Capital Steward-ship

The Best Defense In Turbulent Times

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Defending against a takeover a few months ago may have seemed a worthy cause and the biggest challenge for senior management of upstream companies. Today, a takeover may be the best outcome for many North American E&P companies.

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Despite the collapse in oil and gas prices, many upstream companies could and perhaps should be acquired or their assets sold.

These companies have a negative enterprise value and their assets should be under the stewardship of another management team. A company's assets will find the right home with those who can maximize their value.

We examined the publically traded E&P companies operating in North America (US and Canada), excluding the integrated majors. We included only those with $1 Billion or more in market capitalization to ensure scale and resources were not constraints on success. We looked at the 10 year period from 2004-2014, a time frame that includes good times and the recent price collapse. It is also the period encompassing the rise of the shale revolution, a period where strategic vision, strong fundamental processes and talent would play key roles in driving success.

How does one measure success for exploration and production businesses?

Some would argue reserve additions and production growth are the right measures. But it begs the question; at what cost? Many veterans who lived through previous price cycles will recall the gut wrenching write downs at year end. The excitement of a new discovery could be followed by a severe hit to earnings if the invested capital exceeds the present value of future production. As a business, E&P is unique in this regard.

While other industries are also capital intensive with high risk, E&P has volatile commodity pricing with very little competitive advantage. Like all businesses, we live and die by the discipline of the markets: capital, commodity, labor, supplies, services and equipment. Among these, the capital markets make the final call about any company's future. The oil and gas sector is infamous for its waste of capital. For the industry as a whole, it has been longstanding conventional wisdom that the industry does not earn its keep. Our research validates this.

Capital stewardship - The heart of Upstream Business Success

There is little to no competitive advantage[1] in upstream oil and gas. All companies have much the same access to the resource base, services, talent, capital and other inputs. Success does not come from a patent, brand name or any other enduring asset. Success comes from the skill of management[2] in allocating and deploying resources.

Enterprise Value

The extent to which a company is valued more than the sum of its assets, it has value as an enterprise, a going concern, a business entity. A premium over the market value of the sum of its assets is positive Enterprise Value. A discount or negative enterprise value means the market would rather have another capital steward and the company is ripe for an acquisition or asset liquidation.

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[1] Morningstar calls this economic "Moat": the strength of a company's defenses against a competitor.

[2] Indeed virtually all of an E&P company's employees have managerial responsibility over some critical part of capital stewardship. If not, why have them there?

Investors are asking…

- Is capital allocated in support of core competencies?
- Have allocations expanded the company's Enterprise Value?
- Is cash management appropriate for the business? That is to say, are dividends and re-investment in line with growth opportunities and investor expectations?
- Is the capital structure correct for a capital intensive, cyclical business?
- Is capital deployed efficiently? Have cost over-runs occurred?
- Are Operating Expenses competitive?
- Have there been costly operational mistakes? (i.e. Macondo)

Does it surprise anyone that oil and gas assets trade like pieces on a Monopoly board? When the market believes it is time for a change, a company is vulnerable. In reality, management is vulnerable; the higher the executive position, the more vulnerable the individual is to finding a new career opportunity. Activist investors are the catalysts in this asset re-allocation process. To be sure, they are watching and assessing the opportunities. The sheer volume of hedge fund capital that has been amassed to capitalize on the turbulence in the industry is certain evidence of changes to come.

Return on Capital – The Standard of Stewardship

Capital allocation is arguably the most important business process in generating assets with a positive Net Present Value (NPV). Efficiently deploying that capital is a close second. Field or Lease Operations is a critical process and depending on the cost chain, the third most important. These processes are measured by the Finding and Development cost, Lifting Cost and Lease Operating Expense metrics.

The acid test of a capital intensive business is covering its cost of capital. Either it earns enough to compensate investors and lenders for risking their money, or it does not.

There are several ways to look at capital cost coverage: Debt service coverage for lenders, Return on Equity for investors, Return to Capital for an overall view. The acid test of a capital intensive business is covering its cost of capital over time. Either it earns enough to compensate investors and lenders for risking their money or it does not.

