VIDEO ROUNDTABLE DISCUSSION

Presented by RR Donnelley

OIL & GAS OUTLOOK

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The plunge in the price of crude oil should spur a wave of energy-related mergers and acquisitions over the next several months, some of which will be forced by distressed balance sheets and possible bankruptcies. That was one consensus of a panel of experts during a recent roundtable discussion, "Oil and Gas Outlook." The Deal and RR Donnelley's Venue® virtual data room co-produced the Webcast.

Panelists included **Andrew Safran**, vice chairman of investment banking at **Deutsche Bank**; **Mitchell Fane**, principal, southwest region, transaction advisory services at **EY**; and **Ron D'Aversa Jr.**, a restructuring group partner at the law firm **Orrick, Herrington & Sutcliffe LLP**. **Mark Aiello**, Vice President and General Manager of **RR Donnelley's** Venue® virtual data room moderated the panel.

"If you look at every collapse in commodity prices over the last 15 years, and we all know this happens about every four or five years, there's a strong M&A cycle within 12 months following that collapse," Safran said.

While the full force of this new M&A storm has yet to hit, dramatic signs of its potency are emerging: In April, Royal Dutch Shell announced it would pay $82 billion for the BG Group, the second-largest oil and gas deal in history. Also, last November's $35 billion acquisition by oilfield services giant Halliburton of rival Baker Hughes will result in significant divestitures due to government mandates related to antitrust.

"We are going to see some marquee assets of size hit the market in the middle part of this year," said Fane, who added, "the second half of the year will be a much more robust M&A environment for oil and gas."

The anticipation of far more deal activity comes after a major M&A slump, which was blamed on falling oil prices as well. "With the collapse of oil prices really starting in the third quarter of last year, we saw upstream M&A activity really drop, almost to zero," said Safran. He termed this decline "the lowest level of M&A activity in upstream in the last 20 years."

Upstream refers to oil and gas exploration and production.

Highly divergent views of valuation between potential buyers and sellers account for some of the inactivity. "Sellers are slow to recalibrate into the new price reality, where buyers very quickly readjust their expectations on commodity prices," Safran said.

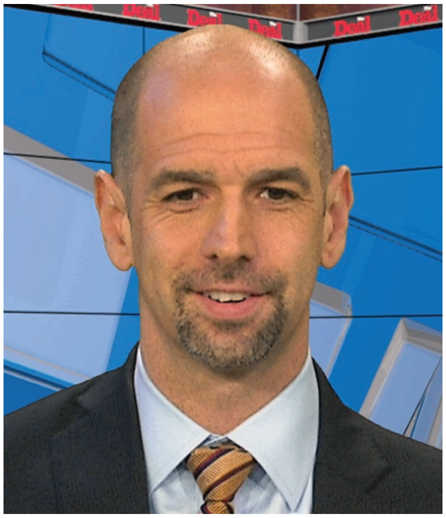
According to Fane, a large spread remains between what potential buyers offer and what those targets want. "Until those prices and those views converge, you're probably not going to see as much of an M&A market in the upstream space and clearly in the distress space," he said.

When it comes to oilfield services, such as drillers, companies have been far too preoccupied with cutting costs and terminating operations to focus on M&A, Fane said. That will come. Oil services in particular are experiencing tough times as oil producers quickly pressured drillers and others to drop prices and offer concessions. "A lot of drillers are experiencing a lot of significant turbulence," Fane said. "You're not quite at the level of distress where you're seeing entire businesses put up for auction, but you are seeing assets that are being idle then being sold to get them off the balance sheet."

D'Aversa, for one, said he believes "an environment of default" will fuel the distressed market as loan covenants are tripped. What's more, he said, reserve-based lenders, who base their loans on the underlying value of exploration and production assets, will be able to recalibrate borrowing levels and decrease the amount of lending because of the fall in oil prices. "A lot of companies are in survival mode now because of some liquidity constraints, and they have been taking a Band-Aid approach to dealing with it," he said.

That has, in part, translated into the sale of some noncore assets, D'Aversa said, adding that the move is only a temporary fix.

When that happens is another matter. Fane cited some of his clients that have been given "18 to 24 months worth of reprieve" from the debt markets. Many upstream



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companies as well have benefited from covenant-lite lending, Safran said and "there haven't been a lot of tripping points to put a lot of companies into bankruptcy." But if commodity prices stay low, that could change, he said.

D'Aversa, for one, anticipates that more bankruptcies are likely in the months ahead. Many deals will result from prepackaged or prearranged Chapter 11 bankruptcies.

Those companies that should be able to best weather this storm, D'Aversa added, are the ones that didn't overborrow, have more liquidity and can quickly reduce operating expenses, either terminating service contracts or renegotiating them.

