolidation. M&A and restructuring activities saw continued momentum in the second quarter. Tough US market conditions are expected

to drive further consolidations and restructuring in the industry.

Oil and gas market trends

Slowest seasonal increase in demand. Demand rose seasonally from 99.2 million b/d in March to 101.1 million b/d in June, which was just 300,000 b/d above June 2018. The increase so far this year has been one of the slowest in recent history. This slow growth has led to cuts in annual demand forecasts for the rest of the year and beyond. The Energy Information Administration's (EIA's) latest (August) growth forecast for 2019 is now only one million b/d—down 300,000 b/d in the last two months. According to McKinsey Energy Insights, 2020 demand is estimated at 100 million b/d.

Global supply, on the other hand, increased through the quarter. Global crude and condensate production rose to 100.8 million b/d in June, up from 99.9 million b/d in March (and up from 100.4 million b/d in June 2018). This increase was despite OPEC crude output falling in Q2 due to tight adherence to quotas, averaging 29.95 million b/d, before dipping further to 29.88 million b/d in July. Saudi Arabia pumped 9.8 million b/d in July (unchanged from March), and back down from 10.1 million b/d in June. The United States, Iraq, and global offshore activity contributed to production increases. After many months of production rise, US crude output finally saw a dip of 300,000 b/d in July producing 11.7 million b/d.

The EIA has revised OPEC production expectations down again to 29.73 million b/d in 2020—compared to 31.96 million b/d in 2018.

Inventory. Organisation for Economic Co-operation and Development (OECD) oil stocks rose to reach 2,903 million barrels in June, up from 2,856 million barrels in July 2018, and just above the five-year average. Overall the EIA now expects stocks to build slightly this year, with average global oil production of 101.11 million b/d outpacing demand by 110,000 b/d. In 2020, it expects this to rise to a 150,000 b/d stock build.

Crude prices weakened slightly over the quarter, with Brent averaging \$64/barrel in July, down from almost \$69/barrel in April. Supply disruptions and demand concerns appeared to balance the market in Q2, but over recent weeks the demand concerns seem to have won out, and Brent prices fell below \$55/barrel in early August. Looking at the longer-term forward curve: after a steepening at the end of

Q1 to over \$10/barrel, backwardation out to 2023 slumped to just under \$5/barrel for both Brent and West Texas Intermediate at the end of Q2 (Exhibit 1a).

Gas prices remained near record lows in most geographical areas. The liquified-natural-gas (LNG) spot in Asia dipped below \$4 per million British Thermal Units (mmBtu) at the end of July for the first

Exhibit 1a

Oil prices declined during Q2 2019.

Oil price, \$ per barrel



¹West Texas Intermediate.

²Average of monthly spot as of August 7, 2019.

Source: Bloomberg

time since the financial crisis in 2008, reflecting a raft of fresh supply combined with relatively low summer demand. Citigroup cut its gas price forecasts for this year by up to 18 percent, putting US Henry Hub at just \$2.50/mmBtu, Holland's TTF at \$5/mmBtu, and the Japan/Korea benchmark at \$5.80/mmBtu.

