

# PETROLEUM GEOLOGY CONFERENCE '99

## Abstracts of Papers

### **Mergers, acquisitions and alliances: their impact on the petroleum industry in the next millennium**

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Professor Dr. Ibrahim Komoo, Dato' Mohd. Idris Mansor, distinguished guests, fellow geologists, ladies and gentlemen. Good morning, and welcome to the 1999 Petroleum Geological Conference. First, I want to thank the Geological Society of Malaysia for inviting me to give the keynote address. I consider it an honor to be standing here before such a distinguished group of geologists.

This morning, I would like to explore with you the impact of Mergers, Acquisitions and Alliances on the Petroleum Industry in the next millennium.

With the discovery of the first commercial hydrocarbons in 1856, Colonel Drake changed the World. Without hydrocarbons and the Petroleum industry that was born from their commercial development, we would not have the fuel to drive automobiles, to fly planes, or to have propelled the industrial revolution out of the steam era. We would not have plastics, synthetic rubber, certain cosmetics and medicines and man would not have landed on the moon. We are part of one of the most important industries on earth. And it starts with you, the explorationist that finds that very valuable, though often under-priced, commodity called Oil and Gas.

Over the last 25 years we have seen our industry go through tremendous change. We've seen the technical evolution of seismic from a 2D exploration tool to a 3D exploration and development tool to a 4D development and engineering tool. We have used our enhanced technology and understanding of the earth to successfully unlock tremendous amounts of oil and gas reserves. Some may argue that we have been too successful. More on that later.

At the same time we have seen independent and major oil companies disappearing through mergers and acquisitions; the weaker companies being taken over by the strong ..... an industrial version, if you will, of Charles Darwin's biological thesis on the "survival of the fittest". Who would have guessed that such name brands as Gulf Oil, one of the original seven sisters, Sinclear, Getty, Union Texas and now, Mobil, Amoco and ARCO, to name just a few, would no longer be a part of our petroleum landscape. What, if anything, does this tell us about the petroleum industry's future. That's what I hope to explore with you this morning. The impact of Mergers, Acquisitions and Alliances on the Petroleum Industry during the New Millennium. And let me add, this is an Independent oil-mans perspective on the subject. Although I will not address the impact of mergers on academia, mining, nor the petroleum services industries, I believe that in most cases you will see a direct correlation.

Before we dust off our “collective” crystal ball to look at the future, let's take short journey back into the past. Let's find out what has driven our industry into an era referred to by the media as “Merger Mania!”

As reported by Ralph Nelson, “the Great Consolidation of the '90's cites as main factors, the generally favorable conditions of business combined with a rising, buoyant securities market at a time of too much productive capacity”. Sound familiar? Interestingly enough, this quote refers to the 1890's, not the 1990's! Mergers and Acquisitions have always been part of industry. During the late 19<sup>th</sup> century John D. Rockefeller built the Standard Oil Empire by acquiring oil fields and merging refineries. The Royal Dutch Company, the company that successfully found oil in Sumatra in 1885, was merged with Shell in 1907.

Later, driven by the energy needs of World War I, oil prices increased and remained strong through the 1920's industrial “boom” years giving the cash flow needed to support the petroleum industries growth. During the 1930's, we saw a dramatic increase in oil reserves, lead by Pop Joiner's discovery of the giant East Texas Oil Field, drive oil prices down to then unprecedented lows, and, as a result, drive many companies out of business or into the arms of competitors.

Were these early consolidations of our industry different than what we are seeing today? Were they the struggles of a new industry finding its feet, or were they the harbinger of things to come. During the late 19<sup>th</sup> and early 20<sup>th</sup> Century, most of the world was experiencing strong industrial growth as a result of the increased availability of cheap hydrocarbon energy. In the Petroleum Industry, independent and “major” oil companies of the day were consolidating to build larger, stronger companies to better provide the “new energy” required by a very competitive and very fast growing industrial world. Later, in the 1930's, with too much oil on the market resulting in lower oil prices, these same companies were consolidating to stay in business.

As you can see, mergers are not only a part of our petroleum industry, but arguably, gave it birth. Now let's fast-forward to more modern times and an event in the late 20<sup>th</sup> century that changed the energy business forever. From the 1940's until 1973 oil prices remained relatively stable at around US\$2.50–3.50/bbl. During 1973, as a result of the Yom Kippur War, Arab states called for an oil embargo on the United States, a defining event that lead to unprecedented high oil prices and a 13 year boom for the petroleum industry that makes earlier oil booms pale in comparison. With significantly increased cash flow from higher oil prices, the petroleum industry experienced increased exploration activity and production levels. And not unnoticed, increased number of personnel. The looming Oil Price Crash of 1986 was an unforeseen event to those oil-men of the 1970's and early '80's. There were, however, many hints of its inevitability as early as 1982 as oil prices began to drop from their 1980 peak, increased cost cutting measures such as layoffs began to emerge and the drilling rig count dropped dramatically. The radical growth of the petroleum industry driven by unprecedented high oil prices during the late 1970's and early 1980's was in 1986 about to come to an abrupt halt. It was time for a reality check. And reality was not a pretty picture.

Although cost-cutting measures had emerged in the early '80's as necessary for the industry, when the oil crash of 1986 arrived oil companies found themselves with high production costs, bloated staffs, excess production and low oil prices. Increased cost cutting measures had to be taken to survive. And as is characteristic of our industry, our performance was stellar. We brought down our collective finding and development costs from over \$20/boe in 1981 to less than \$5/boe in 1995. But, as you can see, most of these reductions were accomplished during the 1980's. By the turn of the decade we had squeezed just about all of the significant cost savings out of our companies possible. But oil prices remained volatile and except for special events such as the sinking of the Valdez and the gulf war crisis, prices seemed forever to stay on the low side. More had to be done to survive.

