BRIEFING

OIL & GAS M&A: DEAL CERTAINTY IN A US$50/BARREL ENVIRONMENT

JUNE 2016

- INCREASE IN "CROWN-JEWEL" ASSETS ON THE MARKET
- TOOLS TO BRIDGE THE VALUATION GAP
- PROSPECTIVE BUYERS IN THE CURRENT MARKET

"WHILE COMMODITY VOLATILITY HAS LED TO PROSPECTIVE SELLERS OPENING A HUGE NUMBER OF DATA ROOMS, IT HAS ALSO CREATED THE MUCH PUBLISHED GAP IN PRICE EXPECTATIONS BETWEEN BUYERS AND SELLERS."

Against the backdrop of the oil price crash, many E&P companies have been seeking to divest non-core assets to free up capital to fund key operations. However, while commodity price volatility has led to prospective sellers opening a huge number of data rooms, it has also created the much published gap in price expectation between buyers and sellers; this gap has become a key obstacle to completing deals.

While the "lower for longer" outlook has been widely accepted by E&P companies, and may help to reduce the gap between buyer and seller expectations, this briefing considers some practical steps on how to get a deal through in the current market by looking in particular at the following: (i) quality of the assets; (ii) potential tools to bridge the valuation gap; and (iii) buyer identity.

NATURE OF ASSETS ON THE MARKET

There has been a general recognition that many of the assets currently on the market are of lower quality; E&P companies have initially tried to divest the non-core assets from their portfolios. Unsurprisingly, only a limited number of these types of assets have been acquired. We expect that distressed transactions of higher-quality, "crown jewel" assets and portfolios will become more of a feature, as hedges run out and lender covenants can no longer be extended or renegotiated. In selling off the family silver, E&P companies may lean towards farm-out or partial sale structures, allowing them to retain an interest in their core assets (together with any potential upside) while passing on or at least sharing the initial financial burden with third parties who possess stronger balance sheets. Some sellers have sought to package quality assets with those of a marginal nature bearing potential liabilities. Although this may be a useful means of unloading unwanted assets, prospective buyers often simply ignore the terms of the bid process and attempt to cherry pick the better assets. E&P companies are also looking to sell infrastructure which can be leased back, generating immediate cash flow. We recently advised M3nergy on the acquisition from Lundin Petroleum of the FPSO Bertam (located on the Bertam Field in Malaysia) for US$265m, and we anticipate that the market will see more of these transactions.

TOOLS TO BRIDGE THE VALUATION GAP

There has been significant market commentary on the valuation gap that has arisen as a result of the oil price volatility and the concomitant uncertain outlook for the sector. One public example was Woodside's rejected US$8bn takeover bid for Oil Search, with Woodside unwilling to raise the offer to tempt investors' support. Oil Search felt the bid "grossly undervalued" the company. Some potential tools to help bridge the valuation gap include the following:

"USING A CONTINGENT CONSIDERATION MECHANISM PRESENTS COMMERCIAL AND LEGAL ISSUES WHICH SHOULD BE KEPT IN MIND WHEN NEGOTIATING AND DRAFTING THE LEGAL DOCUMENTATION."

(a) Contingent consideration

Contingent consideration is an arrangement whereby at least part of the purchase price is dependent upon certain pre-agreed future events taking place. Where a buyer's and seller's expectations are not aligned as to the future price of oil or the likelihood of success on a project, this tool can be useful. It allows sellers to potentially achieve some or all of their higher valuation if their expectations come to fruition after completion, while buyers avoid having to take unwelcome valuation risks and only pay once the increased valuation is achieved. There has been some evidence of this tool being employed more frequently in the market, for example: (i) Hibiscus and Ping Petroleum's acquisition of the Anasuria Cluster in the North Sea from Esso and Shell, which involved contingent consideration being payable only when, in a calendar year, the annual average oil price exceeds a certain agreed price; and (ii) Faroe Petroleum's acquisition of a Roc Oil subsidiary holding an interest in the Blane Unit in the North Sea, which included a US$3m payment deferred contingent upon certain Blane field performance targets being met.

