From Survive to Thrive
Positioning Independents for Success in North American Unconventionals

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The rapid growth of North American shale gas and light tight oil production (LTO) during recent years has significantly impacted global energy markets and transformed many companies. Most of the growth in oil production occurred during a period of high and stable prices, but oil prices fell sharply in late 2014, at least partly due to this added supply.

Producers have responded rapidly and in similar ways to the abrupt change in market conditions. A small number have gone bankrupt, and others face near-certain major balance sheet restructuring. However, the largest and most significant independent companies still possess strong balance sheets.

The strategic environment remains uncertain, but under most scenarios we anticipate a rebound in investment levels and a resumption of the growth in production of North American LTO. E&P companies should use this time of transition to strengthen their competitive positions in five main ways.
Industry has reacted evenly to changes in market conditions

The response of LTO producers to lower oil prices was rapid and uniform, with a three-part agenda of CapEx reduction, balance sheet strengthening, and supplier price concessions.

But industry fragmentation persists

Interestingly, there has been very little industry consolidation since the reset in oil prices and the independent E&P sector remains as fragmented as it has ever been (Exhibit 2). In fact, since the launch of a major sector exchange traded fund (ETF) in 2009, more than four times as many new companies have gone public as the number of legacy companies that have been acquired. Noble’s acquisition of Rosetta Resources was by far the largest M&A deal between public firms with significant onshore positions.

The largest independents have grown progressively larger over time, despite many of the largest firms (e.g., Unocal, Burlington Resources, Kerr-McGee, XTO) having been acquired. Rumors abound regarding the interest of major oil companies in acquiring a large independent. However, with the largest oil majors facing cash flow shortfalls and needing to preserve dividends, such buyouts appear unlikely. Independents have dominated the North American onshore renaissance and will be the vital shaping force in the domestic oil and gas industry for many years to come.
Continued growth for North American gas and LTO are expected

The Energy Information Administration (EIA) expects global oil demand to grow by about 1% per year through 2040. McKinsey’s Energy Insights has developed supply scenarios that would meet this demand growth. In its reference case, much of net global supply growth will come from North American LTO.

We expect LTO production to be lower in 2016 compared to 2015, due to drastically reduced activity levels in recent quarters. But we expect the number of LTO completions to rebound after that.

On the gas side, the demand outlook for North America is also quite robust. However, the steadily increasing productivity of wells in the Marcellus and Utica regions, combined with associated gas from LTO drilling, will suppress the required number of gas well completions for the foreseeable future.

Thus, producers face an uncertain but reasonably optimistic future (in the sense that oil and gas output from North America onshore is likely to grow substantially.) What steps should producers take now to strengthen their positions?
Five ways to outperform in a fragmented market

1. **Rebalance the portfolio and risk for profitable growth.** The challenge moving forward is to build a cash cycle that works in a sub-$50 oil and sub-$3 gas world. The question for CEOs is “What is the most efficient way to ensure I have sufficient cash to execute my strategy?” Hedging is an essential tool, but just one tool in the bag, alongside portfolio composition (including appraisal, development, and midstream projects), capital structure, and the procurement/contracting approach.

As an example, in its public disclosures Pioneer Natural Resources emphasizes the coherence of its resource portfolio, drilling program, midstream and infrastructure investments, and hedging program.

2. **Strengthen the technical base.** Notwithstanding the industry’s cumulative layoff announcements and the drop in rig count, technical staffing levels have held up well. Most companies have taken the pause in activity as a valuable opportunity to improve execution. In particular, they’re examining how to make better choices about well placement, lateral length, stage placement, and stimulation.

An industry veteran recently observed that “Fracking tight oil wells has been an economic success but a technical failure!” This witty twist on the industry’s traditional celebration of technical success points to just how much we still have to learn about the oil and gas-bearing shales. The industry has done a good job of compressing the time it takes to identify sweet spots, but the variability of well results points to tremendous residual opportunities to enhance productivity and reduce costs.
Laredo Petroleum is a compelling example. A relatively young company that was purpose-built for tight oil, Laredo is distinctive for the volume of technical data it collects during drilling, completions and production, and the way in which it uses its continuously-updated earth model to inform the allocation of capital.