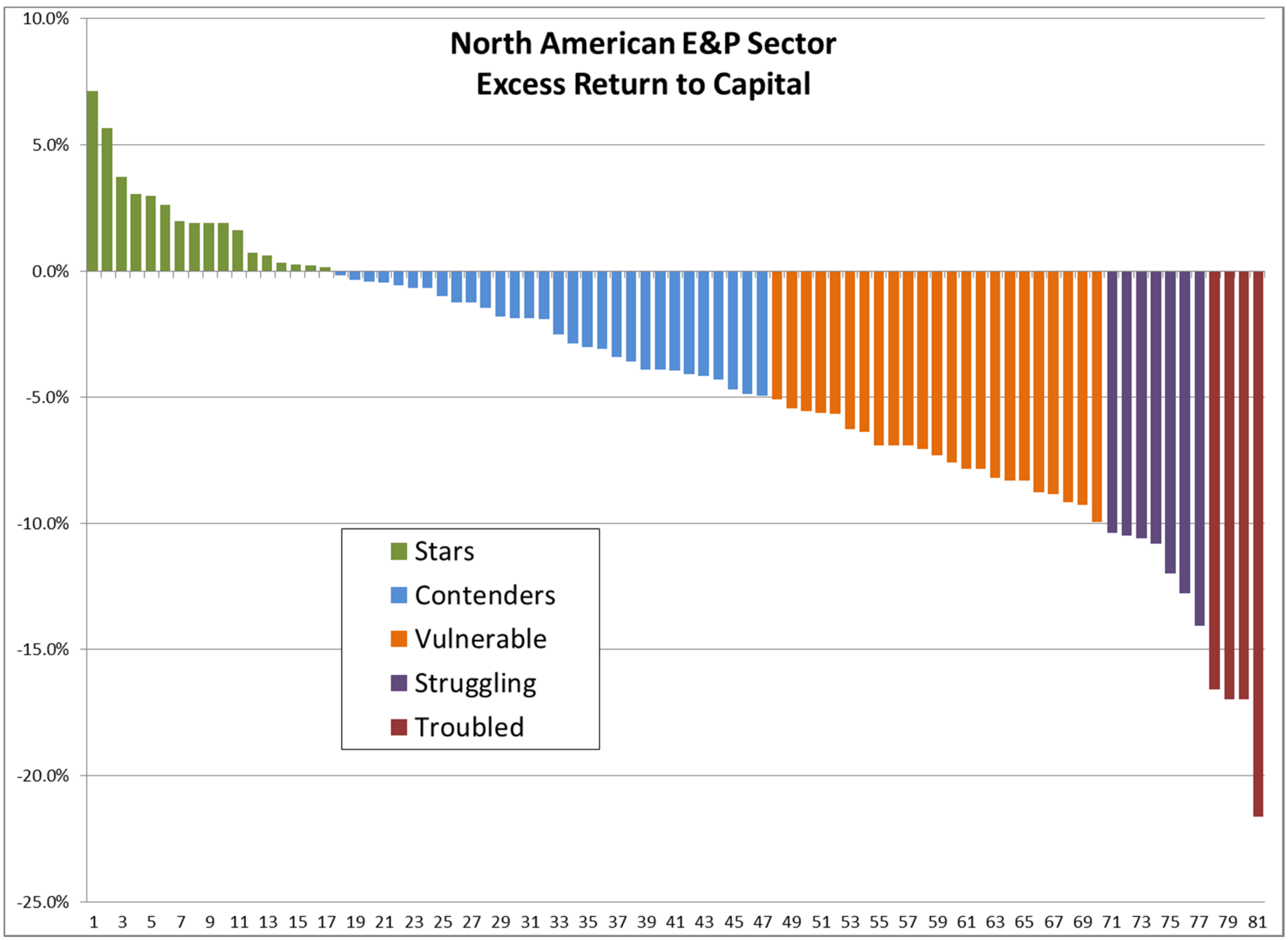
We chose Return to Capital as it provides the most comprehensive picture of capital stewardship. We used the difference between the Weighted Average Cost of Capital (WACC) and return to capital over the 10 year period ending December 31, 2014. If a company returns a positive difference, the excess return is the reward to providers of capital for taking the risk and making a good decision. We calculated WACC using the Capital Asset Pricing Model (CAPM) which has been the cornerstone of investment practice for decades and is still regarded as the best way to measure risk and return[3]. The benefit of the CAPM is that it incorporates risk into the calculation in a way that a simple total return could not.

