Ep. 48: Energy M&A—Today and Tomorrow

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Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

The energy sector in the United States and, in particular, the oil and gas industry have seen some remarkable changes over the last several years. The COVID-19 pandemic, and its effect on regional, national and global economies, was only the most recent and most impactful, coming at a time when global oil demand is reduced, and natural gas faces competition from renewables for electricity generation.

On the show today are Akin Gump corporate partners Wesley Williams and Jessica Hammons. They'll be discussing the energy industry in the U.S. and looking at investment and transactions in that industry, as well as at the factors that could help, or hurt, recovery and growth.

Welcome to the podcast.

Wes, Jessica, welcome to the show. Thanks for making the time to appear today. This is a real top-of-mind topic for those looking at the state of transactions and the energy sector in the U.S., so let's just dive right in.

To set the stage for our listeners, what major trends are you seeing with respect to energy transactions, as I mentioned, particularly in Texas? Wes, if I could ask you to lead off.

Wesley Williams: Sure. Thanks, Jose. I think, over the course of the first half of 2021, we've been seeing the green shoots of recovery in the energy transaction space, particularly in Texas as you mentioned. In 2020, the industry was rocked by both supply and demand issues, and it forced companies to get really lean and operate more efficiently. Also, you had a very constrained capital market, both on the debt and the equity side, for those in the energy space, which made it essential for all these companies to really focus on skinnying down their G&A [*general and administrative expenses*] and becoming low-cost operators. And, as with most down cycles, we've seen some winners and losers over the course of the last year. So, we've seen transactions, albeit the pace was a little bit anemic in 2020. We did see some activity pickup at the end of 2020, and then in 2021 as the demand recovers, and as people start getting back to work and back on planes, we're seeing the transactions pick up as the commodity price rises.

On the upstream side, we've seen companies, both private and public, they've been, like I said, laser focused on being the low-cost operators. We see an extreme amount of focus on free cash flow and being profitable in low commodity environments or low commodity price environments, I should say. But, like I said, as people get back on planes, as things tend to recover in the economy more broadly, demand is going to increase for oil and gas, and that should bode well for those upstream companies that have been able to skinny down in the meantime and then ride this low cycle out. And as prices begin to rise, we see transactions picking up.

Jessica Hammons: Wes, I think it's interesting to note that the volume of gasoline provided or supplied in the domestic markets, which is typically an indicator of consumption, was still down in May versus pre-pandemic levels, but it's only down about 5 percent. And this deficit, we're expecting to be pretty much erased in the coming months, as Wes noted, with employees returning to work and domestic tourism recovering. We're seeing people are continuing to get vaccinated, and they're ready to get back out and travel again. The surplus of gasoline that accumulated during the pandemic has completely been absorbed at this point. So, the inventory that was being held at refineries and tank farms and in pipelines is back in line with our pre-COVID averages. So, it's safe to say that demand is back, or close to where it should be.

Wesley Williams: No, I agree. I mean, I think that when you think about energy transactions, in my mind when you're when you're thinking about hydrocarbon energy, you're thinking about upstream companies that I talked about a little bit earlier. You're also talking about midstream companies and services companies. And on the midstream side, while the demand side of the equation forced a lot of midstream companies, like their upstream counterparties, to focus on efficiencies and profitability in a down cycle, deal activity in the midstream space in 2020 was very low. It continues to be very low and slow in 2021.

Companies in the midstream space have been more focused on really just operating the assets that they acquired during their growth mode. So, I think you had a lot of midstream companies, whether they were private equity backed or public companies that had, for the better part of the last decade, just really been focused on building out systems, acquiring systems, selling those systems. And management teams that were focused on building, growing and acquiring the systems or doing it with an eye towards selling those systems to a larger midstream company. But with the constraints on capital, these guys just found themselves in a spot where there were very few interested buyers.

Much like in the upstream space, a number of smaller midstream companies exploded over the last few years, but the consolidation is what stopped. It was kind of like a game of musical chairs, and those management teams that were stuck with assets and systems that they had built when the music stopped had to figure out if they had built something that was profitable and sustainable. And some of them did, some of them didn't. And we see that some of those companies had to seek bankruptcy protection. Some of them have been combined with other companies, but the pace at which those sales and combinations had historically occurred significantly sloped down.

But the increase in demand that Jessica's talking about should boost the volumes, and the systems should produce more revenues for these midstream providers and ultimately bode well for midstream companies. It should allow these midstream teams to also operate and really profit with respect to their existing systems until the A&D [*acquisition and divestiture*] market recovers. But that typically trails the upstream sector.

