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EY Oil and Gas – PE perspective

March 2017

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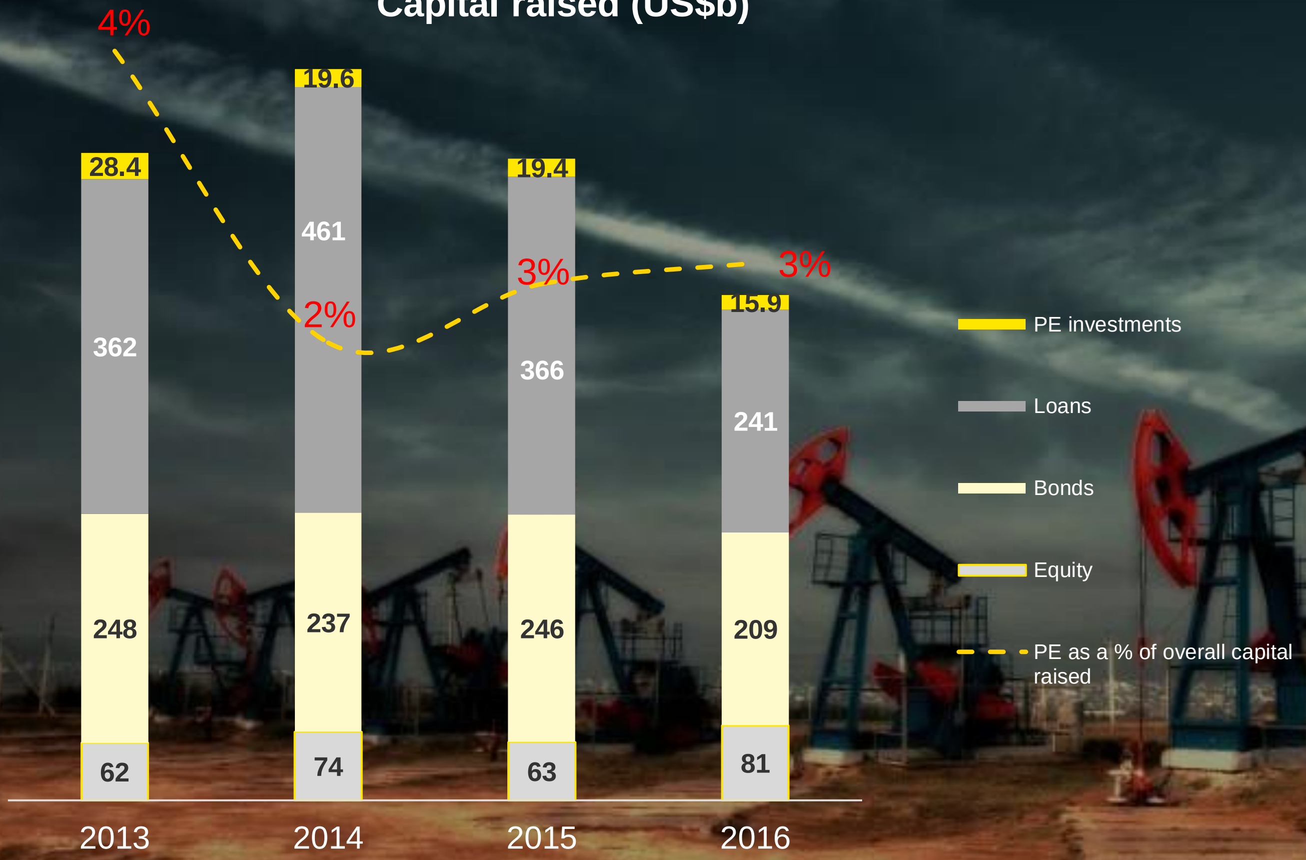
Contents

PE investment in the context of industry capital raising

Private equity is a small proportion of the total capital invested in the industry

Post oil price decline, PE firms have followed a *"wait-and-watch"* approach for investing in the sector, accounting for approximately 2-4% of the total capital raised globally (between 2013-2016)