Spending and capital expenditures

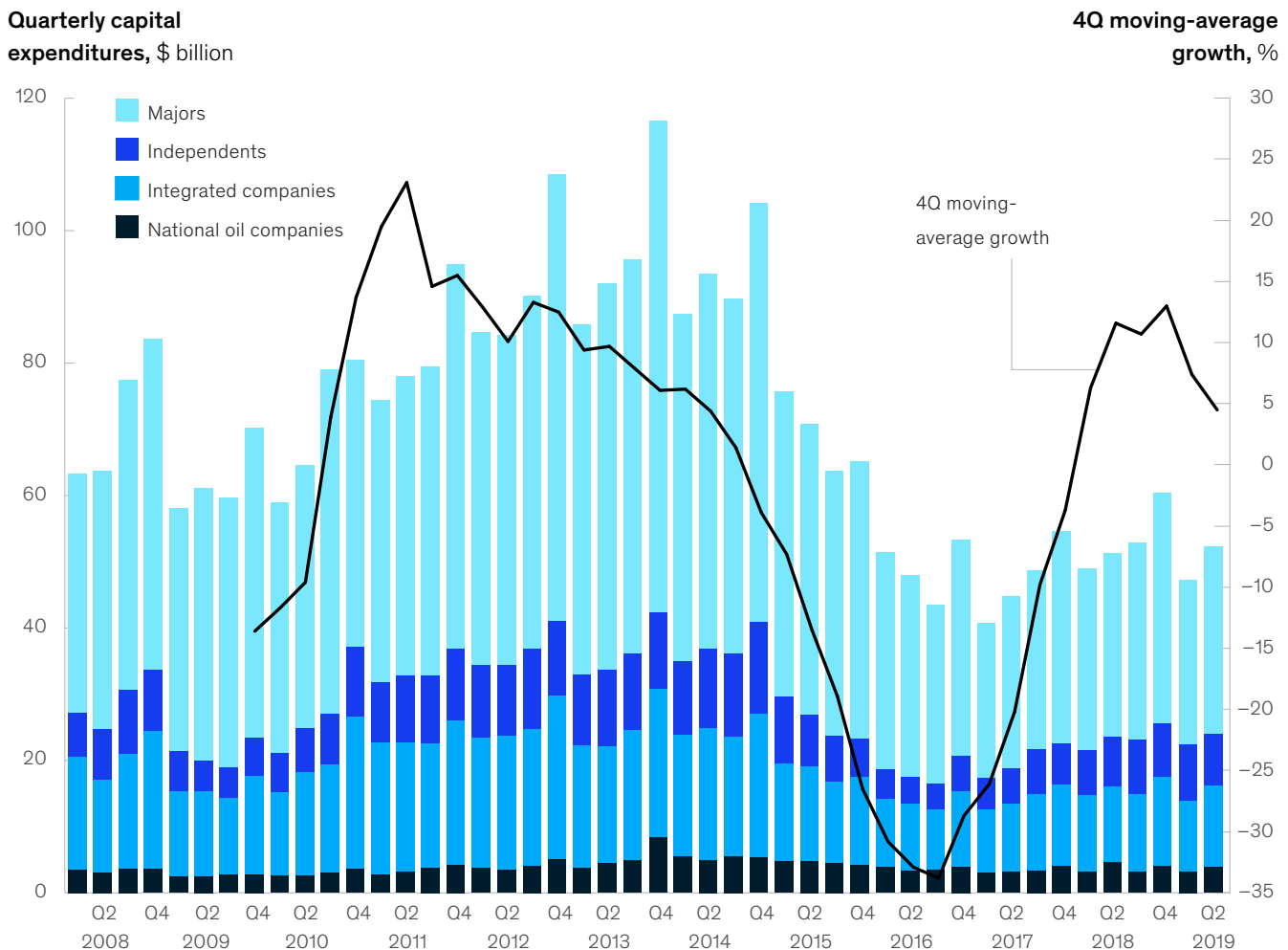
Capex in Q2 2019 rose to \$52 billion, up marginally

from \$51 billion in Q2 2018. But year-to-date levels are relatively flat compared to 2018 (Exhibit 1b).

In **North America**, capex is still being squeezed despite rising output, though output itself is now rising more slowly than in 2018 and early 2019. The cuts are being driven by demands from investors to live within cash flow and return cash to shareholders, rather than reinvesting or drilling more wells, partly through an increased focus on drilled but

Exhibit 1b

Upstream capital-expenditure spend increased slightly quarter over quarter during Q2 2019.



Note: Sample includes 8 majors, 17 independents, 10 integrated companies, and 5 national oil companies.

Source: S&P Capital IQ; McKinsey analysis

uncompleted (DUC) wells. Sure enough, the total number of DUC wells fell to 8,208 in June from 8,576 in February—evidence that shale producers are following through on their plans. The Dallas Fed said that its US onshore spending index fell into negative territory again in Q2, indicating contraction. The slowdown is more pronounced in gassier basins due to persistently low gas prices.

In the Mideast, activity was on the rise, including in Saudi Arabia, where \$18 billion worth of contracts was awarded in 34 packages in early July, aimed at maintaining output at legacy offshore fields. High capex in gas/LNG and midstream in the Middle East and elsewhere continued to help those service companies with a significant presence in these sectors.