Using a contingent consideration mechanism presents commercial and legal issues which should be addressed when negotiating transaction documentation. Where the contingent portion is linked to oil price, the seller will likely want the "relevant period" to be long enough to allow for a price rebound (e.g. 3 to 5 years). Where contingent on milestones, these must not be too prescriptive in order to prevent "technical avoidance" by the buyer. Milestones should ideally be objective not subjective and there should be a clear mechanism for determining whether the milestone has been achieved or not and for resolving related disputes. In addition, in the context of partial sales or farm-ins, key assessments will be the extent to which the parties can influence the achievement of milestones such as: (i) whether the buyer or seller retains operatorship; and (ii) whether the buyer will be able to delay certain decisions on milestones under the JOA. In all cases, it would be prudent for the seller to ensure that sufficient security or credit is in place to cover the contingent or deferred payment obligations.

"COMMODITY PRICE HAS NOT BEEN THE ONLY CHALLENGE TO TRANSACTIONS – REACHING AGREEMENT ON THE QUANTUM AND DIVISION OF DECOMMISSIONING LIABILITIES HAS ALSO PRESENTED A MAJOR BARRIER TO M&A."

(b) Shifting the power: retained decommissioning liability

Reaching agreement on the quantum and division of decommissioning liabilities has presented a major barrier to M&A in recent years. Another innovative approach to bridging the valuation gap may be the apportionment of such liabilities between buyer and seller. Decommissioning security and costs were traditionally borne entirely by buyers. In the current market, deals involving development assets and late-life assets have slowed due to the sensitivity of their owner's valuations to the short-term price outlook and the potential impact of earlier cessation of production. Sellers are realising that, without a deal, they will face all of those liabilities sooner rather than later and have been more willing to explore the possibilities that involve them bearing a proportion of them.

Although a sale for positive consideration and a "clean break" is still the most attractive result for a seller, there has been an increasing trend of sellers disposing of their interest in a field while retaining liability for the decommissioning. Such transactions frequently involve the re-transfer of the asset back to the seller when cessation of production is about to happen. Using this structure means that sellers defer the decommissioning liability, potentially gain in some upside (if a gainshare or contingent consideration structure is used), and the buyer obtains production without the related decommissioning liability. Further, selling assets but retaining the cost burden of decommissioning could help unblock the backlog of proposed asset sales which have so far failed to attract buyers. The retention of the decommissioning cost burden by the seller could attract smaller independent companies and oilfield service companies. Industry players have argued that specialist owners should be in a position to operate these late-life assets more effectively and would collaborate with others in the region. There is an expectation that the buyer is able to extend field life through options which the seller may be unwilling to carry out, e.g. increased investment in upgraded production facilities, infill drilling or tie-backs of satellite fields.

"THE CONSIDERABLE DEVALUATION OF THE MALAYSIAN RINGGIT OVER THE LAST FEW YEARS HAS A MATERIAL IMPACT. HOWEVER, OTHER REGULATIONS HAVE ALSO HANDCUFFED THE ABILITY OF THE SPACS TO CLOSE DEALS."

BUYER IDENTITY IN THE CURRENT MARKET

(a) Malaysian SPACs

In theory, the much-publicised special purpose acquisition companies ("**SPACs**") as "cash rich" oil and gas investment funds should be well-placed buyers in the current market. Yet there are a number of factors which have hampered the ability of SPACs to close out deals. There were four SPACs listed on Bursa Malaysia: Hibiscus Petroleum was the first in 2011, raising US$78m, followed by Cliq Energy (US$188m) and Sona Petroleum (US$172m) in 2013, and Reach Energy (US$245.9m) in 2014. Although these SPACs have raised significant funds to invest, the rules require them to hold funds in Malaysian Ringgit, yet any acquisition price is likely to be set in US dollars. The considerable devaluation of the Malaysian Ringgit over the last few years has a material impact. However, other regulations have also handcuffed the ability of these SPACs to close deals.