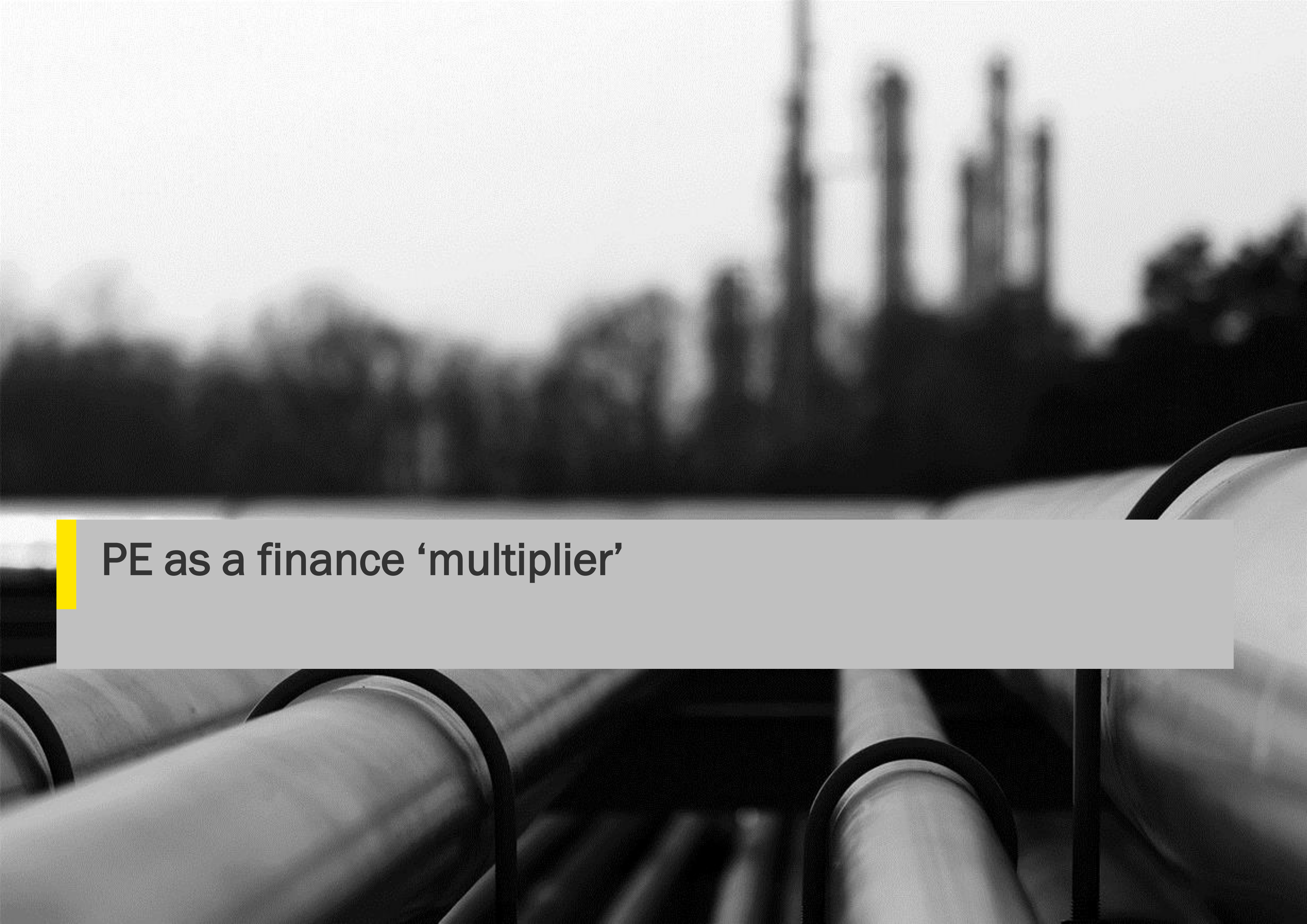
Capital raised (US$b)



- Capital raised by oil and gas companies during 2016 continued to remain under pressure
- Equity markets received a boost, mainly from a few sizeable new IPOs and several follow-on offerings from US shale companies.
- Debt market for investment-grade bonds remained relatively robust, albeit at lower levels than 2015
- Surge in activity in Q4 2016

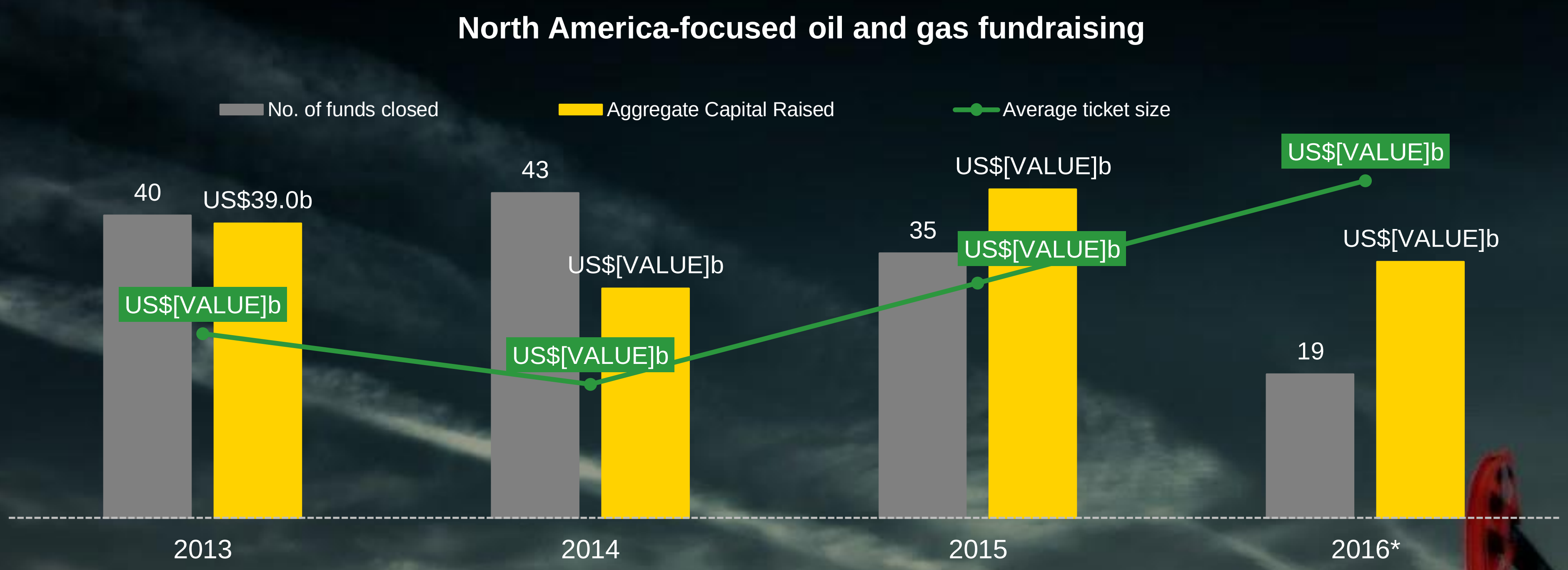
Source: EY Global Oil and Gas transactions review 2016, 1Derrick