OFSE market performance

While revenue gained ground in all segments, driven by steady international offshore growth, margins were squeezed again in Q2, especially in the US onshore sector. While several OFSE companies have spoken about increasing prices, the continued market situation has restricted the ability to gain traction. Some sectors are more affected by others, with pressure pumping being a prime example of a structural issue.

Looking at the key OFSE metrics for the quarter

The Baker Hughes North American rig count was little changed, edging down from 1,094 at the end of March to 1,091 in the last week of June, having dipped as low as 1,050 in the third week of May (Exhibit 2a). Since the end of Q2 it has fallen a bit further, reaching 1,079 in the first week of August. In the Permian, where the bulk of rigs are located, numbers fell by 19 from 454 at the end of March to 441 at the end of June, with little change since. Away from North America, onshore rig numbers in the Middle East were up 19 at 359 in June from 340 in March, while numbers are down in Africa and Western Europe.

Offshore rig numbers rose by three through the quarter from 270 in March to 273 in June, continuing the upward trajectory observed in Q1 (Exhibit 2b). The biggest rises were in Europe (Black Sea, North Sea, and Mediterranean), where the total was up by 12 to 49. There was also a rise in North America, while Africa fell slightly.

Overall revenue for the OFSE sector was up 4.7 percent on Q1 (after a 7.7 percent quarterly fall in Q1) and 0.9 percent on Q2 2018 (Exhibit 3). The nonintegrated services segment performed most poorly, with revenue slipping below Q2 2018, while all other segments are up on the year.

