CREDO WEALTH

Back to the future

According to Pythagoras, the ancient Greek philosopher, “after certain periods of time the things that have happened once happen again and nothing is absolutely new”. While Pythagoras was considering the universe’s life-cycle, M&A activity in the oil and gas industry offers an abridged version, spanning mere decades.

Globally, M&A activity has been supported by a continuation of the favourable market conditions that sparked last year’s M&A revival. This trend is now poised to spill over into the oil and gas industry: given the slump in the price of crude, the impetus to buy is greater than the impetus to build. It is now cheaper to acquire reserves than to develop them. A brief survey of history supports this argument: in the past 50 years, each collapse in the price of oil has been accompanied by a surge in M&A activity.

With the recently announced bid for BG Group by rivals Shell, the cycle may have already begun. The £47bn deal would be the sector’s largest since Exxon and Mobil merged in 1999, and will increase Shell’s reserves by 25% and production by 20%. Following completion of the deal, Shell will stand as the largest independent natural gas producer in the world, with the resources to fully exploit BG’s vast fields. The success of the deal, however, is predicated on oil prices returning to $90 a barrel. In a few years’ time, if the oil price recovers, deals such as Shell’s will look like a strategic master stroke.

Underlying the deal, however, is an attempt to cut costs. Industry returns have now fallen below the cost of capital. Consolidation enables companies to reduce costs through efficiency savings: cutting overlapping business functions and stripping out exploration expenditure. Finally, with reserve replacement rates declining and likely to fall further given cuts to capital expenditures, M&A will enable companies to boost the shelf-life of the reserves on their balance sheet. Accordingly, targets are likely to be smaller and less-well-funded Exploration & Production companies that have plentiful reserves yet insufficient capital, which can plug the reserve and production gaps of their larger peers. As one of the smaller oil majors, BP are widely touted to be one such takeover target.

For many investors, the outlook for the energy sector appears bleak, to say the least. According to Bernstein Research, over the past 100 years, the average return on capital for the upstream oil and gas sector has averaged close to 10%. Industry returns for 2015 are forecasted to be in the region of 5%. As Pythagoras might have observed, however, such returns are cyclical. In financial parlance, mean-reversion is at work. Looking back to the 1986 collapse in the oil price, the subsequent slump in returns was similar to that of today. Yet through restructuring, cost-cutting, divestments, and M&A, the industry recovered despite persistently weak commodity prices.

Assuming that this time it isn’t different and mean-reversion returns to the fore, this implies future upside to return on capital. Combined with sweeping cost-cutting, a spate of M&A deals will likely drive this reversal of fortunes. Looking back to the 1986 collapse in crude oil, industry returns reverted to their long-term average by 1989. Looking forward, capex cuts, efficiency improvements and cost deflation today may lead to a significant returns rebound tomorrow.