Note: To analyse yearly trends in deal value, mega 2016 PE deals considered as outliers and excluded from analysis, which includes PE investment in Rosneft, Petrobras (NTS), NGGD and Essar Oil.



PE as a finance ‘multiplier’

PE has the capacity to invest a great deal more than it has recently

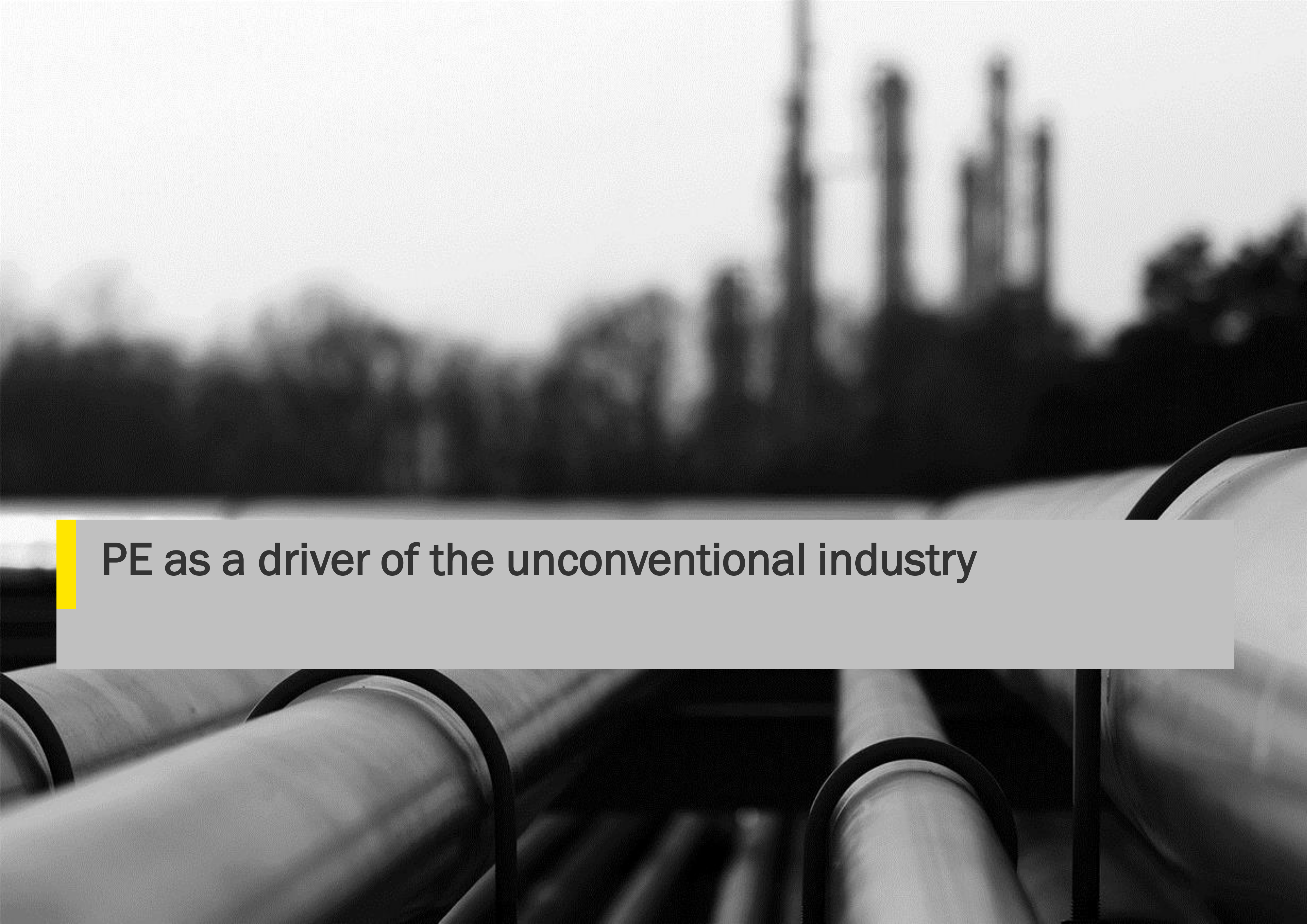


Source: Preqin Special Report: North American Oil & Gas, November 2016

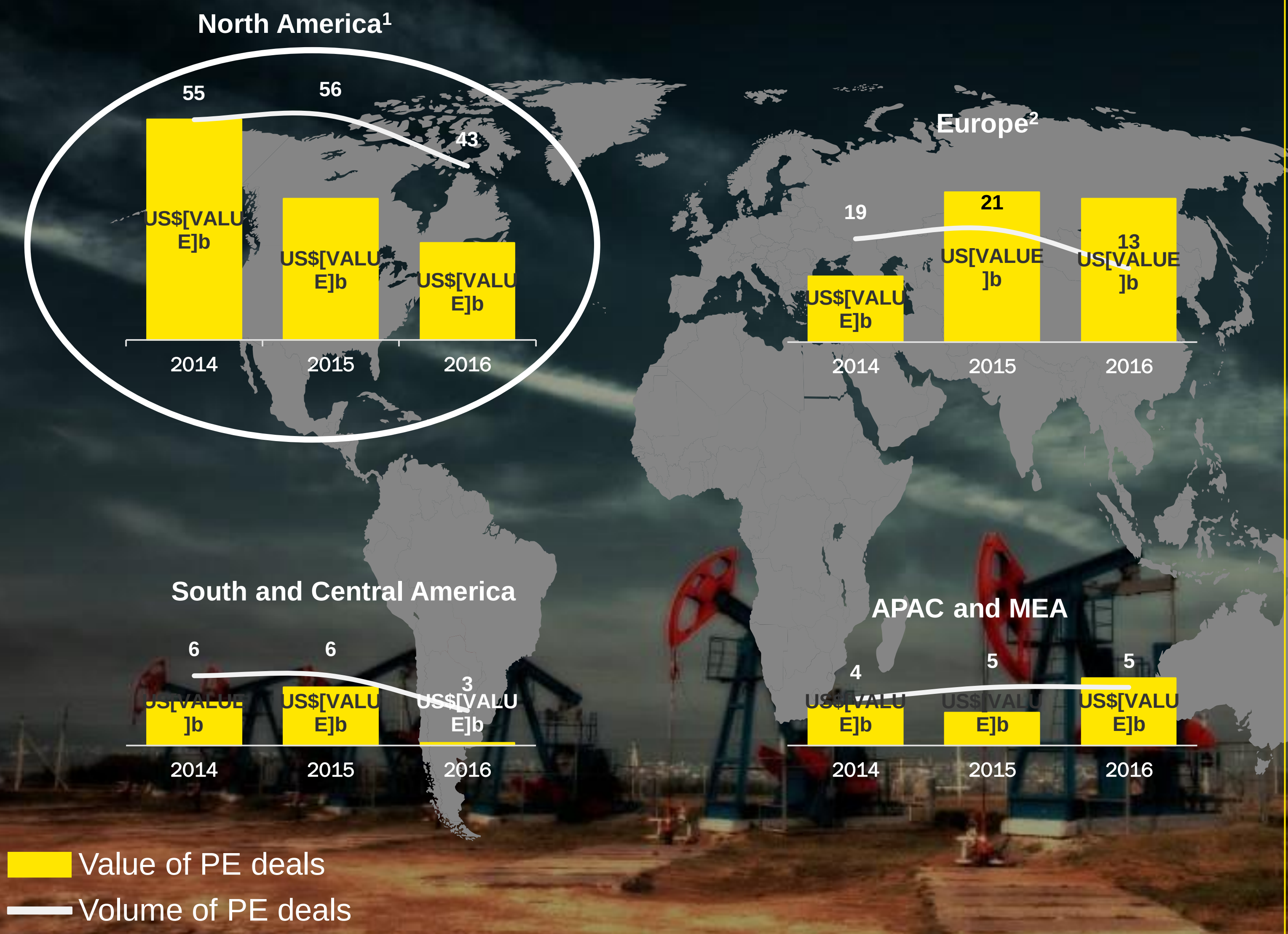
Note*: 2016 numbers are till October 2016

- Despite price volatility, PE oil and gas fund raising has not been impacted significantly. 2016 saw US$33.9b of funds raised for investment in North-America alone.
- Average ticket size for each fund increased to US$1.8 b in 2016 compared with US$1b in 2013.
- Significant capital overhang in the industry from past fund-raisings, not much that has been raised could be invested; close to US$100b still available as dry powder capital for investments.
- **PE will typically use leverage of 1-1.5x equity (in the US) to magnify its investment.**

PE as a driver of the unconventional industry



PE's significance derives from its focus on the North American unconventional sector 2016 activity was relatively very low until Q4 2016



- PE firms has been most active in North America, accounting for more than a third of the total global PE deal value between 2014-2016.
- Recent years have seen broader interest in other mature basins, such as the North Sea. Notably, Europe's share in total global deal value increased to 38% in 2016, from 16% in 2014.
- Interest in US unconventionals surged in Q4 2016

