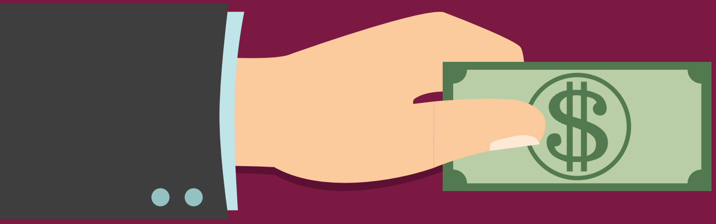

The Price Is Right:

What Makes an M&A Deal Go Round, and What You Can Do When Companies Combine

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This year and the last have been significant for acquisitions in the energy sector. At the corporate level, we are seeing the Halliburton takeover of Baker Hughes, the Shell buyout of BG Group, and Repsol's acquisition of Talisman. At the asset level, there was the Woodside-Apache liquefied natural gas project, Nigerian companies' acquisition of western companies' interests in the country, and various master limited partnership mergers in the US.

The *TWA* Forum team talked with some of the top minds in the energy mergers and acquisitions (M&A) arena about what is driving the market, and how to prepare yourself if you are employed on either side of a transaction. This article will provide an overview of what happens behind closed doors before a merger or an acquisition takes place.

What Gets the Ball Rolling?

What are the key drivers of M&A activity in the energy sector?

Alan Tambosso (AT): The key drivers are currently cash flow, cash flow, and cash flow! Assets that are currently making money are in demand. Previously, assets were traded on a reserves basis. Transactions were very often based on a proved plus probable reserves value at a specified discount rate, say 15%. However, the focus has changed now as the market demands a current cash flow.

The shift in M&A drivers from reserves to cash flow occurred in the early 1990s when junior companies would buy underdeveloped assets with lots of reserves and then put capital in to accelerate the cash flow of the asset. This in turn provided more capital to develop more reserves, which created growth. The market reacted by funding these companies, as markets will always allocate capital toward companies with high growth potential.

Recently, low commodity prices have highlighted the focus on cash flow. Assets must be producing positive cash flow or the company holding the assets will not be able to sustain itself. Other drivers of transactions are debt, including operational obligations, such as abandonment liabilities. Companies with high levels of debt are less likely to

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be able to acquire a company or asset. In addition, acquirers may not want to purchase a target with high debt load.

What are the primary benefits of an M&A activity?

Lucas Law (LL): Some of the primary benefits are the opportunities to consolidate assets, divest noncore assets, increase focus and resources on core assets (economy of scope), reduce overall costs and competition for assets and resources (economy of scale), or enter a new area (geographical or product diversification). Sometimes, it makes sense to acquire because it is cheaper than to initiate or develop internal projects or technologies. Acquisitions can also be done for taxation purposes. The end goal of any M&A activity is to improve financial performance, reduce risk, and maximize shareholders' returns.

Jeffrey Dodson (JD): There are a number of potential operational and strategic benefits, especially given the recent price volatility. With commodity prices at a lower level, I believe there is an opportunity to acquire certain assets at inexpensive prices from distressed companies, which may in the longer term bring value to stakeholders and better position the buyer among its peers. If the acquisition is priced right and integrated effectively, the shareholders should generally benefit through the increased equity value of the company.

AT: A variety of supporting businesses and industries also benefit from M&A activity. Firms in financial services provide M&A support and guidance as well as financing for transactions, while engineering, accounting, and legal firms are engaged in reserves, regulatory, and shareholder reporting.

What are the negative aspects of M&A transactions?

AT: When a company sells an asset, it is giving up some of its cash flow, which can negatively impact its financial situation. Selling assets is certainly a faster way to depleting them vs. producing them, which, depending on the timing of the transaction, may be a good or bad decision. In addition, a company could potentially get into a downward spiral of selling assets to pay off debt, which in turn reduces cash flow, reduces capital to grow the business, and reduces the ability to pay off debt.

LL: The challenge with any M&A transaction is often in executing the integration or calling the timing for the activity. Is it the right time to buy? Is the target price too high? Can the integration be done well? Is there an overestimation of potential synergies? Is there a lack of proper due diligence? The M&A process is complex with many factors influencing the outcome. Factors such as poor information technology integration, high employee turnover, inadequate due diligence, and lack of communication can quickly derail an otherwise successful transaction.

It is difficult to achieve a merger in which each party is equally represented because balancing different structural, emotional, and political cultures is often not feasible. There is typically one dominant party in the transaction; in this case, its culture and management style tend to dominate. Trying to please everyone is not realistic.

JD: If the amount of analysis, due diligence, or integration efforts is not sufficient, it can impact the organizations involved and the transaction. The key is to do your homework and remember it is never too late to turn back prior to closing on a transaction, despite breakup fees.

What market conditions typically result in increased M&A activity?

AT: Stable markets. A downturn, such as we are seeing now results in a slowdown of M&A activity. Buyers, such as private equity, would ideally like to get in and purchase now at discounted prices. However, if the producing companies themselves are not in a hurry to sell, perhaps based on the belief of a rebound in prices, the bid-ask spread will be too high and no transaction will occur.

As an example, natural gas prices fell in 2009. Initially, there was not a lot of

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natural gas M&A activity as companies thought that prices would go back up. Buyers wanted to purchase assets at discounted prices, but sellers did not want to sell as they thought that the prices would go back up. After periods ranging from months to even years depending on the specific company, capitulation to the reduced prices set in and transactions began to occur.