Jessica Hammons: Wes, I agree. I don't feel like we've seen as much consolidation in the midstream space in the last couple of years, but I do think, especially with the boost in demand for oil and gas and the way that the A&D market seems to trail for the midstream sector to the E&P [*exploration and production*] space, I think we will start to see more activity on the midstream side in the coming times, but I think it may be looking out into 2022 before we really see that larger uptick in activity.

Wesley Williams: Yeah, I think that makes sense. So, we've talked about upstream, we've talked about midstream. What we haven't talked about is services companies, and these were hit particularly hard throughout the pandemic and the downturn in the commodity prices. There's no doubt that, in my mind, significant consolidation needs to happen in the oilfield services space. A lot of these companies had a difficult time over the past couple of years, and they struggled to generate sufficient cash flow and revenues to service their debt that they incurred in better times, whether that was in a time where you had more capital flowing into the space, whether it's debt or equity, but also just better commodity price environments as those commodity prices get depressed, and rigs drop. Service companies get particularly hard and they're one of the first to feel the downturns. And, so, with the overall wave of capital constraints, reduced demand, it's not out of the question that we're going to see additional services companies seek protection of bankruptcy, or maybe they do some sort of out-of-court restructuring.

But the great thing is we've recently seen this uptick in commodity prices. We've seen an uptick in transactions in the upstream space. So, presumably, more rigs will start to run. These services companies are going to be able to get their fleets back out, their personnel back out in the fields. A big question in my mind is whether many of them are going to be able to survive long enough to see the recovery through. At some point, you can only burn the candle down to the end of the wick for so long. So, ultimately, it's just going to be a question of whether the increase in demand is going to free up capital for services companies to help sustain them through the recovery, to get back to better times.

Jessica Hammons: Particularly with their debt coming due that they incurred in better times.

Wesley Williams: Right.

Jose Garriga: Thank you both. Let's stay with the topic of consolidation, a thread that you all have mentioned here. There's been a fair amount of activity recently regarding consolidation transactions, certainly through the first half of this year. Do you anticipate more consolidation transactions on the horizon for the industry? Wes, what do you think?

Wesley Williams: Like I said earlier, I think this uptick in the commodity prices and demand is really going to drive consolidation. You've had a lot of upstream companies, which, for the past decade, have been told to grow, grow, grow. And, so, they've done that. And then over the course of the last year and a half or two years, they were then told, "Whoa, whoa. Wait, don't grow. You need to operate at a cash flow."

And I think what you're seeing here is the industry as a whole getting much more disciplined in the way it approaches operating these upstream businesses. And, so, I think you're going to see continued activity by those who are really good at just maintaining cost discipline. And I think you've seen, Bonanza Creek has announced a merger and a couple of acquisitions; Contango, a KKR-backed company recently announced a combination as well.

And I think what you've seen, again there are any number of transactions like this, whether it's Pioneer-DoublePoint or whatever, where you've got a ton of consolidation happening. What you're seeing this year is that a lot of the consideration that's being used for these consolidations is stock and not cash; that's primarily attributable to the limited amount of capital that's flowing into the energy space, whether it's based on ESG concerns, regulatory issues, downturn in the commodity price, their lack of returns in the industry for the last few years, or whatever. But you are seeing a lot of this consolidation.

And I think that you've got a lot of companies positioning themselves to be aggregators in the space and trying to be the leader in being the low-cost and the low-LOE [*lease operating expenses*] company, if you will. Ultimately, I think what you've got is a continued focus on consolidating all of these various companies. I mean, the number of companies that you have in the Permian, or in the Eagle Ford or at Bakken, there's consolidation that can happen. And I think that there's certainly an appetite for that to happen. And I think that's what we've seen in the beginning of 2021.

Jessica Hammons: I agree a hundred percent with Wes that, for the remainder of '21 and I think even continuing into '22, we're going to continue to see an active market. Consolidation is definitely going to continue. Accretive strategic transactions are going to continue. And like Wes said, these larger upstream players are going to continue to consolidate acreage, to recognize synergies and cost efficiencies and try to build scale. I mean, I think we're going to continue to see these in-basin consolidations, like Bonanza Creek's merger and other acquisitions in the D-J Basin.

But I think we'll also see consolidations that cross basins like Southwestern's acquisition of Indigo and the KKR-Contango merger that Wes mentioned earlier. I mean, all of these are going to create economies of scale and operational efficiencies, which is really important to investors at this point. But then there are also others, like the Cabot-Cimarex deal, that don't necessarily fit the mold of the synergies, necessarily, within basins, but they are really just attractive financial metrics. And I think that will continue to drive deal activity as well.