Source: 1Derrick and EY analysis

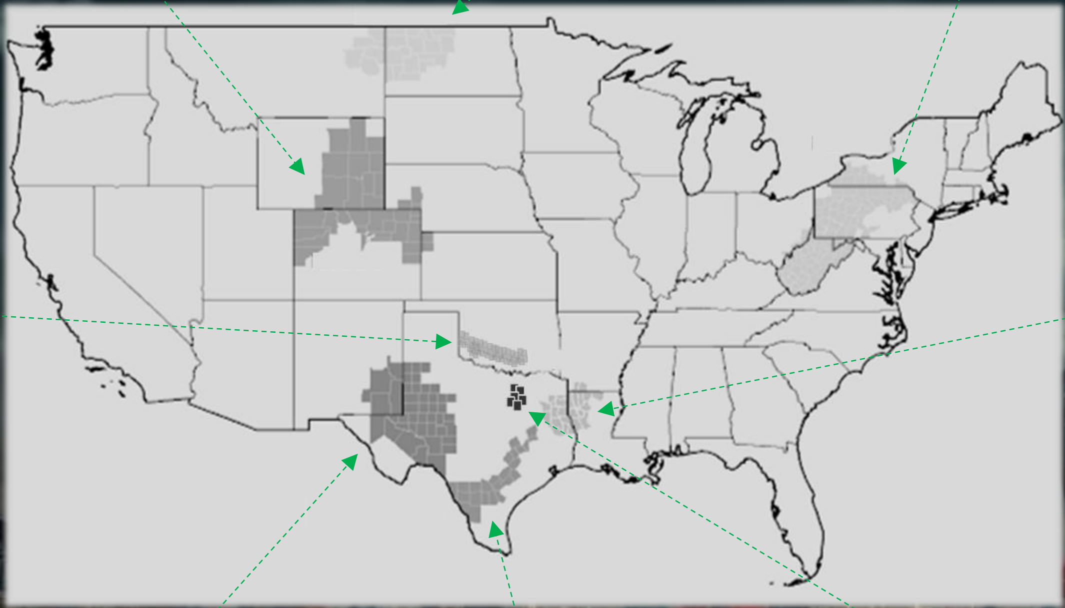
Notes: [1]North America includes US and Canada

[2]Europe includes transcontinental countries i.e. Russia, Kazakhstan and Ukraine

Note: To analyse yearly trends in deal value, mega 2016 PE deals considered as outliers and excluded from analysis, which includes PE investment in Rosneft, Petrobras (NTS), NGGD and Essar Oil.

More specifically, low cost, fast response and quality acreage positions in key US basins, most sought after by PE

PE deal value and number of deals for key US basins (2013-2016)



- Increase in PE investments expected in order of basin efficiency.
- Activity expected to remain primarily concentrated on fast response, low cost and quality acreage positions (eg. Permian unconventionals).
- For higher cost basins with more mature assets (Bakken and Eagle Ford) activity has been slow but some uptick expected considering PE's inclination to unlock value while filling capital shortage gap.
- Key considerations for PE to be successful in unconventional plays would be to understand basin characteristics, nimbleness in adopting new technology and continuous learning.
- Notably, PE has faced strong competition from strategics who are willing to pay higher premiums and have outbid PE in few instances.
- Thus, PE focusing on mid-sized deals, that does not put them in direct competition with larger public companies.