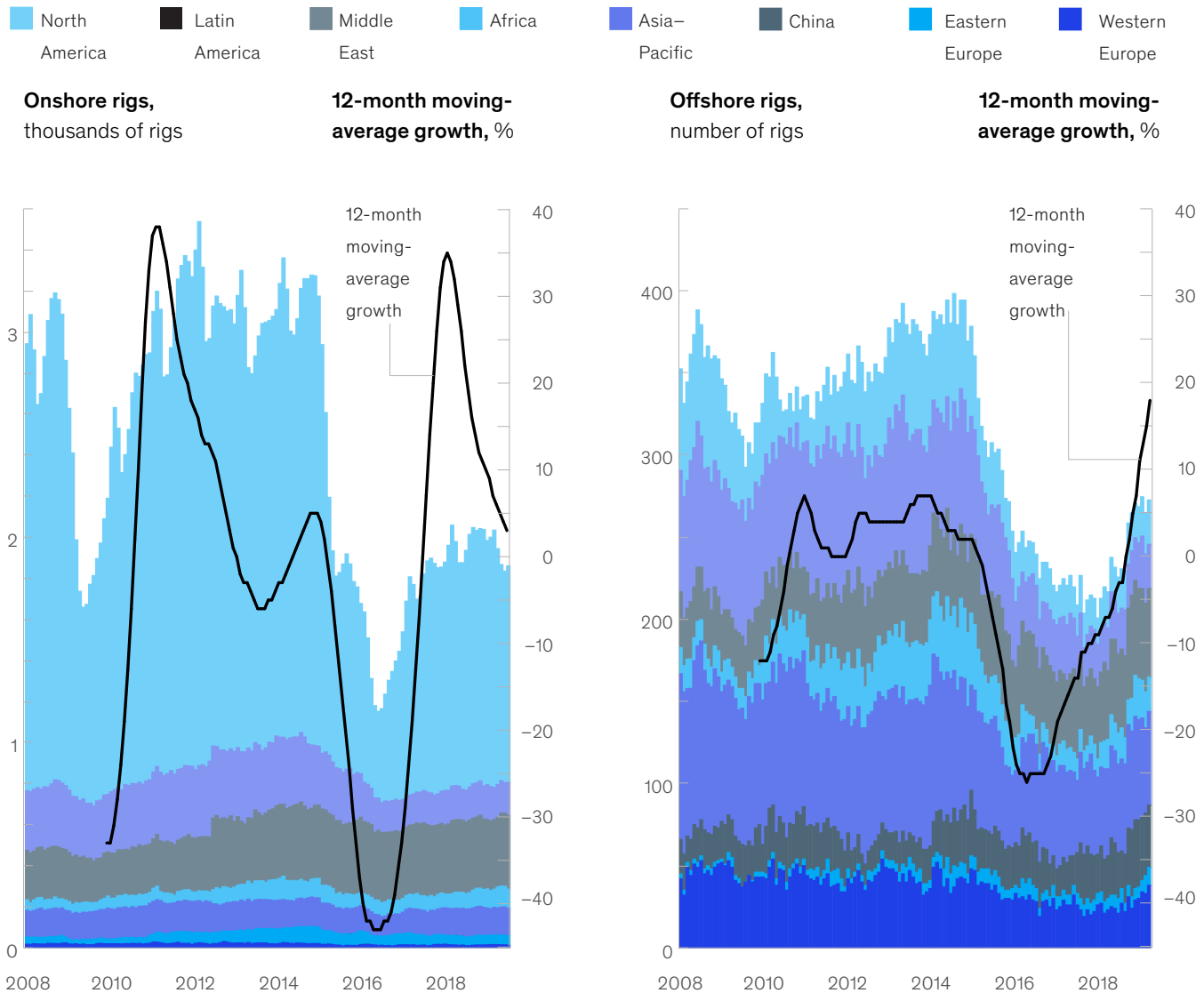
Segment performance

Equipment. Revenue saw a quarterly rise of 5.4 percent after a 10.0 percent fall in Q1, which pushed levels 4.7 percent above Q2 last year. Margins (average earnings before interest, taxes, depreciation, and amortization) were 3.2 percentage points (pp) down on Q1 at 8.3 percent, after remaining flat over the previous two quarters, and down 3.6 pp on Q2 2018 (Exhibit 4). Equipment book-to-bill ratios rose again in Q2 and are now at the highest levels since 2014 at above 8.5 times. But total shareholders returns (TSR) since 2015 fell from minus 7.8 percent at the end of Q1 to minus 19.9 percent at the end of Q2 (Exhibit 5).

Assets. Revenue was up 4.5 percent on the quarter and 4.3 percent on Q2 2018, after a fall of 1.5 percent in Q1, as new summer contracts kicked in. Margins declined further from Q1 levels being down 3.1 pp at 19.5 percent, after falling 2.2 pp in Q1. They are now 5.2 pp below the levels of Q2 2018. Assets remain the worst performing segment in the equity markets; the sector has delivered negative 70 percent TSR since 2015. Many companies remain mired in debt chalked up through the downturn, and contract backlogs are still well below pre-crash levels. For example, Transocean's backlog slipped to \$11.4 billion in Q2 from \$12.1 billion in Q1, well down on the \$18.6 billion seen in Q2 2015.

Exhibit 2a

The global onshore rig count declined by 4 percent quarter over quarter, while the offshore rig count increased slightly by 1 percent.