It turns out that of the 85 companies analyzed; 15 returned their WACC as displayed in Figure 1 below.

The Stars

These are Stars because their 10 year average return has exceeded WACC, in some cases by a significant margin. As the metaphor goes, these businesses are "firing on all eight cylinders". These are also companies that have positive enterprise value, that is, they are worth more than the sum of their assets. The business plans are well conceived and have been well executed. These are cases where the three pillars of People, Strategy and Process are strong and aligned: The strategy is clear and well understood, the business processes effectively support the strategy and the right people are doing the right things.

Figure 1



[3] Data was provided from Morningstar, calculations by Pangea Global.

The Contenders

The next group of 33 companies did not earn their cost of capital, but the shortfall (less than 5%) is not so large that extenuating circumstanced could be at play. For the Contenders, success is possible, if not likely. In some cases these companies are undergoing a strategic shift. In others, a management change is in play. But the point is, the directors recognized the need for change and took decisive action. For the first 6 of the Contenders, the miss was less than 1% (100 basis points), almost too close to call and they could well surface as Stars in the future.

There are other members of the Contender group where the strategy is less than it could be, but they are executing well. A review of publically available information shows alignment is suffering. The Exploration Strategy is geographically and/or geologically fragmented. Strategic intent is bland and fuzzy. Lines of communication are long, relying on strong local leadership, a dispersion of talent. Most telling is that the critical business processes: capital allocation and capital deployment are not working well. Managements of some of these companies generally appear to recognize they need better focus. At least they are saying the right words.

In other cases, integration into high performing business units may not have taken place. This could be a leadership (people) issue, faulty communication, teamwork and decision making (process issue), or outside the core competencies of the company (strategy and people issues). Only a deep and thorough evaluation would surface the root causes. But a thorough business review would get at these concerns and identify not only the causes, but the options to remediate them. A commitment by the leadership to a review and fundamental change is crucial if performance is to improve.

The Vulnerable

The next group of 23 is comprised of The Vulnerable. Their WACC coverage ranges between negative 5% and 10%. This is a mixed bag of recognized companies, lesser known mature companies and start-ups. These companies are vulnerable to a variety of events including takeover, a move from an activist investor group or worse. None have established sustained profitability, yet for whatever reason, some have garnered favor among equity analysts. Others have been roundly criticized for poor stewardship. Clearly this is a group of mediocre, poor performers that have wasted significant capital over a 10 year period of pretty good times.

The Struggling

These have been followed by a group of 8 that have underperformed by between 10% and 15%. To be clear, this is return on assets that is *below* cost of capital by a significant margin over a 10 year period of generally rising prices. The best that can be said is that they are struggling. Some of these companies are undergoing turnarounds, some have been made available for sale, yet others, as of publication seem to be barely hanging on. These are clearly poor capital stewards and should see especially tough times during sustained low prices unless they make significant changes.