In a volatile market, sellers who have made strategic decisions to auction parts of their portfolio will favour proposals offering deal certainty and speed. Proposals from SPACs can suffer on this basis because: (i) the transaction is conditional on the consent of the SPAC's shareholders and the Securities Commission; (ii) the SPACs must acquire operatorship but, given that they are effectively start-ups with no operating history, relevant governments may refuse to grant consent to the transaction; and (iii) the timetable for approving a deal can be in the region of three months. There is a perception in the market that SPACs are required to overpay or offer some other favourable terms to sellers to obtain preferred bidder status.

A SPAC must complete a qualifying acquisition ("**QA**") within three years of listing. To date, only Hibiscus has completed its QA – in April 2012, Hibiscus acquired an equity stake in Lime Petroleum for US$55m and more recently acquired the Anasuria Cluster in the North Sea along with Ping Petroleum (as mentioned above). However other SPACs have struggled. Cliq Energy's deadline to complete a QA lapsed on 9

April 2016 and a petition has recently been filed to wind it up. Sona announced in November 2015 that it had entered into an agreement to acquire a 100% interest in the Stag oilfield offshore Western Australia. While the Securities Commission granted conditional approval, it noted that the US$50m proposed purchase price was deemed “not fair” by an independent expert and this was subsequently reduced to US$25m following negotiations with the sellers. Nonetheless, in April 2016, an overwhelming 77% of Sona's shareholders voted against this acquisition. Sona is now left with less than three months to complete a QA.

While SPACs have so far attracted considerable industry attention and have managed to secure investment from sovereign wealth funds and prominent financial institutions alike, the recent headlines on Cliq Energy and Sona demonstrate the difficulties they face in closing deals.

(b) Increasing role of Private Equity

For private equity funds with committed capital for energy transactions and good management teams, current market conditions present an opportunity to acquire and develop assets with a lower cost base during the current period of lower oil prices and make significant returns if prices recover over the next few years particularly because access to the capital markets is more difficult given the current oil price. Private equity has raised considerable funds to be deployed in the sector with: (i) Temasek, Riverstone and Global Natural Resource Investments committing US$525m to Origi Exploration in 2014, (ii) Blackstone committing US$800m in Tamarind Energy in 2014 and (iii) the Carlyle Group committing US$500m in Magna Energy in 2015. Whilst this has resulted in some M&A activity with Mandala Energy (backed by private equity major KKR) announcing a US$180m farm in to the Lemang PSC in October 2015, and more recently the acquisition of Cooper Energy’s interest in Sumbagsel and Merangin III PSCs located in the South Sumatra Basin for a consideration of US$8m, it has not resulted in the level of deals that were expected.

There have been questions about the returns required to satisfy private equity investors and the length of time it takes to develop projects which may prohibit investment by those private equity funds who would look for a return on their investment in a shorter timeframe. It may be that many funds are waiting until the stressed E&P companies move into a distress situation, bankruptcies occur and debt is written off in order to obtain discounted valuations. However, one senior figure at a large E&P company has described private equity houses as the barbarians at the gates and we anticipate that they will feature strongly in M&A transactions over the next 12 months.

“WHILST PRIVATE EQUITY PURCHASERS MAY FEATURE, THERE WILL ALSO BE OTHER COMPANIES FOR WHOM THE ASSETS ARE A NATURAL FIT.”

(c) Natural fits

With a market saturated with assets for sale, announcing the opening of a data room is unlikely to draw a flood of competing offers. In the current market, there is a much smaller pool of potential buyers than was previously the case and a more bespoke marketing initiative is needed. While private equity purchasers may feature, there will also be other companies for whom the assets are a natural fit. These are typically companies who are already in the region, possibly on the same or nearby blocks, and have a deep understanding of the type of asset that is for sale.

Conclusion

During the remainder of 2016, we expect to see more motivated sellers in the market offering higher quality E&P assets and infrastructure. For flexible sellers, and innovative buyers, the current market creates opportunities to close deals and realise value through M&A. Parties should not feel constrained by what is “market standard”; there are many examples of creative commercial approaches which are aligning buyers and sellers and helping to push the deal through.

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.

CHRIS KILBURN
Partner
Singapore
+65 6551 9124
ckilburn@wfw.com

ELIZABETH MUIR
Associate
Singapore
+65 6551 9166
emuir@wfw.com

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