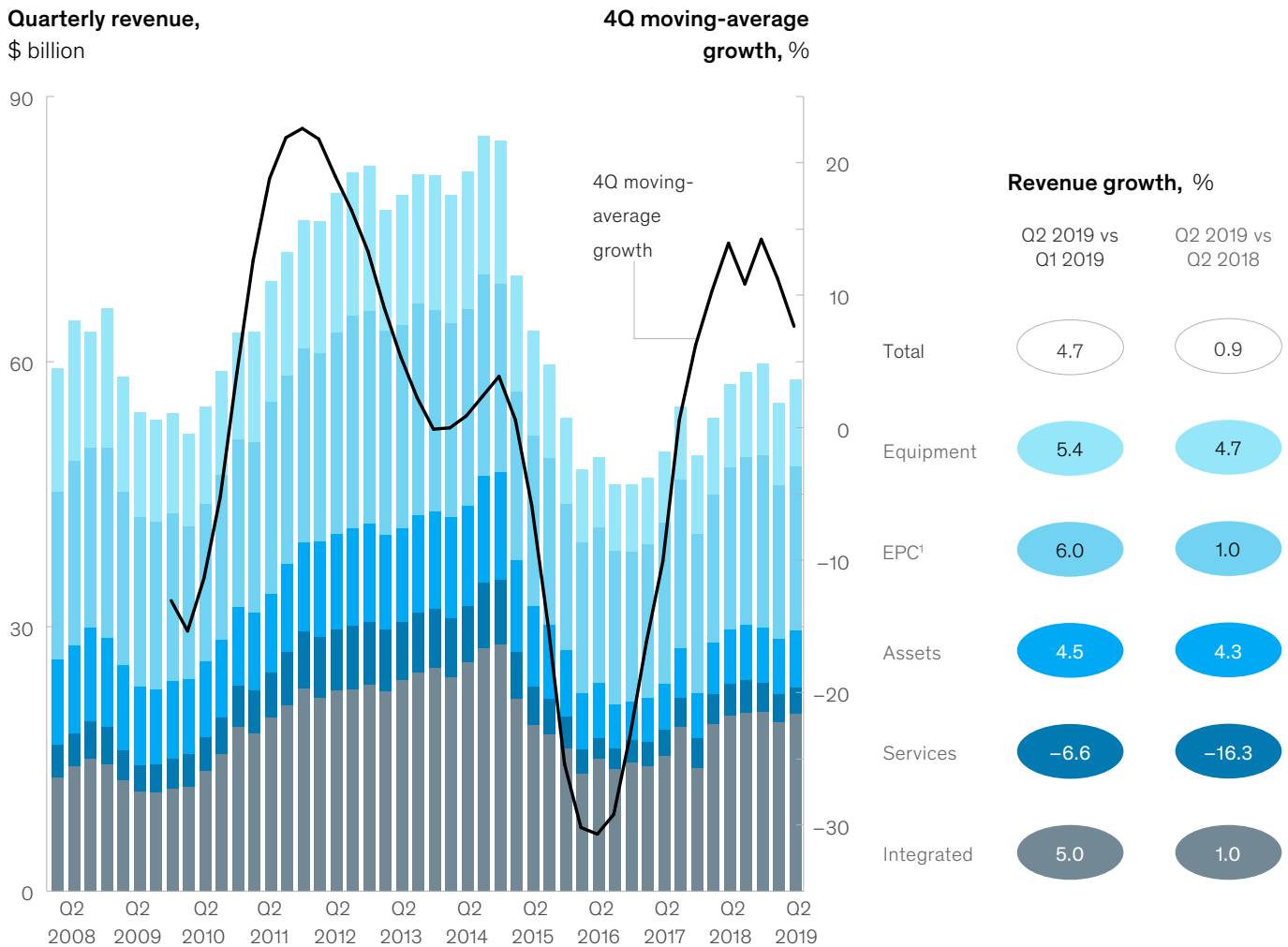
Source: Baker Hughes Rig Count; McKinsey analysis

Services. Revenue was down 6.6 percent compared with Q4 2018, after falling 3.8 percent in Q1 and 10.0 percent in Q4, leaving it 16.3 percent down on the year. Margins were down 2.5 pp on

the quarter at 6.3 percent, which was 6 pp lower than the same quarter last year. As with recent quarters, businesses exposed to the US onshore areas suffered most, driven particularly by lower

Exhibit 2b

Total Q2 2019 OFSE revenues were up both year over year and quarter over quarter.



Note: Revenue as announced; adjusted for different accounting/disclosure policy. Sample includes 11 equipment, 10 EPC, 17 asset, 3 integrated, and 7 services companies.

¹Engineering, procurement, and construction.

