Allegiance Capital Corporation
PRIVATE INVESTMENT BANKERS

Oil and Gas Poised for Increase in Momentum as Market Sentiment Improves

Industry Update
June 2018

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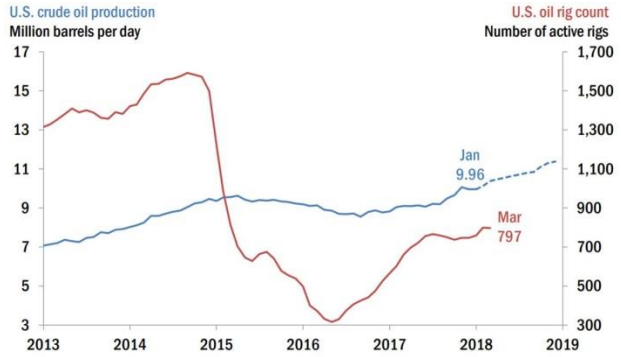
As market sentiment improves around the oil and gas sector, investments in the segment will cautiously gain momentum in 2018. Post-downturn, the oil and gas industry has put a clear focus on cost reduction measures and internal performance improvement. As a result, this has laid the foundation for oil and gas companies to now actively seek attractive growth opportunities, which include balancing and integrating their portfolios across the value chain (upstream, midstream, and downstream) as well as pursuing economies of scale. In conjunction with the increase in oil prices, an increase in investor activity, and the Organization of Petroleum Exporting Countries' (OPEC) production cuts, the outlook for mergers and acquisitions in oil and gas for 2018 remains fairly optimistic.

Oil & Gas Landscape

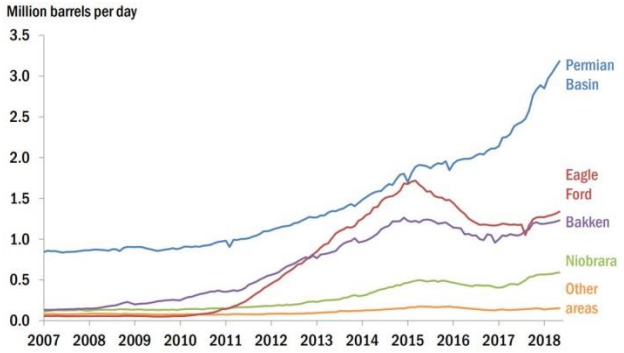
In May, the WTI crude oil futures price broke $70/barrel, a 40% increase from $50/barrel the same time last year. The total U.S. rig count as of February 23rd was 799, a 33% increase from 602 rigs 12 months prior, and a 100% increase from 400 rigs the same time in 2016.

Figure 1.0: U.S. Oil Production & Rig Count



***Sources**: Baker Hughes; Energy Information Administration*

Figure 2.0: Crude Oil Production by Region

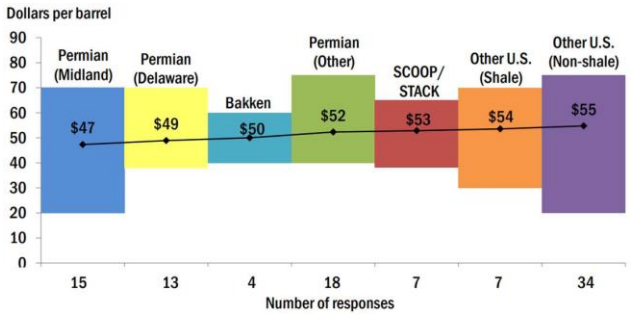


***Source**: Energy Information Administration*

The Permian Basin has remained the most economic region (highest profitability for drilling new wells and lowest operating costs for existing wells), which has resulted in the basin receiving the most interest from M&A players in 2017.[1] However, with valuations increasing in the region, basins like the Niobrara, Anadarko, Marcellus, among others will offer more opportunistic M&A movement.

With respect to the oil and gas industry's focus on cost reduction and performance improvement, profitability levels have returned for both existing wells and new drilling. As referenced below, profitability for new drilling averages in the mid-$50/barrel, and for existing wells, profitability averages in the low-$30/barrel.[2]

Figure 3.0: Breakeven Prices for New Wells

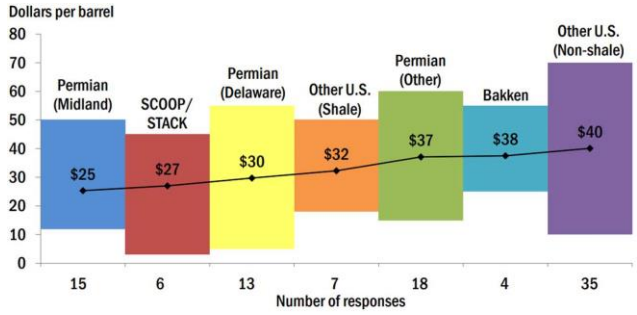


Dallas Fed Energy Survey – In the top two areas in which your firm is active: What WTI oil price does your firm need to profitably drill a new well?

***Source**: Federal Reserve Bank of Dallas*

Notes: Line shows the mean, and bars show the range of responses.

Figure 4.0: Shut-in Prices for Existing Wells



Dallas Fed Energy Survey – In the top two areas in which your firm is active: What WTI oil price does your firm need to cover operating expenses for existing wells?