LL: Management teams need to have confidence in forecast corporate earnings for increased M&A activity to occur. If prices are volatile, no party in the transaction will be eager to make the first move. Paralysis tends to set in and no transaction can be made if the bid and ask are too far apart. If M&A activity does increase, it may often be a sign of confidence in the economy from the management teams. In addition, it is difficult for a company to acquire during a downturn economy as companies are often looking to conserve cash and not take on more debt.

Do you foresee an increase in M&A activity in the energy sector this year?

AT: M&A activity typically slows down in the summer and picks up again in fall. There will be more price history by then with the new price regime fully reflected in accounting statements and cash flow projections. Corporate strategies will be evaluated and companies will determine if they can grow and survive with the new prices, or if they need to sell assets or the entire firm. The short answer is that while M&A activity has been slow so far this year, it should pick up later this year.

LL: There are many opportunities for purchase within the energy sector. Companies that are highly leveraged and poorly managed or have challenged cash flows and unhedged production will have a tough time surviving in a continuing period of low prices. Businesses with good foresight, strong cash flow, and healthy balance sheets can benefit in this dynamic and volatile market. In addition to this, great assets will always find a buyer.

The Mechanics of M&A

How is a company valued for an M&A transaction?

AT: A number of metrics are used. As mentioned before, cash flow is certainly of paramount importance; however, valuations typically include a variety of other metrics such as reserves value before and after tax (both proved and proved plus probable reserves are typically reviewed); comparable transaction metrics such as the cost per barrel of production and reserves; and market metrics for comparable companies, including price to earnings and price to cash flow. These values are all part of a range of estimates for the value of a company or asset. As both the buyer and seller will be calculating these metrics, the transaction needs to make sense for both sides.

LL: The value of a company in an M&A transaction is often calculated using multiple methods. Some common methods include asset evaluations (discounted cash flow), cash flow multiples, relative valuation of comparable companies and transactions, future earnings, current enterprise value to daily production volume, and projected future growth rates and opportunities.

JD: How a company is valued varies, but generally, in the upstream space, it is by the asset base and reserves. In the midstream and downstream spaces, companies are generally valued by a multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization) and cash flow valuation.

How are M&A deals in the energy sector typically financed?

LL: M&A deals are typically financed through the issuance of shares of the acquiring company. Other options are cash and issuance of debt. Issuing new shares works well when the acquiring company has a relatively strong share price (i.e., at a premium) in the market.

JD: M&A deals in the energy sector are typically financed with a mix of debt and equity. In some transactions, financing may be achieved by way of a share transaction to facilitate a tax-free transaction to the shareholders.

Are look backs done to analyze the effectiveness of M&A transactions?

LL: There are three potential types of M&A transactions: accretive, neutral, and dilutive. Which one will occur depends on the timing of the acquisition or divestment in the boom-and-bust cycle. Other major influencing factors include sale price, type and size of resources acquired or divested, and the various debt instruments and liabilities involved. Most deals are considered either accretive or neutral at the time of the merger or acquisition. Public companies do not typically release details of a look-back analysis, so it is difficult to determine the number of deals that were truly accretive. However, financial analysts will typically provide their views on specific transactions.

JD: Look backs are certainly done, either by the companies involved in

The Employee Aspect

Can you provide an employee perspective of an M&A transaction at an acquirer or target company?

JD: When I was employed by and involved in an M&A transaction at a large chemical company earlier in my career, it was quite hectic because in addition to your day job, you had to also be responsible for the challenges of taking on significant responsibilities relating to the transaction.

LL: I have been involved on both sides of corporate transactions many times, being at both acquiring and target firms. Each time was different. The size of the acquiring company (number of employees, properties, and complexities) plays a huge factor in the selection and size of the integration team. The acquiring company will lead the integration team, and sometimes, they will hire a third party advisory team to help with the transition. The integration may be structured with different levels: the top level to handle the big picture, the next level to handle the different departments, and so on. A great human resources department is a tremendous asset through this process.

What is your advice for individuals working at an acquiring company?

LL: Put aside any ego. Do not create an atmosphere of "us versus them." There should not be an attitude of "winner takes all." Be open to new ideas and suggestions coming from those in the acquired company.

For those in a leadership role within an acquiring company, know that the first impression you make is extremely important. Reach out to the people at the company you are acquiring. Communicate often and understand that emotions are running high during initial uncertain times. Do not play office politics or let anyone in your team do so. Rumors should be handled and stopped quickly. Be real with your people.

What is your advice for individuals working at an acquired company?

LL: Give the acquiring company a chance to be successful by putting your best efforts forward. Understand that the new culture and management style will be different. Be prepared to get rid of the past and stop comparing the new company with your previous employer. The transition may be more noticeable when going from a small company to a larger company. In that situation, there will be more corporate layers, and processes may take longer or require more steps than before.

the transaction or by various financial analysts. In my experience, there is not a typical conclusion. Generally, the results are evident one way or the other, but sometimes the results can be more ambiguous.

Do companies make it known that they want to be purchased?

AT: Public companies do not always announce to the market that they are pursuing a deal to either buy or sell assets or the corporation itself, as this could affect the share price of the company prior to the completion of the deal. Some companies may say that they are exploring strategic alternatives to enhance shareholder value, which most people interpret to be saying that the company, or part of it, is for sale.

If a company lists its assets or itself for sale publically, it can confidently say that it has explored all possible options for generating and maximizing shareholder value. This is because it has ensured that the assets, or the company, have been shown to all possible buyers on the market. **TWA**

Answers to InterAct puzzle

Answers to questions: Butane; Due Diligence; EBITDA; Technology; Dry Hole; Microfluidics; Frans Johansson

Answer to word building: Editors.

List of TWA Editors for this issue can be seen on Page 2. Details on how to join the editorial team can be seen on Page 40.