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Oil and Gas ADVISORY ■

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# 2021 Oil and Gas M&A Trends

The oil and gas industry faced a tumultuous 2020, impacted by both the decline in oil and gas prices and the coronavirus pandemic. Given the economic impact of the global spread of COVID-19 and the volatility of oil and gas prices, 2020 saw the least oil and gas M&A activity in more than a decade. However, despite these challenges, 2021 promises an increase in M&A activity and deal flow as the world slowly begins to normalize and economic activity bounces back.

## Energy Transition Acceleration

In an effort to focus more on clean energy and renewables, several companies made high-profile low-carbon-target announcements in 2020. For the beginning and the rest of 2021, it is likely that environmental, social, and corporate governance (ESG) investing will continue to grow. Further, with the world focused on ESG, oil and gas companies are likely to face more scrutiny from their investors moving forward – because of this increased scrutiny, renewable generation will continue to expand across the industry. Private equity clients in particular are mandating that organizations do an ESG screen as part of due diligence, and so responsible investment (i.e., clean energy, renewables, and energy storage) will be a larger trend in 2021.

To improve ESG, many companies will divest higher-carbon assets and acquire lower-carbon oil and gas, as well as renewables and electrification. While improving ESG is the main benefit, this strategy is also a way for companies to make a return on capital in a volatile commodity market.

## Continued Consolidation Across Sector

In 2020, there were more than 100 upstream and oilfield service (OFS) bankruptcies. Based on current oil prices, the number of bankruptcies in the oil and gas industry will likely remain elevated. However, while many companies resort to bankruptcy, many other companies that are overleveraged lean toward consolidation. Consolidation can drive down costs for these companies so that they can operate within their cash flows and reduce their spending.

Much of the deal value in 2020 was driven by corporate consolidation; however, only two upstream transactions were larger than $10 billion. These transactions represent a shift in oil and gas M&A that will continue from 2020 to 2021. The focus in 2021 has been on lower-premium, all-stock corporate consolidations with an eye to the Permian basin, which remains the single largest region for drilling and M&A activity. Trend analysts anticipate that 2021 could also see larger-scale consolidation outside of the Permian, in plays like the Bakken and Eagle Ford in the United States and the Montney and other unconventional plays in Canada.

## Decrease in OFS Dealmaking

In 2018, there were 71 deals worth $21 billion; in 2019, there were 61 deals worth $19 billion; but in 2020, there were only 28 deals worth $1.9 billion – a more than 50% drop in number of deals and a 90% drop in value. It was the first year since 2013 that no OFS transactions exceeded $1 billion. The OFS sector of the oil and gas industry continues to face challenges managing an oversupplied, highly competitive market. However, 2021 has seen a push toward venture capital investments and joint ventures to utilize and commercialize untapped or otherwise underutilized technology portfolios. These transactions have been small in total dollar amounts, but they may boost productivity and service revenue in this sector.

As the challenging market conditions for OFS persists, OFS companies will likely have to continue stabilizing their balance sheets, which may reduce available capital for M&A deals. As the OFS capacity remains oversupplied in 2021, there will be few compelling reasons to drive deals. Instead, companies will likely use their capital for research and development. Further, as large service companies scale back North American operations, there will be decreasing deals in the OFS sector.

## Downstream Operators Investing in Distribution and Retail

In 2020, two of the top five largest transactions in the downstream sector involved retail business, with the other three involving terminals and storage assets. None of those deals targeted refineries. The lack of large refining deals in 2020 reflects a natural slowdown after several years of large-scale consolidation in the sector. Near-term market volatility and longer-term energy transition concerns have also caused this slowdown in downstream refining deals.

The International Energy Agency projects that 1.7 million barrels of refining capacity will be retired in 2020 and 2021. If this lower throughput is not offset by lower costs, U.S. refining earnings could fall by 20% over the next decade. Further, in the short term there will be reduced utilization by lower demand because of COVID-19, and in the long term there will be a decrease in refining deals because of tighter fuel efficiency standards, electric vehicles, and export market competition.

Going forward, many downstream operators are likely to invest more in distribution and retail to capture higher margins and increase market share. Downstream companies with retail assets will likely continue to find deal opportunities because convenience stores were a strong leader in the downstream M&A space, even in 2020. For example, retail deals (7-Eleven–Marathon Speedway, Casey's–Buchanan Bucky's) accounted for 75% of last year's downstream deal value.

Despite lower product demand and prices, there may be more M&A deals in the refinery space as refiners divest their assets to replenish a lack of capital. Refiners – both integrated and independents – will continue to make divestments to unload underutilized and unprofitable assets in 2021. Trend analysists also predict that companies that provide logistics and supply services to large industrial segments (e.g., gas, lubricants) may be attractive targets for private equity investors.

## Increase in Nontraditional Capital Sources

Since 2016, equity issuance, IPOs, venture capital, and private equity investments have dropped to almost zero. These deal mechanisms are often replaced with debt. The oil and gas sector debt issuance has continued to rise, spiking to more than $240 billion in 2020, $98 billion of which was in the second quarter alone. Trend analysists anticipate that the amount of debt issuance will continue to increase in 2021.

## Continued Increase in Midstream Megadeals

Like other segments, midstream deals declined in 2020. However, like in 2014 and 2016, megadeals valued at more than $10 billion drove deal value upward. In 2020, there were nine midstream transactions larger than $1 billion and three larger than $10 billion. Year over year, there has been reduced interest in the midstream sector because there have been consistently lower commodity prices and less drilling activity. However, despite low commodity prices, long-distance pipelines and other long-lived assets should continue to attract institutional investors because there is a more predictable long-term cash flow with these types of assets.

One challenge to midstream M&A in 2021 has been the increase in ESG by large institutional investors and smaller private equity funds. A move toward cleaner energy will reduce the demand for traditional fossil fuels. However, many trend analysts believe that even with a push toward ESG, midstream assets may have value for alternative uses, including transporting biofuels, carbon dioxide, and hydrogen.

## Increase in Midstream Infrastructure Deals

The midstream sector of the oil and gas industry announced 24 deals over the last year; 70% were asset deals, of which Berkshire Hathaway's acquisition of Dominion's midstream assets was the largest at $9.7 billion. There may be an increased interest in infrastructure-related asset deals, especially for transmission, storage, and LNG-targeted applications and exports. The growing demand for storage and liquefaction capacity for petrochemicals and LNG exports could also drive additional asset deals and private equity investment as well.

## All-Stock Deals in Permian

Last year saw several high-profile, all-stock, low-premium upstream deals, many of which focused on the Permian. The deals in 2021 will likely continue to be all-stock and low-premium as companies try to balance commodity price risks and wide valuation spreads between the buyers and sellers. As private equity investments in the oil and gas sector have dropped, all-stock and similar transactions with a significant equity component may be able to provide upside benefits to the sellers, including the ability for sellers to avoid trying to generate private equity investments. While many of these types of deals in 2020 were related to upstream, it is likely that midstream and downstream deals could be structured the same since there are still some long-term uncertainties around energy demand in a post-pandemic world.

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