Source: S&P Capital IQ; McKinsey analysis

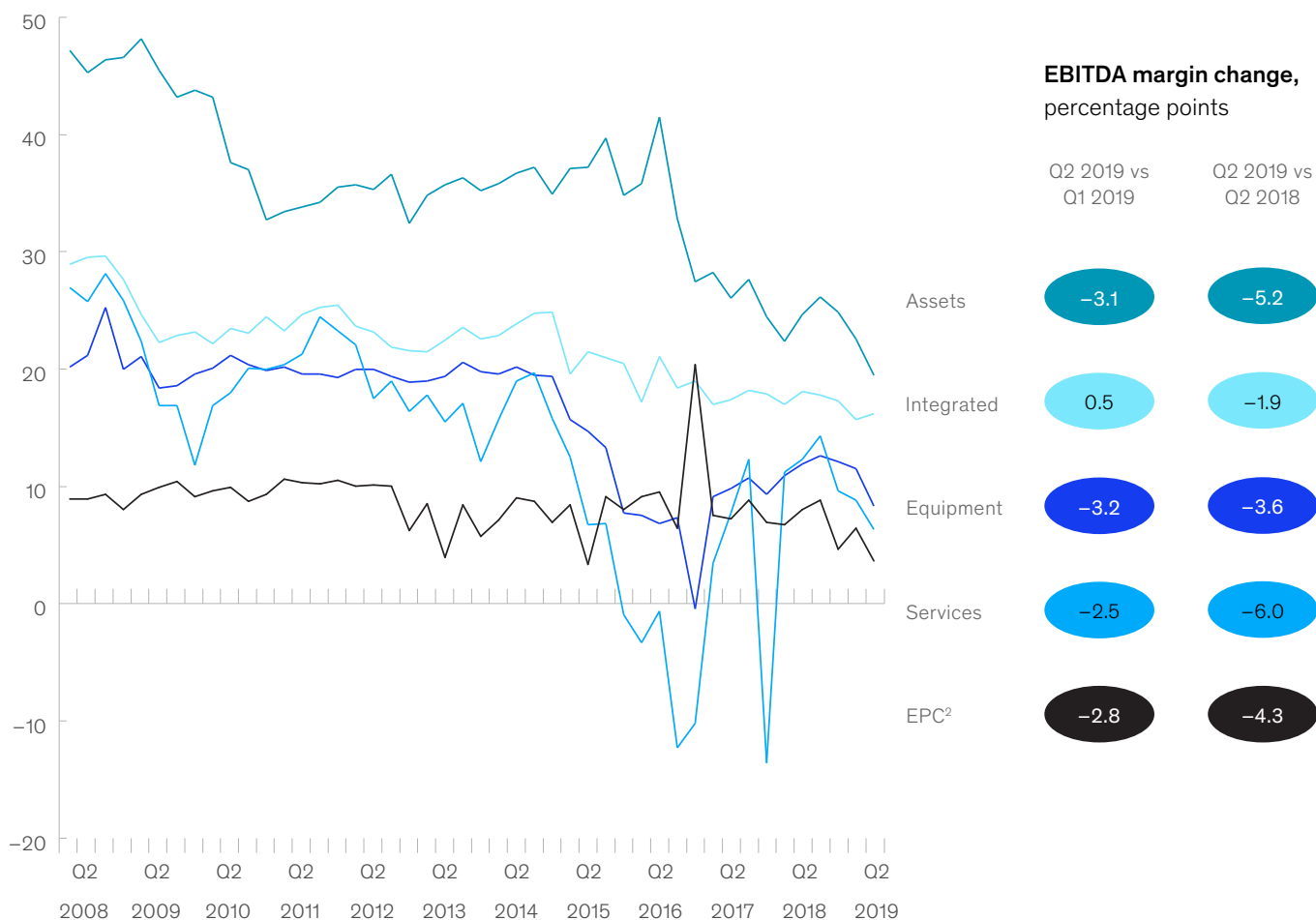
pricing for stimulation services, especially pressure pumping. In an effort to boost margins longer term, smaller service companies have been stacking surplus equipment and reducing capacity.

Integrated companies. Revenue was up 5.0 percent on the quarter, after falling 5.6 percent in Q1, and levels remained 1.0 percent up on the year. Margins were up 0.5 pp compared to Q1 2018 at

Exhibit 3

Q2 2019 margins declined quarter over quarter and year over year across most OFSE sectors.

EBITDA¹ margin, %



Note: Revenue and EBITDA as announced; adjusted for different accounting/disclosure policy. Sample includes 11 equipment, 10 EPC, 17 asset, 3 integrated, and 7 services companies.

¹Earnings before interest, taxes, depreciation, and amortization.

²Engineering, procurement, and construction.