3. **Build a distinctive organization and leadership model.** McKinsey’s research in fragmented industries shows that organizational effectiveness is a key determinant of long-term financial performance. The research points to nine specific building blocks of winning organizations. As North American onshore moves to its next innings, the companies that thrive will be the ones that build institutional strength, while they put yellow on maps of the sweet spots in major basins.

Southwestern Energy is a leader in this regard. When asked about company culture, a common answer from Southwestern employees is “There is an equation on the outside of our building: $R^2/A\rightarrow V$. That is, the right people doing the right things, wisely investing the cash flow from the underlying assets, will create value.” Leadership backs up the sign with action—senior executives spend a full day with each class of new hires training them on corporate values and investment decision-making processes.

4. **Reinforce the supply chain for the longer term.** The push for supplier concessions has delivered significant benefits, but the savings may not be sustainable. A pessimistic view is that producers have—deliberately or otherwise—entered into oil-linked pricing agreements for critical services and equipment.

While factor markets will inflate and deflate with overall activity, enduring cost improvements will come from fundamental choices around specifications, the contracting process, and how suppliers are selected.

In order to create a cost structure that will stay competitive over the long term, ask these three critical questions of every supplier:

- Is the supplier’s relative price or its relative performance more important in determining my economics?
- Is the value I receive from the supplier contained completely in goods and services, or do I also receive intangible benefits such as access to technology?
- Would it be more efficient and effective to back-integrate and provide the materials and services myself?

As an example of the latter, Apache has leveraged its scale and begun to manufacture its fracturing chemicals directly (via tolling) thereby cutting the cost of one of the higher-margin line items in its completion cost structure.

5. **Restore the M&A toolkit.** There is one near-universal theme of competition—scale is good, especially in fragmented, capital intensive industries. In North American unconventionals, the scale that matters most is at the basin level. That is where services are purchased and delivered, where technology is applied, and how most organizations are structured.
While we expect the industry’s activity level to recover, it is less likely that commodity prices will return to their recent peaks. So companies that want to thrive will have to become more competitive—and getting larger in basins will be key.

In recent years, far more companies have been launched than have been acquired in North American onshore. Before players can take advantage of consolidation opportunities, many will have to renew their skills in transaction targeting and execution. The key success factors for deals start with valuation, but also include portfolio and organizational fit, and impact on the pace of innovation. A deliberate approach to post-merger integration will be essential to capturing the benefits.

**EXHIBIT 4**

**M&A integration approach**

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<thead>
<tr>
<th>Phase 0</th>
<th>Phase 1</th>
<th>Phase 2</th>
<th>Phase 3</th>
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<tbody>
<tr>
<td>“Integration preparation”</td>
<td>“Integration planning”</td>
<td>“Integration execution”</td>
<td>“Transition to business”</td>
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- Set up of integration management office, and governance
- Preparation critical announcement must-haves (communications, integration approach, taskforce definition, …)
- Determine the end state operating model and organization design
- Identify synergy potential and define synergy initiatives to capture value
- Establish an overall master plan for integration
- ‘Real’ integration work starts
  - People transitioning
  - New processes and organization structures in place
  - Synergies being realized
- Ramp-down of integration management office and taskforces and transition to business
- Continued realization of synergies (especially transformational)

**Positioning For The Next Phase**

The past year has put great financial stress on the independent E&P sector. Onshore independents responded rapidly and decisively to the abrupt changes in market conditions; all have suffered, but most have survived.

As the energy rebound takes shape, the time is right for most players to equip themselves for this next phase of competition. Companies should focus less on survival tactics and more on strategic positioning. Explore changes in portfolio, technology, organization, operations, and M&A strategy that will create distinctive value in the months and years ahead.