The Troubled

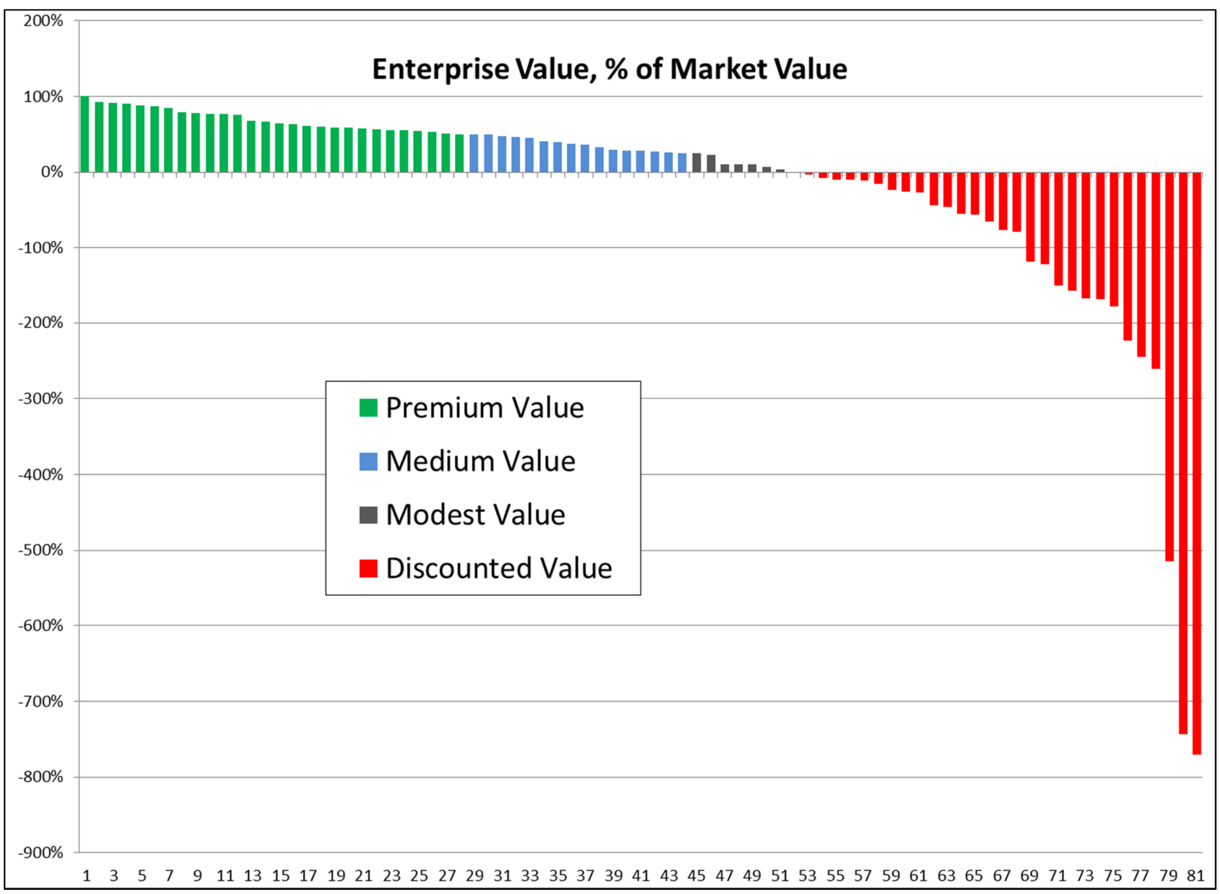
Finally, we have the bottom of the barrel, the truly troubled companies. They exhibit returns to capital of between negative 15%, exceeding negative 20%. Most of these are clearly chronic capital wasters. The fate of these companies is in doubt. Having failed to return their cost of capital, it is hard to envision they will have the financial resources to weather the storm. Bank loan assessments this fall and asset valuations at year end will perhaps provide some insights. The true test will be in their cash flow and ability to service debt and fixed costs.

Enterprise Value-How the Capital Markets Value Stewardship

We think of Enterprise Value as the equity market's recognition of good capital stewardship. If the market values the company greater than its breakup value, it has positive Enterprise Value. An acquiring company would need to compensate shareholders for the wealth management has created in building the asset base. Another perspective is that it is the premium over the net present value of the assets attributed to sound leadership. A discount or negative Enterprise value means an acquiring company would realize more wealth from the assets than the incumbent management team can deliver.

Figure 2 demonstrates that the top 28 North American E&P Companies would command an acquisition premium of greater than 50 percent. The next 15 would command a premium greater than 25%. For most of the rest, the assets are worth more than the company. That suggests that at least 27 players are likely acquisition targets over the next few years.

Figure 2



Building Enterprise Value

As year end 2015 results become known, and the impact of low oil prices on asset values is factored into market valuations, the number of acquistion targets may well increase. The majors are desperate for places to deploy capital and the big projects seem to be fading in attractiveness. They have an appetite and the means to satisfy it. Absent making some changes the competitive landscape will have fewer players over the next few years.

The good news is there are options senior leaders can take to ensure a good outcome. That may mean that a takeover is the best option for the shareholders. The goal should be to mazimize Enterprise Value. the action items are the same whether the company is acquired or remains independent.

- Ensure the best people are in the right positions.
- Focus the company on its core assets, those that align closest with core competencies.
- Review business processes from the bottom up and revamp as necessary to achieve optimal results. Often it is taken as *efficiency*, but it really means *effectiveness*.

The specifics will vary by company. In our work advising E&P companies we have seen big differences from one company to the next. The one common denominator among the success stories is a relentless commitment to improve results. Change only comes about where that commitment is infused into the company culture. There are many ways to achieve change, but it all starts at the top.