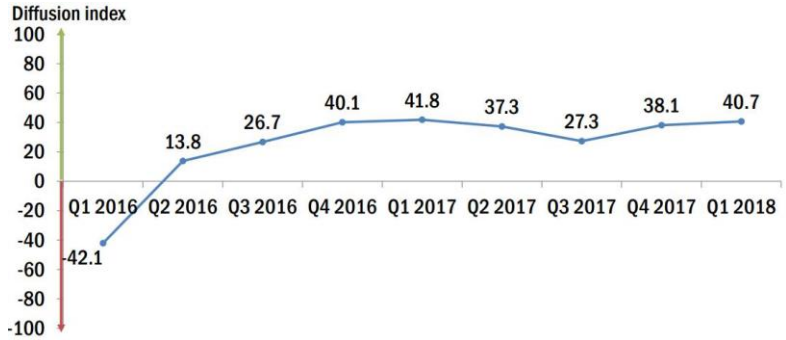
***Source**: Federal Reserve Bank of Dallas*

Notes: Line shows the mean, and bars show the range of responses.

Additionally, according to a survey conducted between March 14-22, 2018 by the Federal Reserve Bank of Dallas, energy operators have seen a fairly consistent increase in business activity. Some highlights from the survey include:

- Utilization of oilfield services firms' equipment increased at a faster pace than in the fourth quarter of 2017
- Labor market indexes continue to point to rising employment and employee hours, with job growth primarily driven by oilfield services firms
- Oil and gas production increased for the sixth quarter in a row, according to executives at exploration and production (E&P) firms
- On average, respondents expect West Texas Intermediate (WTI) oil prices to be at $63.07 per barrel by year-end 2018

Figure 5.0: Energy Survey Business Activity



Dallas Fed Energy Survey – In the current quarter vs. the prior quarter: has your firm's level of business activity increased, not changed or decreased?

***Source**: Federal Reserve Bank of Dallas*

Notes: Index is the percentage of firms reporting an increase in activity since the prior quarter minus the percentage reporting a decrease. Positive values reflect expansion in oil and gas activity, negative values reflect contraction and zero reflects no change since last quarter.

From a global perspective, as of January 2017, OPEC and its allies began oil production cuts to clear the global glut of crude oil. OPEC plans to continue these cuts through the end of 2018. In total, there are twenty-one nations cutting production outputs by nearly 1.8 million barrels a day.[3] Whereas OPEC and most of its allies are reducing their output, the U.S. is producing more oil than it has ever historically produced.[4]

Moreover, according to the EIA, U.S. Energy Information Administration, the U.S. is forecasted to dominate the oil industry over the next five years as the world's largest exporter. It is forecasted that the U.S. will export 5 million barrels per day by the year 2023. Currently, the U.S. is exporting 2 million barrels per day.

Value Chain Investor Interest, Fresh Dry Powder, and a New Emerging Player

North American energy M&A in 2017 was primarily concentrated on upstream deals that totaled $172 billion in transactional value. As a result of this concentrated activity, oil and gas companies and investors are now looking to balance their portfolios targeting other areas across the value chain.

According to a Bain & Company oil and gas outlook,[5] areas forecasted to see an increase in growth capital include:

- Offshore, midsized oil development projects
- Oil sands
- Gas projects focused on improving oil-to-gas ratios
- Downstream oil and gas

Heading into 2018, with an impetus from the oil and gas sector's cost reduction efforts, stabilized oil prices, and OPEC's production cuts, there has been a surge in activity from investors, including private equity (PE).

Since 2017, there have been several energy-targeted PE funds that have been raised to capitalize on this rebounding sector. In fact, based on our research, over the past 16 months there has been over $21 billion of fresh dry powder (earmarked capital) raised for investments in the energy sector.[6] This figure does not include dry powder remaining from PE's record amount of capital raised in 2015 and 2016 in addition to previous years.

Moreover, a new player in energy M&A has emerged – the Special Purpose Acquisition Company or SPAC. A SPAC is a shell, or a "blank check" company that first raises money through its IPO to acquire an unspecified target company, and then seeks out a private company to purchase and grow.[7] With the decline of MLPs, master limited partnerships, who have historically financed energy deals, the SPAC has emerged to fill this gap. A couple of examples include megafunds Carlyle and TPG Capital who have backed energy-focused SPACs Regalwood Global Energy for $300 million, and TPG Pace Energy for $600 million respectively.[8] Both PE's and SPAC's focused and aggressive capital raising points to a restored confidence in the energy sector.

Post-downturn, the oil and gas industry appears to be well on its way to recovery. With U.S. operators achieving profitability in a new era, and inclusive of the U.S's positioning to reign as the world's leader in crude exports, capital and M&A activity will continue to gain momentum in the sector throughout 2018. Growth capital and liquidity opportunities for operators both large and small have and will continue to emerge, opening up opportunities that did not exist just a few months ago. For business owners who missed the window in late 2014, the tide is turning and it may now be a good time to explore your prospects.

Sources:

1. U.S. Energy Information Administration
2. Federal Reserve Bank of Dallas. *Dallas Fed Energy Survey*. Print. 23 Mar. 2017.
3. Denning, Liam. "OPEC's Year-One Report Card in Five Charts". Bloomberg. Web. 30 Jan. 2018.
4. Domm, Patti. "US oil production tops 10 million barrels a day for first time since 1970". CNBC. Web. 31 Jan. 2018.
5. Parry, Peter. "Accelerating Capital: 2018 Oil & Gas Industry Planning Outlook". Bain & Company. Print. 22 Nov. 2017.
6. Pitchbook and Allegiance Capital analysis
7. Investopedia, Special Purpose Acquisition Company – SPAC
8. TPG Capital and Carlyle

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