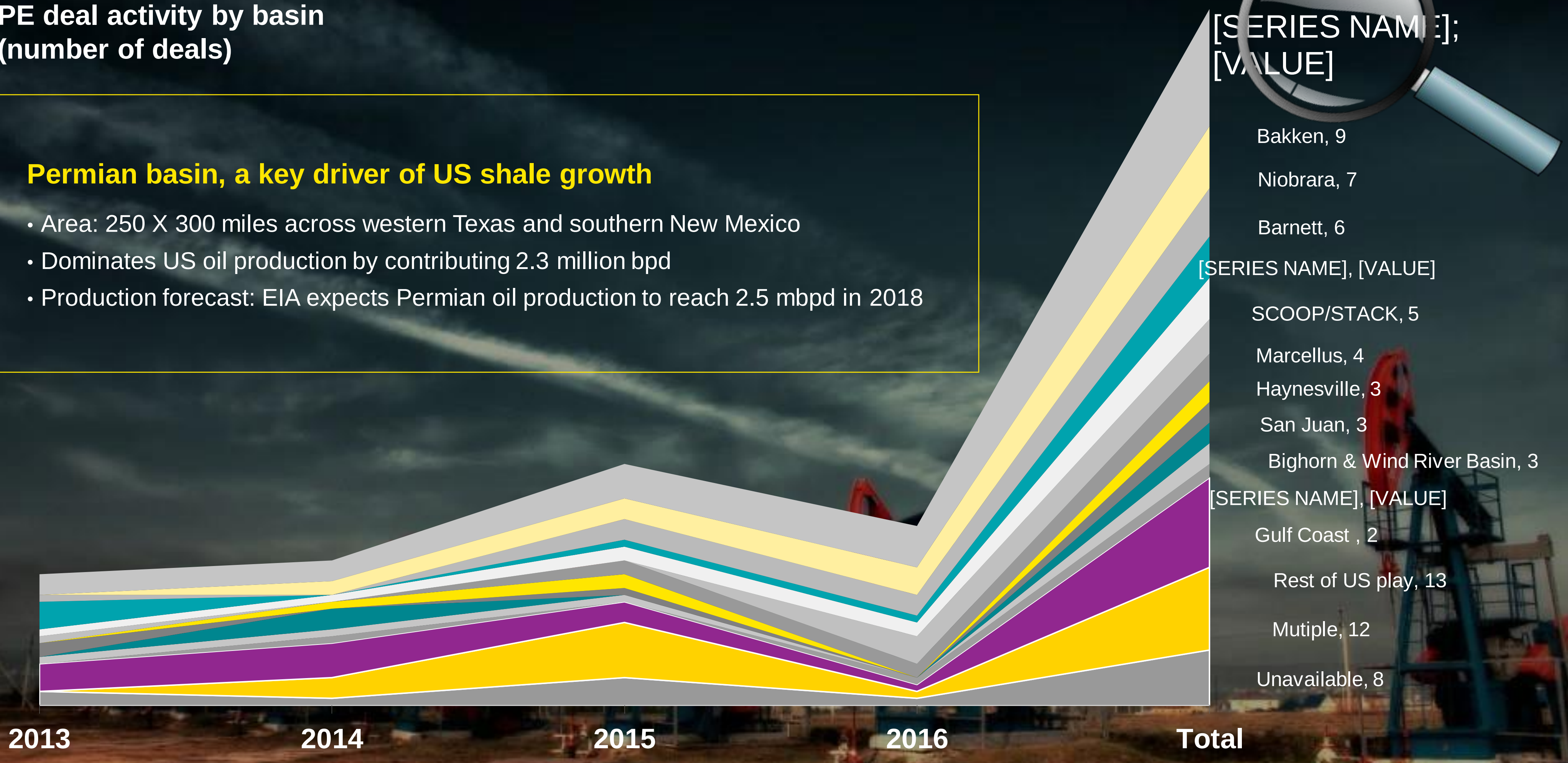
Source: 1Derrick and EY analysis

PE is disproportionately focused on US unconventional, with Permian basin accounting for maximum number of PE deals in last three years

PE deal activity by basin (number of deals)

Permian basin, a key driver of US shale growth

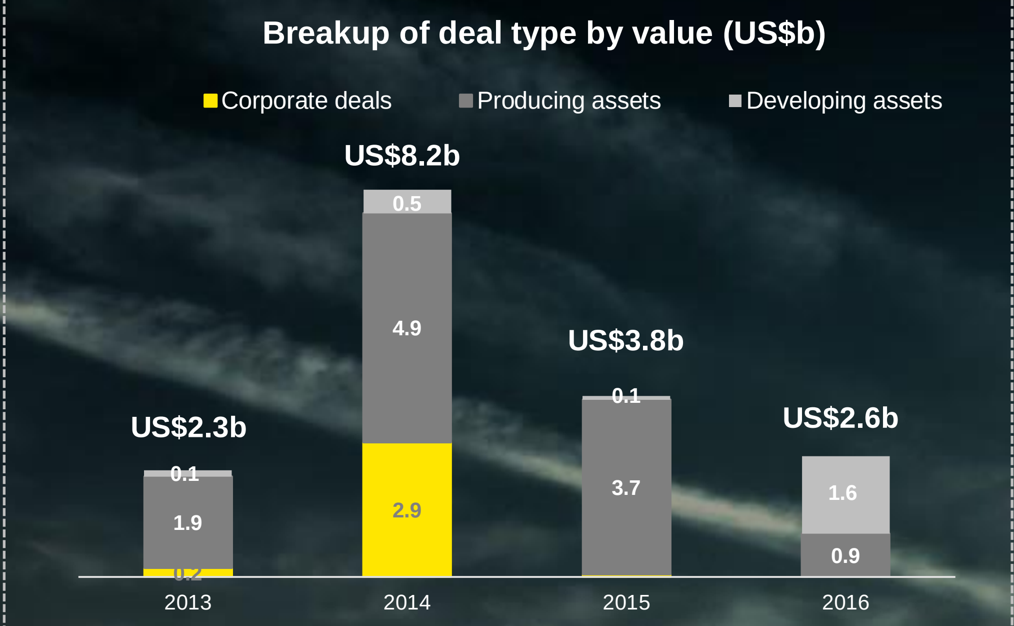
- Area: 250 X 300 miles across western Texas and southern New Mexico
- Dominates US oil production by contributing 2.3 million bpd
- Production forecast: EIA expects Permian oil production to reach 2.5 mbpd in 2018



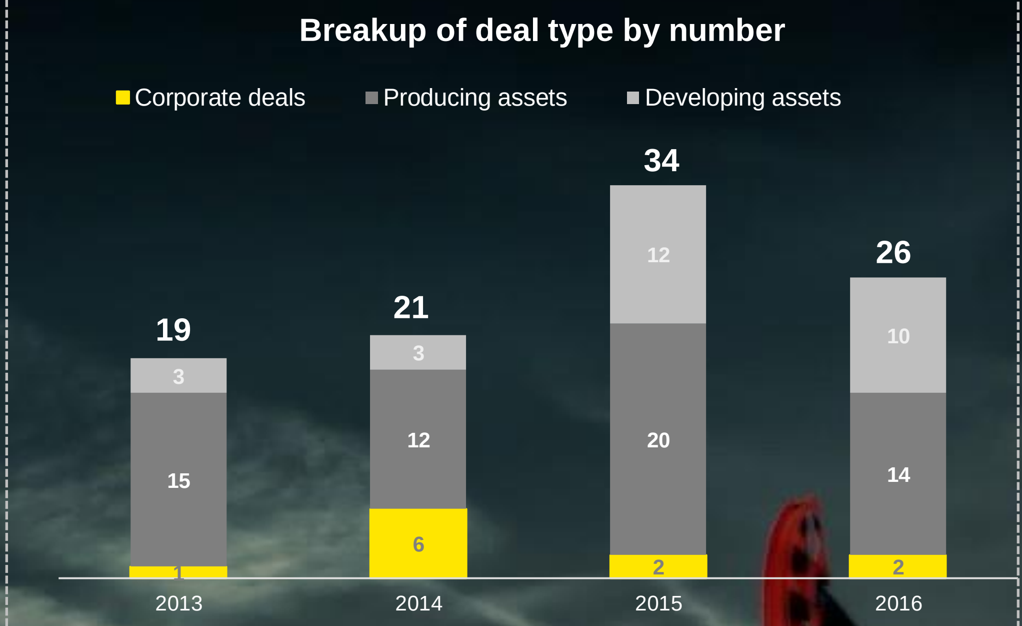
"Permian Basin dominates US shale due to lower break-even costs, existing infrastructure and multi-stacked plays that respond favourably to horizontal drilling"