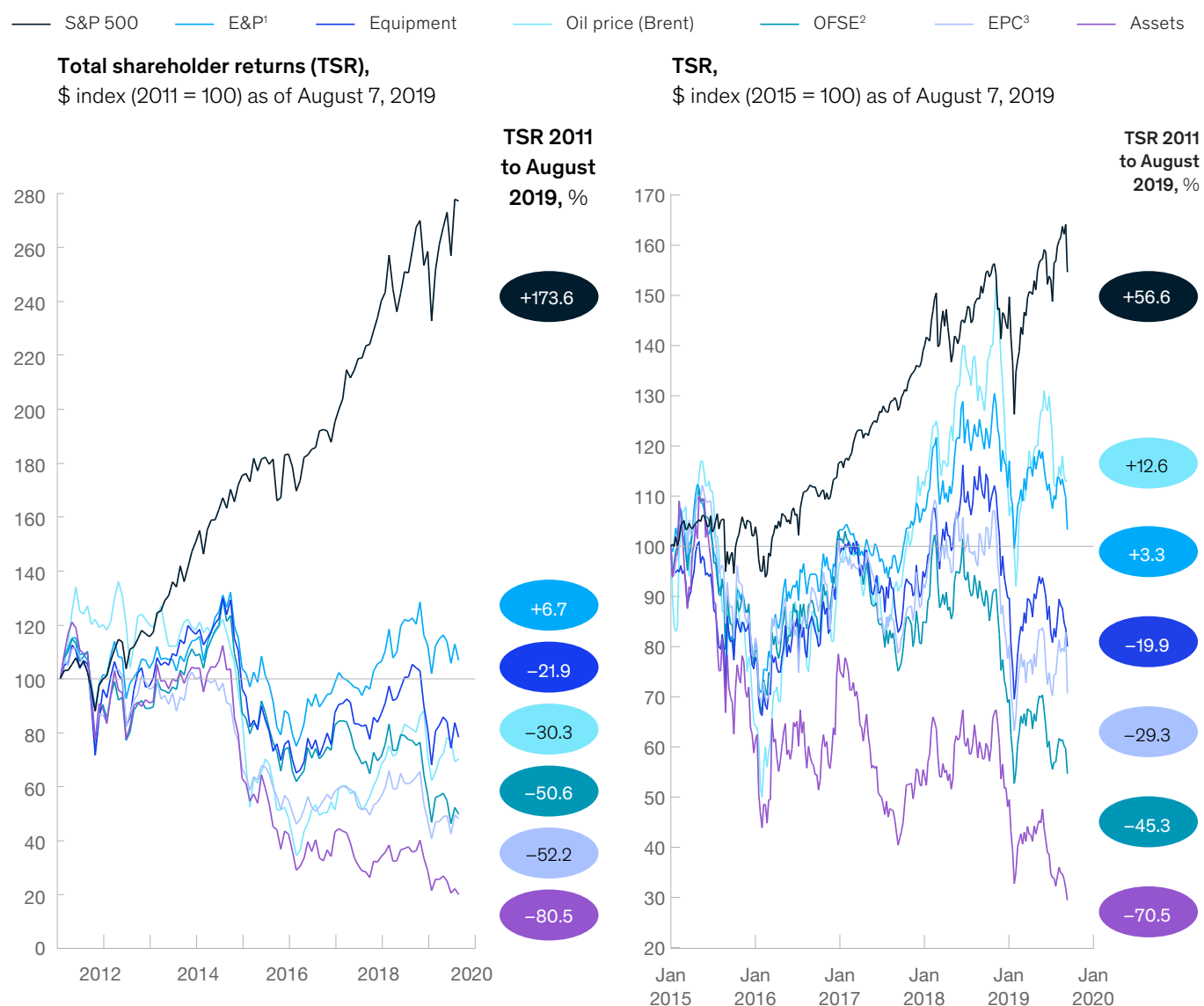
Source: S&P Capital IQ; McKinsey analysis

16.5 percent (second only to assets among OFSE categories). However, this was still down 1.9 pp on the year. Halliburton has cut its capital spending by 20 percent year on year, mostly in North America,

with much of it aimed at increasing efficiency and refurbishing equipment to improve returns and cash flow. Looking ahead, all three major integrated companies are expecting to see international growth maintained, however alongside continued challenges in North America.

Exhibit 4

Overall, returns to shareholders were declining throughout most of Q2 2019.



¹Exploration and production; includes majors, national oil companies, integrated companies, and independent companies.

²Oil-field services and equipment; includes asset, EPC, equipment, integrated, and services companies.

³Engineering, procurement, and construction.