I think what we'll continue to see consolidation in the services space as well, like Wes mentioned before. Some of the larger oilfield service providers have already started to be more acquisitive. I think we'll continue to see that. I think there will be a lot of those types of transactions with stock as the consideration. And like we said before, the pandemic really hit the services industry hard. So, the continued liquidity issues are going to result in more bankruptcies in this space. So, I think there'll be lots of good targets for acquisitions during this time.

Jose Garriga: Thank you. A reminder, listeners, we're here today with Akin Gump partners Wes Williams and Jessica Hammons, discussing trends in energy transactions in the U.S. and, specifically, in Texas.

There was a mention of private equity earlier, so let's talk about that a bit. What trends are you all seeing in capital deployment in the energy sector, and what issues do energy PE investors care most about right now? Wes, what do you think?

Wesley Williams: Yeah, I think over the course of the last few years, energy-focused private equity funds have had a difficult road in raising institutional capital, but a lot of these funds were able to have fund closings within the last couple of years or immediately prior to the pandemic. And, so, they have plenty of dry powder to deploy still, but equity sponsors these days are being pretty specific about when and how they deploy that capital.

The big focus is on reducing the G&A costs of their existing portfolio companies and management teams. We've seen, and probably will continue to see, equity sponsors employing a number of methods to decrease the costs associated with their portfolios. And, generally, this is accomplished by consolidating portfolio companies within the fund complex, reducing the number of management teams overall, or the size of each individual management team, but also seeing equity sponsors clubbing up with other equity sponsors who are doing the same things with their portfolio.

And, so, I think there's consolidation sometimes that just happens within one existing private equity portfolio, but sometimes it bleeds across company lines. I think, right now, energy private equity investors are trying to build companies to fit the environment and finding management teams that fit those assets. They're really looking for good assets that can operate at cash flow. They're looking for long-term management teams that are not just acquisitive management teams with an eye towards selling those assets that they've built over a two-year period and flipping them quickly. I think they're really focused on finding the management teams that are not only good at finding and acquiring deals, but also operating those assets in a profitable manner. I think what we're seeing is that there were fewer portfolio company fundings. As the commodity prices rise, demand increases. It stands to reason that we would see more portfolio companies getting funded.

But like I said, it's going to have to be the right management teams and the right assets. I think that the existing energy private equity funds are very focused on the fact that they have the capital that they have now. With the ESG pressures that the institutional investors are facing, it becomes a little bit more doubtful about the success of being able to raise a true upstream fund or true hydrocarbons-focused fund.

And with respect to that, I think that some of these energy private equity shops, I mean, we've seen them pivot towards renewables as either a standalone silo or as a piece of an existing energy platform. But as we see these fundings occur in the upstream of what I'll talk about is really just the hydrocarbon space. I think what you'll continue to see is a reduced number of portfolio companies receiving new funding or a reduced number of management teams getting backing. And I think you'll see continued consolidation within the portfolios.

Jessica Hammons: I think this is probably a good place in our conversation to note the significant activity in the SPAC area as well. And this is an area where investment funds are definitely getting in on the action of SPAC, taking a minority interest in SPAC transactions, and just kind of as a little aside, just to remind everyone, a SPAC is essentially a blank check or a special-purpose acquisition company that raises money through an IPO. But when it IPOs, it doesn't have an operating company, but it's just a shell company that then goes out and finds an operating company to acquire, typically in the next 12 to 24 months after the IPO. And the original investors in the SPAC then have the opportunity to vote on the proposed combination, what's called a de-SPAC transaction, and they can also pull their money out of the SPAC before it makes an acquisition in an operating company.

And, so, investment funds are really getting in on this action, taking these minority interests. It gives them some optionality as they move forward on those de-SPAC transactions. But I think it's really important to note that there are over 400 SPACs that are currently looking for targets right now. That's over $130 billion of SPAC capital that still has to be invested. So, I think we're going to see some of the SPACs focus on the energy space, particularly in the energy transition space. And, so, I think we'll see some of those investment funds looking at investments there as well.

Jose Garriga: Thank you, Jessica. So, picking up a thread, something I believe that Wes mentioned, and that's ESG, how are ESG and climate change considerations impacting energy transactions? Jessica, let me stay with you for that.

Jessica Hammons: Sure. So ESG, which stands for environmental, social, and governance, is definitely something that's here to stay. It's something we started to hear more about a few years ago, but it's really taking center stage with investors and regulators in recent times. So, I think it's going to be something that continues to be important in the energy space. Investors are continuing to demand improved efficiencies and lower G&A like Wes talked about on their investments, but they're also really focusing on improvement to ESG credentials as being necessary for their continued investment.