Source: 1Derrick and EY analysis

Asset level deals, specifically producing assets/ development asset, remain favorite with PE firms



Source: 1Derrick and EY analysis

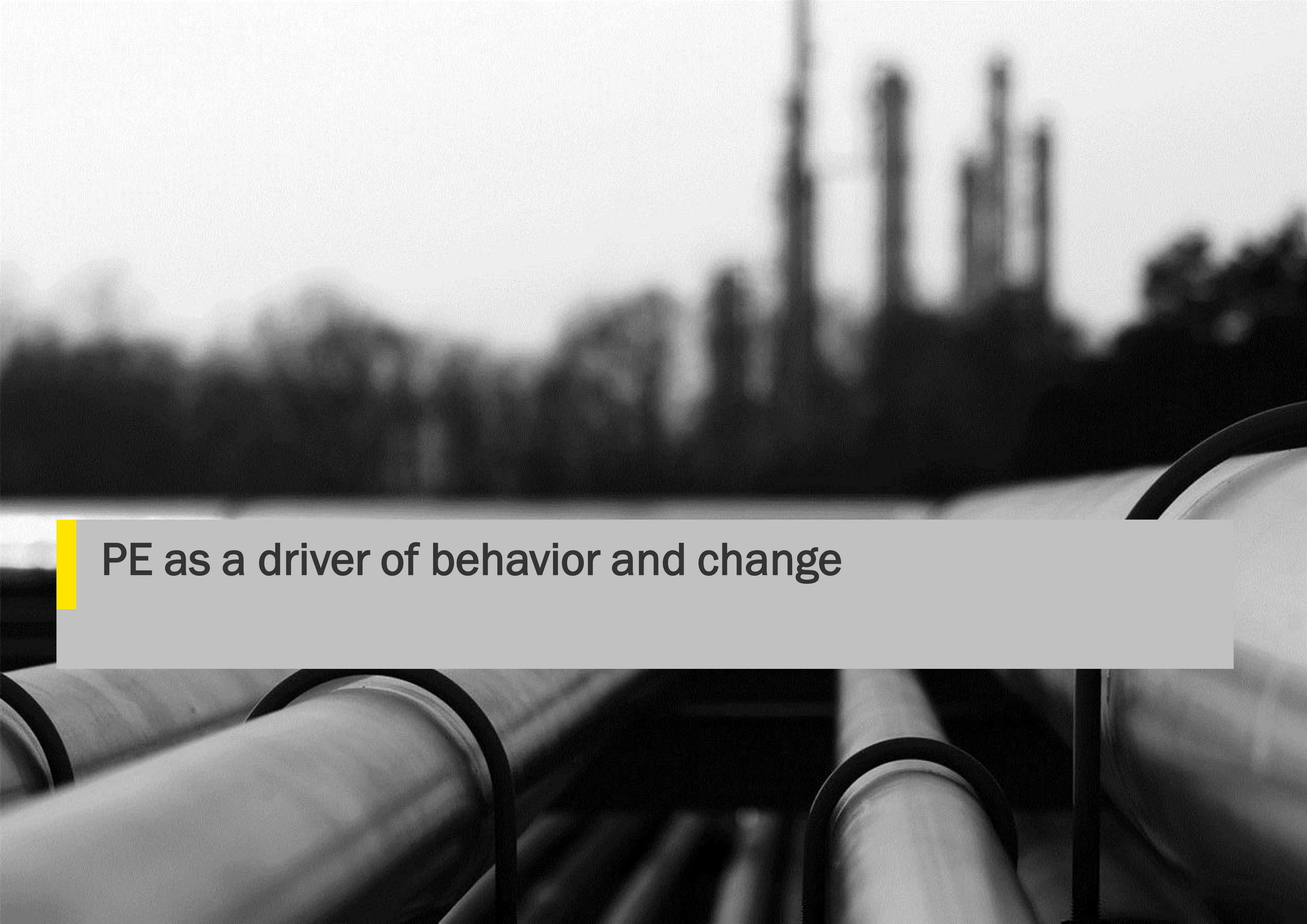


Key points

Asset type deals dominate PE transaction landscape. Key drivers include:

- Majors and independents coring down their portfolio of assets (not necessarily bad assets)
  - Either they need capital to shore up their balance sheets, or
  - Drill down to focus on one or two areas (basins or offshore/onshore) resulting in divestiture of the assets in other regions/ segment
- Distressed asset deals from operators in need to boost liquidity and pay down debt.
- Relatively lesser technical/ exploration risk in producing assets compared with developing or underdevelopment assets.