Source: S&P Capital IQ; Thomson Reuters Datastream

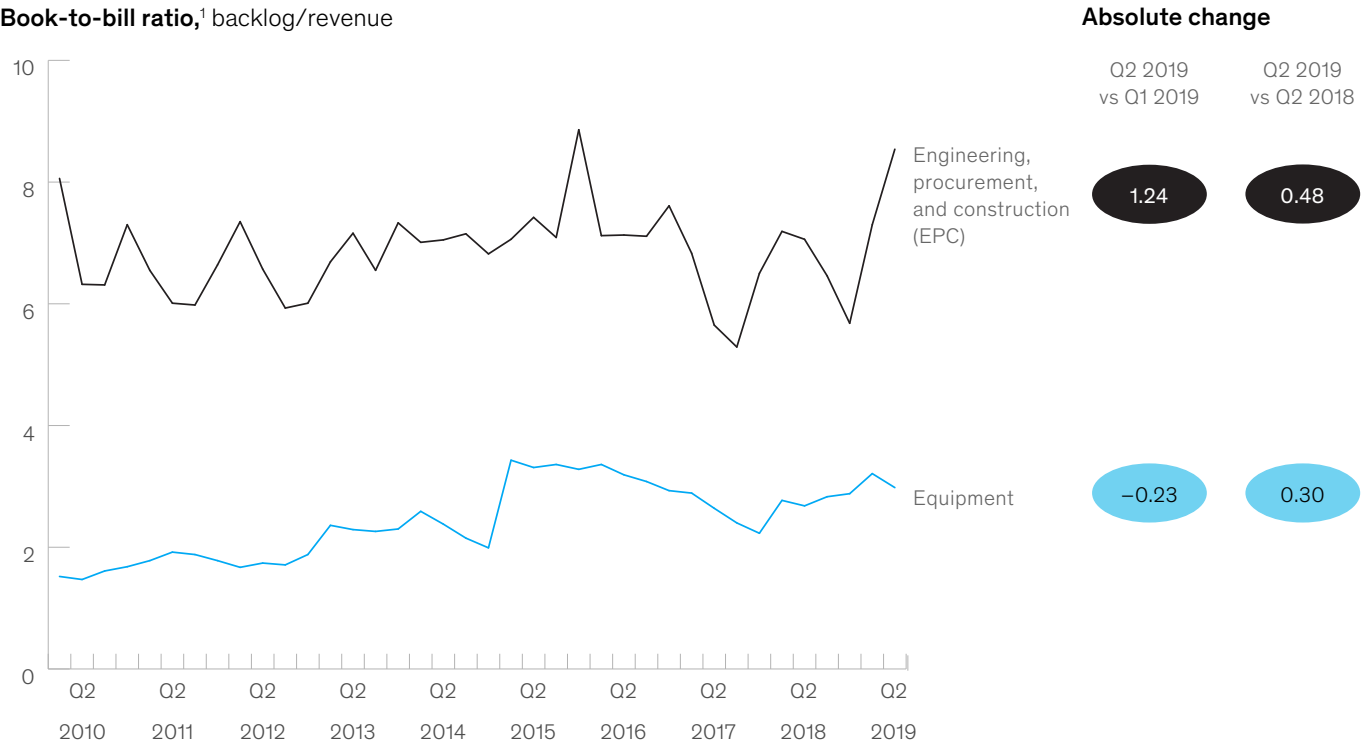
Engineering, procurement, and construction (EPC). Revenues for EPC firms were up 6 percent after falling by over 10 percent in Q1 and are now 1 percent above Q2 2018 levels. Margins came under

further pressure, falling 2.8 pp to just 3.6 percent, after a rise in Q1. EPC margins are now 4.3 pp below the levels this time last year. New projects continue to be sanctioned, but perhaps, in some regions, not

Exhibit 5

Book-to-bill ratios continued to increase in Q2 2019 for the EPC sector and declined for the equipment sector.

Book-to-bill ratio,¹ backlog/revenue



¹Revenue and backlog as announced; adjusted for different accounting/disclosure policy. Sample includes 6 equipment and 6 engineering, procurement, and construction companies.

Source: Company filings; S&P Capital IQ; McKinsey analysis

as fast as had been expected earlier in the year. As expected, liquefaction has been particularly active, with deals including Novatek's July \$7.6 billion EPC

award to TechnipFMC for the Arctic LNG 2 plant in Russia. TSR since 2015 fell from minus 18 percent at the end of Q1 to minus 29 percent at the end of Q2.

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