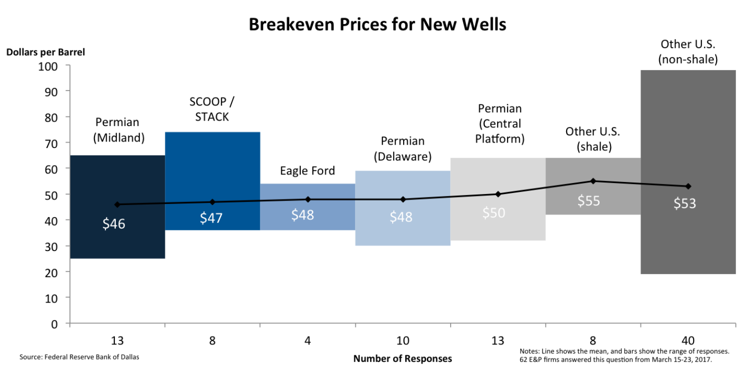
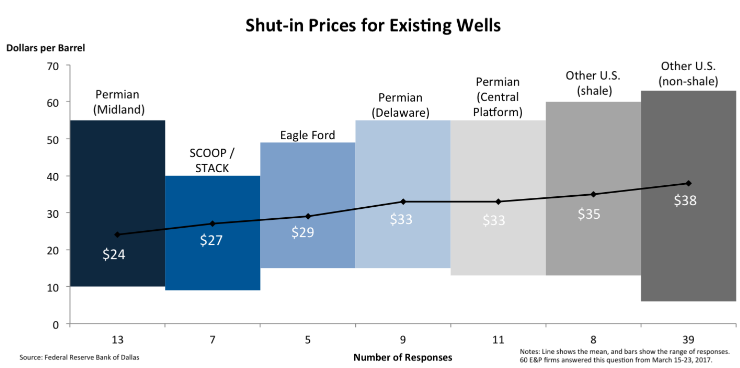
Capital Perspectives: Oil & Gas Outlook 2018

By Bryan Frederickson and Eric Swanson, Managing Directors, GulfStar Group

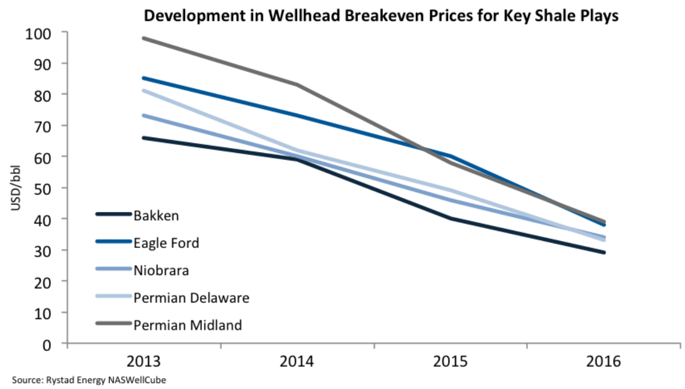
Oil and gas professionals entered 2017 unsure if the optimism they were experiencing at the end of 2016 was a sign of firming conditions or yet another wrenching false start on the long road to a broader market rebalancing. Twelve months later, a much stronger case can be made that U.S. markets indeed are improving, and opportunity is finally expanding beyond the core areas in a handful of plays. The year of 2017 began as a distinct tale of haves and have-nots. Financial performance throughout the value chain depended almost entirely upon asset location and customer base. Holdings in the Permian Basin translated to a solid 2017 for operators and asset sellers, while competitors focused elsewhere faced varying degrees of struggle for much of the year. Entering 2018, numerous metrics point to a broadening in the opportunity spectrum, though the most economic basins retain a substantial head start.

At the national level, the tide clearly continues to rise. Total U.S. rig count as of early December 2017 is up year-over-year by 332, a 56% increase. Crude inventories that sat at historical highs of more than two billion barrels throughout 2016 and the first half of 2017 (versus a long-term average of approximately 1.6 billion) are finally declining, and are projected to continue to do so on a seasonally adjusted basis through 2020. Producers have taken dramatic steps to curb costs and optimize operating efficiencies, with numerous publicly traded companies now citing $50 per barrel as adequate to fund capital expenditures and dividends from cash flow. Current well-level economics render average existing production profitable at prices into the low $20s per barrel. For almost all major U.S. basins, profitability is achieved substantially below recent mid- to upper $50 pricing. Even new drilling and completion activity has returned to profitability in areas outside designated sweet spots.