The bulk of M&A activity in the second half of this year will come from the upstream segment, Fane said. "You'll have some of the larger, better-capitalized companies coming in and buying some of the less well-capitalized businesses."

The panelists stressed that not all parts of the oil and gas industry pipeline have been impacted in equal measure. For example, longer-term contracts and less volatile pricing tend to better protect midstream companies, which operate and own pipelines, transport and storage. If commodity prices stay low for an extended

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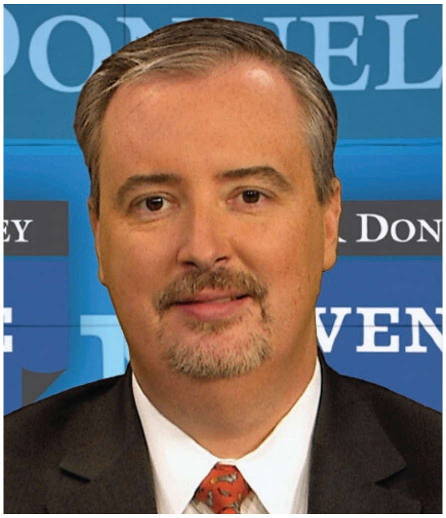
ANDREW SAFRAN DEUTSCHE BANK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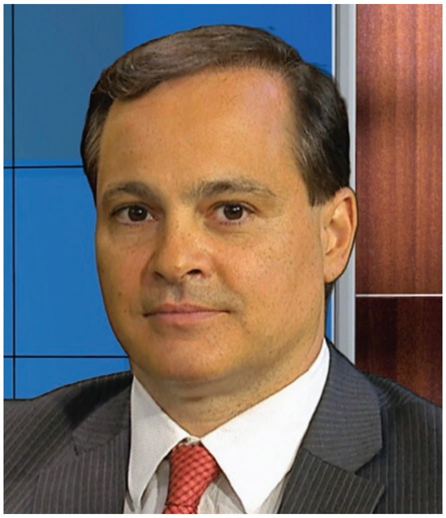
RON D'AVERSA, JR. ORRICK

time and drilling levels decline, that could change, Safran said. But he stressed that if healthy margins return, American midstream companies are "well positioned" and will "continue to grow."

When it comes to pipeline operators, Fane added, a well-positioned, well-financed company could actually benefit from the downturn. That's because where two pipelines might have been constructed in a particular location, only one will be built, giving the operator a better earnings stream.

The one exception to that, D'Aversa said, is shipping, which has been hard hit across the entire sector and has already experienced some bankruptcies. Tankers trying to keep business once existing long-term charters end face what he called a "lose-lose dynamic." They either charter their customers again but at rates significantly lower than before or move to spot, or one-day charters, and risk losing business to competitors willing to cut prices.

Downstream companies—refineries and distributors—are actually doing "quite well," Safran said. In part, he explained, because the so-called "crack spread"—the difference in the price of crude oil and refined products—is "robust." They've also benefited due to independent refiners owning significant midstream assets. "Probably 30% to 40% is in their midstream business," Safran said.

Because refineries are doing relatively well and due to aggressive consolidation in the past half-dozen years, further consolidation is unlikely, Safran said. Large refineries buying other large refineries would also run into regulatory issues, he added. However, it may be possible that individual assets will trade.

The role of foreign investors in the expected M&A wave is also an open question. As Fane described, a number of offshore entities came in two years back "under the guise of trying to learn more about our fracking technology and investing very heavily in [exploration and production] assets." Many of those took the form of joint ventures.

Safran, for one, believes foreign companies "will be a little bit more cautious because I would think some of those joint ventures don't look so robust today."

Fane, though, said he believes foreign interest remains in both upstream and downstream investments, including petrochemicals.

Private equity was widely expected to swoop in and become an acquisition force in oil and gas. That hasn't happened yet, Fane said, in part due to the valuation gap. Safran, however, said that PE has lined up platform companies and backed management teams that are "looking for opportunities, and they will find them."

Some PE firms have also acted as lenders in the sector, D'Aversa said, with debt-to-equity swaps possible as time goes by.

Master limited partnerships—publicly traded tax-advantaged limited partnerships—have become extremely popular ownership structures within energy and a potent force in M&A. According to Safran, about 130 MLPs represent more than $700 billion in total market cap. In an MLP structure, operating limited partners actually hold assets. However, many MLPs have separate general partners that manage the assets and are entitled to significant distribution rights. As they grow bigger and more successful, the distributions can result in higher capital costs and make those MLPs "somewhat noncompetitive on the acquisition front," Safran said.

Kinder Morgan, Energy Transfer Partners, Crestwood Equity Partners and pipeline giant Williams Cos. have all responded by buying out the limited partnerships and creating new corporate structures, the panelists pointed out. This should free up capital for acquisitions. ■