Note: To analyse yearly trends in deal value, mega 2016 PE deals considered as outliers and excluded from analysis, which includes PE investment in Rosneft, Petrobras (NTS), NGGD and Essar Oil.



PE as a driver of behavior and change

Key PE considerations

"Opportune time for deep pocketed investors with strong management teams, who can provide innovative financing solutions and unlock value in an era of low-for-longer oil price"

1 Right management

PE are backing strong management teams, with technical competence and experience in managing capital intensive business to pursue both greenfield initiatives and consolidation strategies.

2 Geology – "good rocks"

PE focussed on investing in producing assets (with high-quality reserves and low marginal cost of production).

Quality of rocks is important, as PE firms unlock value by taking advantage of the inefficiencies and dislocations.

3 Creative deal structures

PE firms getting more flexible and innovative in deal structuring.

Examples of new structures - JVs, strategic partnerships and structured debt deals (upside from warrants).

Higher volatility, lower prices and increasing debt burden of PE-backed companies, among key factors driving creative deal structures.

4 Balance sheet strength

Balance sheet capacity for leverage, an important consideration for PE investment.

"Bankability" of the reserve base (break-evens, PDPs, PDNPs, PUDs) key differentiator for restructuring opportunity.

5 Exit type and entry point

PE firms start with identifying a handful of specific potential acquirers that can help drive value creation throughout the ownership period of the asset.

Entry price is an equal consideration as overpaying (given stiff competition from strategics) may result in decreasing the returns generated.

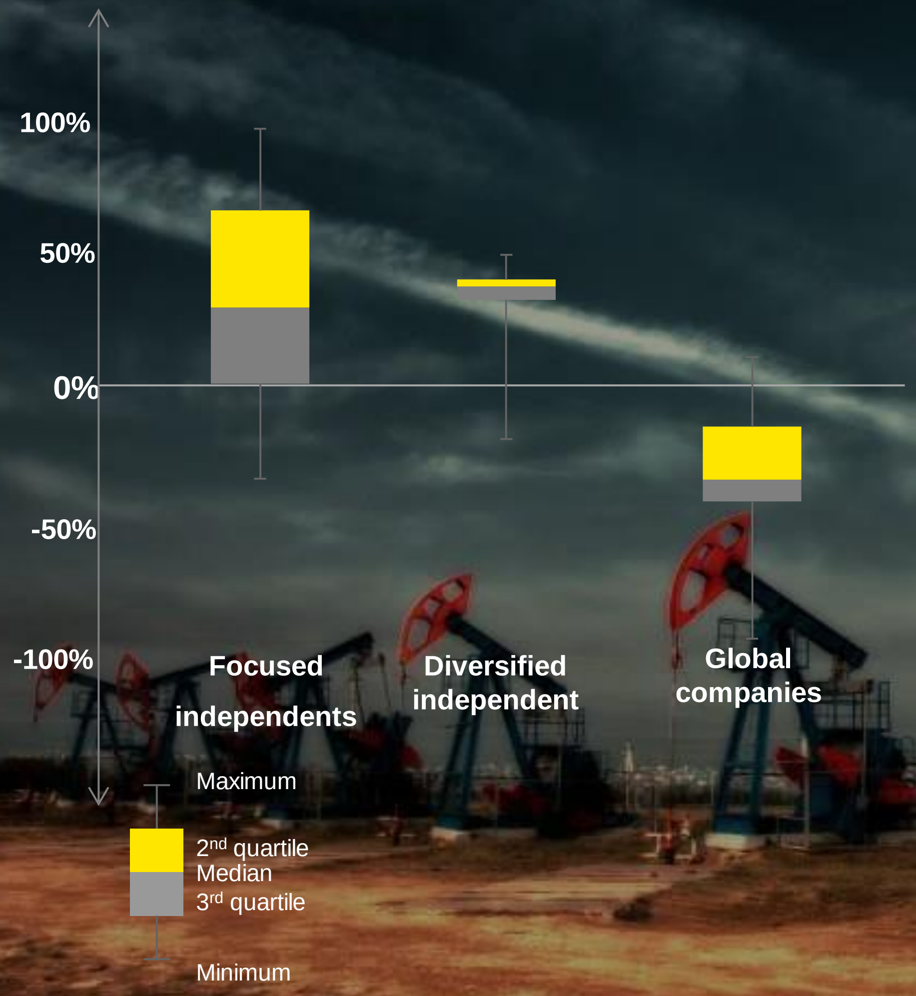
6 Financial sophistication – hedging

PE firms have active hedging programs in place that provide downside protection for oil price volatility.

Specifically, for E&P deals, majority of oil and gas specialist PE firms look to hedge the majority of production for 18-36 months.

PE's relentless and narrow focus on financial performance tends to promote high performance behaviours in the unconventional 'independents'

Relative performance by types of operators



- Thorough understanding of basin characteristics, nimbleness in adopting new technology and continuous learning are critical for success in shale
- Focused operators have a wide range of performance, driven by the quality of the management team
- PE drive high performance at independents that have tight connection among different business functions within the organization that drive better decision making – however, this connectivity is generally informal rather than process enabled

Source: 1Derrick and EY analysis

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