Throughout 2017, capital markets activity has been mixed. Total public equity issuance in 2016 rebounded to more than $41 billion from an unsurprising down year in 2015, and was consistent with the pace of issuance during the robust markets of 2012 through 2014. Initial public offering activity during the first-half of 2017 was likewise healthy at $2.3 billion in the first quarter alone, equal to that in all of 2016. Since that time, new issuance has slowed considerably. A total of $20 billion has been offered year-to-date and currently only one IPO has been registered in the fourth quarter. The signal from equity markets is clear, prioritizing fiscal discipline, profitability and cash generation over near-term growth. This message appears to have been received, as third quarter 2017 earnings among the major integrated oil companies were up 69% year-over-year with positive reported free cash flows.



Debt capital markets have fortunately compensated for the stall in public equity appetite. Public high-yield debt offerings in 2016 slumped to $13 billion after peaking at more than $55 billion in 2014. Year-to-date issue volume through October 2017 exceeded $40 billion, potentially on pace to rival activity during the $100 oil days, and making oil and gas the most active industry on a global basis. Improved balance sheet health has contributed greatly to this trend. Fourteen oil and gas-related companies filed for bankruptcy protection in 2017 versus 55 during the same period in 2016. Borrowers are capitalizing upon current market appetite to refinance maturing indebtedness at favorable rates, which continue to decline even as the supply of offerings increases. After spiking mid-year, interest rate spreads have declined rapidly and show little sign of reversing in the near future.

Traditional senior lenders are likewise returning to the market. Loan volume to U.S. oil and gas companies is on pace to exceed $40 billion, up substantially from the 2016 total of $29 billion. Banks holding large portfolios of impaired oil and gas loans have largely worked through their problem borrowers or found a measure of borrowing base comfort after recent redeterminations. Increased competition for new loan generation from a smaller pool of borrowers has pushed interest rates down by nearly a full percentage point since the beginning of 2017. Spreads to LIBOR now range from 194 to 294 basis points, per data from Loan Pricing Corporation.

Merger and acquisition activity carried its strong pace into 2017 as strategic buyers actively sought to bolster portfolios. Much of the early 2017 activity was focused in the Permian as strategics established or expanded positions. Investors rewarded public companies for adding lower-risk, onshore assets that are expected to provide attractive returns throughout the cycle. Private equity-backed portfolio companies also seized the opportunity to monetize holdings. Many planned exits had been postponed following the commodity price declines of 2015 and 2016, as potential strategic buyers focused internally on cutting costs and divesting non-core assets to fund operations and preserve dividends. As the year progressed, deal count remained strong but per-transaction value declined. A major driver was the migration of acquisition activity to basins that presented more attractive entry valuations such as the Marcellus/Utica, Anadarko and Niobrara.

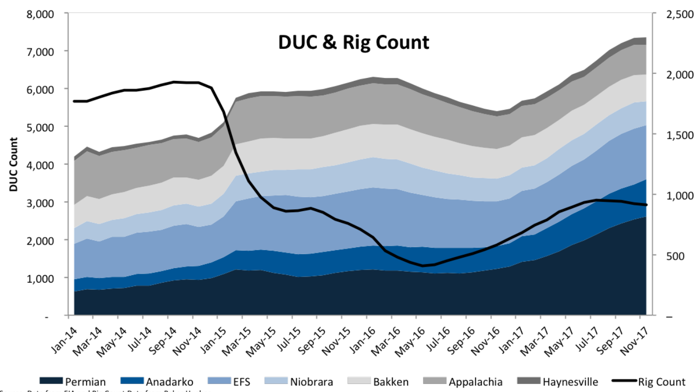
Private equity (PE) funds continue to seek opportunities within the industry after raising record amounts of capital in 2015 and 2016, but faced challenges deploying this capital in a choppy market. Exit strategy likewise became a greater concern. Sales to strategic purchasers are historically the most common mode of monetization. Such sales were recently complicated, as normally active buyers were temporarily out of the market after already establishing positions of scale and closely monitoring their balance sheets. As 2017 progressed, PE funds increasingly capitalized upon more stable markets to exit longer-dated investments.

The launch of new funds nonetheless continued in 2017, with Carlyle Group and Blue Water Energy each raising $1 billion or more. Numerous midsize funds such as Post Oak Energy and Kimmeridge Energy likewise tapped an increasingly optimistic investor base. Each of these funds was raised in the second half of the year, suggesting that the overall investor universe was largely unfazed by the collapse of $2.0 billion EnerVest Ltd. in July. EnCap closed out 2017 with a flourish, announcing final close of its $7.0 billion EnCap Energy Capital Fund XI in December. U.S. acquisitions by private equity groups increased to 36% of total third quarter 2017 M&A volume, up substantially from 15% in the same period in 2016 and 30% in the second quarter of 2017. Transaction sizes declined throughout the year, with PE buyers focusing on acquisitions of non-core assets from the major producers. While PE groups continue to back management teams in pursuit of consolidation strategies, the strong preference is to fund those with whom they had previous success. Fewer PE groups are providing open commitments and agreements to fund administrative overhead while the teams look for opportunities. Most now require up-front identification of specific assets and well-articulated plans to deploy incremental capital into follow-on acquisitions within defined geographies.