The current administration has made it really clear that it intends to prioritize climate change, with the U.S.'s re-entry into the Paris Climate Agreement. The new president has signed multiple executive orders to establish goals related to carbon-free electricity sector by 2035 and net zero emissions. So, this focus on climate matters is really being prioritized and focused on by all of our federal government agencies, including the SEC. So, I think it's something we're going to continue to see particular focus on in the energy space as companies try to become better corporate citizens and show less of a carbon footprint as we move forward.

Wesley Williams: I agree with Jessica on that. I mean, I think that certainly ESG is here to stay. What we've seen is not only from a regulatory standpoint, and I think even the SEC here recently has come out soliciting input on proposals for additional disclosure surrounding ESG. That's going to take a year or so for that to finalize, but not only do you have the regulatory aspects of it, you've got institutional investors, activist stockholders, all very, very focused on this right now.

I think that this is something that all of our hydrocarbon clients are going to have to focus on. It is something that is important to investors and important to the public as a whole. So, they're going to continue to focus on it. I think it's important to note that even the most accelerated energy transition, whether you're going to wind or solar or whatever, it's all going to still depend on oil and gas for years to come, right? Oil and gas and hydrocarbons are going to be just an important part of our overall energy needs.

And while this transition is something that the companies are really going to have to focus on and consider how they're going to pivot with respect to these overall concerns, they still have to understand that there's going to be a huge demand for oil and gas for years to come. But this energy transition is going to continue to be white hot: Renewable projects, solar, wind, electric vehicles, other green efforts are going to continue to gain momentum. Investors are going to be looking for profitability, ultimately, from those sorts of projects, which, to date, has lagged. But I think as we continue to have an increased overall focus on alternative energy, those types of companies will find ways to become more efficient, more profitable. And Jessica, I don't know if you've got something that you want to add to that.

Jessica Hammons: The other thing I was going to say, Wes, is that I think we're starting to see how these big hydrocarbon players are really starting to take note of this and try to pivot to move into other areas. I mean, we're starting to see a lot more in the carbon capture and storage projects. Exxon and BP have shown commitment to this. Talos just announced a JV to do some carbon capture projects in the Gulf of Mexico. And I think we're going to continue to see historical hydrocarbon players get involved in this area.

Wesley Williams: I wholeheartedly agree with that, and I don't think it's just limited to larger companies like the majors or companies like that. I think that what we've seen, we've seen increased inquiries from smaller, more entrepreneurial companies that are really looking to try to capitalize on this increased focus on climate change and trying to figure out better ways to raise capital, deploy capital and really participate in carbon reductions and building sequestration plants and looking at alternative ways to really capitalize on this climate change focus.

Jose Garriga: Thank you both. Just to close, then, if I could ask each of you to provide, what are some key takeaways that you'd like to share with our listeners on this topic? Wes, could you lead off, please?

Wesley Williams: The main takeaway from this is energy’s cyclical. And I think after having done this for a couple of decades now, every time we see a down cycle, we see people predicting the end of the hydrocarbon space, and it always tends to cycle. I think there are new headwinds today that we haven't faced in the past. I think the decreased demand, the decreased commodity prices and overall profitability of hydrocarbon companies has caused capital flow out of the sector.

We've got ESG considerations, climate change considerations, a new administration with new regulatory developments, but like the commodity price itself, these headwinds tend to cycle as well. So, generally, investors will chase returns, and once demand returns to normal levels, investment will return to the hydrocarbon space, but we will also have the benefit of having focused on more alternative energy, which will also probably tend to cycle in the future as well. But I think that the focus that companies should have right now is just, especially in the hydrocarbon space, is just building companies that are profitable for the long term, as opposed to the theme over the past 10 or so years, which has been acquire and flip.

Jessica Hammons: I echo what Wes has said and just would like to reiterate that companies should just try to position themselves for long-term success. I think ESG concerns and energy transition is going to continue to be more prominent, but traditional energy transactions in the more traditional fossil fuel/hydrocarbon area are going to continue for the foreseeable future. And those traditional energy companies should just continue to work hard to push, to improve efficiency, drive down costs, improve their impact on the environment and increase their ESG credentials, and consider combined projects involving renewables and other energy transition projects that will complement their current strategies. And I think that that will help to build for a long-term success for these types of companies.

Jose Garriga: Thank you. Listeners, you've been listening to Akin Gump corporate partners Wes Williams and Jessica Hammons. Thank you both, terrific conversation, for making the time to come on the show today and give listeners a really great overview of developments in the energy transactional space.

And thank you, listeners, as always, for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, YouTube and Spotify.

To learn more about Akin Gump and the firm's work in, and thinking on, corporate and energy matters, search for “energy” on the Experience or Insights & News sections on akingump.com and then take a moment to read Wes and Jessica's bios on the site as well.

Until next time.