Special Purpose Acquisition Companies (SPACs) also remain a growing component of the energy M&A market and financing landscape. Often referred to as “blank check” companies, SPACs first raise capital from public or private investors with the intent to subsequently identify and pursue future acquisitions. Energy megafund Riverstone Holdings backed Silver Run Acquisition Corp., first acquiring Centennial Corp. for $810 million and later Silverback Exploration for $855 million. Riverstone expanded its SPAC exposure with the formation of Silver Run Acquisition II, which acquired Alta Mesa and Kingfisher Midstream in August 2017. The trend has expanded into the service segment, with former Schlumberger CEO Andrew Gould partnering with CSL Capital Management to establish $300 million Sentinel Energy Services.

The major markers are thus lining up favorably entering 2018. Oil prices have several times tested lower bounds and recovered, cost reductions have been absorbed, corporate balance sheets are healthier and capital is available. While the rig count build in the Permian Basin reflects its historical superior economics, others will gradually catch up. This is especially true as the land grab for Permian acreage that started in mid-2016 has driven up cost of acquisition to prices routinely in excess of $30,000 per acre, and often approaching $60,000 per acre. Rates for oilfield services are likewise showing signs of upward pressure.

U.S. land well starts continue to recover from their recent historical nadir in the second quarter of 2016. Permitting activity has likewise increased materially since the beginning of 2017, nearly doubling over the last 12 months from 584 to 1,014. Permit activity is notably increasing in the DJ, Marcellus and Utica basins, confirming the spread of new drilling activity. However, the count of drilled uncompleted (DUC) wells built consistently, particularly in the Permian and Eagle Ford. There are a number of likely contributing factors to this DUC build-up, including capitalizing on currently low service costs, drilling to hold acreage until oil prices further rebound and needing additional infrastructure development. This growing inventory of DUCs provides a low-cost, easily available supply to



Source: Data from EIA and Rig Count Data from Baker Hughes

maintain production growth. The DUC count could receive greater attention, as well productivity peaked in late 2016 for the Permian, Eagle Ford and Niobrara according to EIA data.

Natural gas markets, meanwhile, are not anticipating to be rescued by commodity price improvements. The U.S. became a net exporter of natural gas in 2017 for the first time in 59 years, with shipments to Mexico continuing to increase and more liquefied natural gas leaving American ports. LNG exports totaled 464 billion cubic feet through September 2017. Annualizing that figure yields a projected 2017 export total of 619 bcf, representing only 2.3% of the 26.7 trillion cubic feet of annual U.S. production (2.0% net of imported gas). While LNG exports can only benefit U.S. producers in the long-term, it is simply too small a portion of the total market to expect a material near-term impact.

Gas market conditions do, however, share some similarities with those experienced by oil markets 12 to 18 months ago. In addition to general expense reduction efforts, well design optimization continues to drive down the break-even to economic production. Average lateral lengths have nearly tripled in some basins over the last 10 years, now averaging more than 7,000 feet. Eclipse Resources set a U.S. record in June 2017 with a Utica gas well lateral of 19,500. Frac stages per well increased proportionately, while drilling days dropped in half. Proppant intensity across the industry has increased 60% in the last three years, and predictions are that pounds per feet will continue to increase as operators look for critical mass in production rates. As a result, many producers now cite break-even at less than $3.00/MMbtu and in some Haynesville and Utica plays less than $2.00/MMbtu. Natural gas' recovery story will therefore continue to rely on operating efficiencies and production discipline.

Entering 2018, OPEC helped set the stage for a constructive outlook by extending production cuts of 1.8 million barrels per day through all of 2018. Continuing improvement in fundamentals and the supply/demand balance should help support prices. Increasing focus among public investors upon returns and profitability should yield disciplined growth that maintains balance sheet strength. The pace of restructurings continues to slow, but the legacy of numerous 2016 bankruptcies is an environment where producers and service providers alike have been able to reset operating profiles and capital structures to prosper in a lower-price environment. With capital continuing to flow to the industry and a healthier lineup of both large and small companies, 2018 deal activity should be robust. Private equity groups and SPACs will help to take up whatever short-term slack results from the inward focus of major public companies. The public and private markets will likely continue to trade assets as large producers consolidate their holdings to achieve operating efficiencies and shed non-core assets. The outlook entering 2017 was an expectation of fitful industry growth, and for healthy companies, basin-specific transaction activity. Recent rig count and permitting data support the thesis that continued recovery in commodity prices and rationalization of operating costs should result in more widespread opportunity in 2018.

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