As a result, during the early 1990's major oil companies began to rationalize their non-core assets, and majors and independents alike began to expand overseas in an effort to find the large reserves that eluded them in the mature oil basins of the United States and Europe. There was an increase in Alliances to pool resources in order to cut costs and to enhance profitability. Innovation such as 3D seismic was helping find more hydrocarbons at less cost and mergers among independents and mini-majors were starting to get our attention.

Today it's hard to pick up a newspaper, trade journal or magazine without reading about some company being reorganized, restructured, re-engineered, merged, acquired or joining in an alliance. Why is this? What drives these companies to such measures and what are the benefits and negative aspects of such decisions? What impact will these decisions have on the next millennium? To find the answer, let's look at what drives mergers, acquisitions and alliances of the 1990's. And let's see what the benefits and negatives are for such strategies.

Although every merger, acquisition and alliance has its own rationale and dynamics, most have common drivers. One of the most important of which is the need for companies to continue to grow. As noted by Douglas Terreson, managing director for Morgan Stanley, the petroleum industries recent record is not good: "In recent years," he says "the energy industry has failed to generate the risk-adjusted returns that investors can get in other sectors of the S&P 500. This has led to slower earning growth, lower valuation and under-performance in the stock market." There are many reasons for this poor performance, foremost of which, is that the petroleum industry has been too successful at finding oil. There is just too much of the stuff around and too many companies producing it. Even with today's higher oil prices there is still a large "oil Bubble", as illustrated here by the Cambridge Energy Research Associates, of excess production capacity and there will be for several years to come.

Companies can no longer make an impact on their bottom line by continuing to cut costs. It's a process, at this point, of diminishing returns. One way, however, for oil companies grow and, at the same time cut costs, is to merge and then cut redundant costs. It has been announced that the mergers of Exxon/Mobil and BPAmoco/Arco will save the two combined companies US\$4.8 billion dollars/ year.

A barometer, if you will, showing the state of the consolidation of the petroleum industry is seen in the Oil and Gas Journal's annual report of the largest US companies. In 1985, 400 companies qualified for the listing. In 1990 the group was reduced to 300 and in 1995 only 200 companies could be found to qualify for the list. In September, the Oil and Gas Journal speculates that next year the list may drop to 150 companies!

As an example of just how fragmented the petroleum industry is, did you know the Exxon-Mobile combination will create the world's largest publicly traded oil company, but still will have only have 4% of the worlds oil production. This according to David Moore of Andersen consulting in an article in the July 23, 1999 edition of the Wall Street Journal. And, as you can see from the slide, it will take a combination of at least three or more of the majors to approach the size of even the smallest of the four Super-majors. Of course, as the largest companies get larger, it puts pressure on the smaller companies to do the same.

Globalization is another important driver. As larger and more expensive projects such as ultra-deepwater drilling and production and the exploration and development of such remote areas as the Former Soviet Union become available, only the larger companies will have the resources to pursue them.

Growth, production over-capacity and its resultant instability of prices, a fragmented industry and globalization are the key drivers of mergers, acquisitions and alliances, but they are not the only drivers.

Another force for merger is the competition from National Oil Companies, which at first diversified into downstream but have increasingly become more aggressive in the upstream sector, and not just within their nation's borders. For example, Petronas, one of the most successful National Oil Companies in the world, has since 1990 developed upstream presence in 12 countries outside of Malaysia and recently formed an Alliance with Premier adding Indonesia and Australia to its portfolio.

Other important drivers are deregulation, which is especially important in the refining and marketing business and gas and power utilities, the need for portfolio enhancement, the desire to increase market share, and the costs of environmental regulation, especially considering the Kyoto accords.

The benefits of Mergers, Alliances and Acquisitions can be significant. Increased size means more revenues, more capital and better access to capital, long term financial stability, more cost-cutting opportunities, larger pool of experts, bigger data bases, and access to larger upstream projects, to name a few. And not un-noticed by the service industry, bigger oil companies have more clout to squeeze the-hell-out of them for even more cost reductions.

But mergers and alliances are not all roses, there are thorns hidden in those bushes. As David Moore, Andersen Consulting, points out, "Mergers in general have a surprisingly high failure rate. About 44% of all large mergers completed between 1994 and 1997 fall short of their corporate parents initial financial and strategic expectations. As in a marriage, I suggest that you be very careful about that urge to merge, a bad partner can sometimes be deadly! Mr. Moore continues, "oil mergers are particularly mediocre, about 70% of them haven't achieved the benefits they sought to accomplish". The reason "synergies are difficult to obtain and take more time and effort to capture than companies expect."

A report from Mckinsey puts it this way, "buying a company is the easiest way to get bigger faster, but only 23% of acquisitions earn their cost of capital." Why such low rates of success? The main reasons are that the premiums paid are often too high, the joining of two disparate company cultures can be extremely difficult and disruptive, management indecision during the transition stage, project delays, lost time from re-organization, staff insecurity and the ill-well of employees, and government regulation.

Now, are you ready to look into that crystal ball? What will the impact of Mergers, Acquisitions and Alliances have on the next Millennium?

As you know, oil and gas are commodities and, as the last quarter century has shown us, the price of oil and gas is subject to a variety of pressures. As a result, the price of oil has been volatile and will most likely remain so in the future. Even if OPEC manages to control production, in the long term higher oil prices will cause OPEC to lose market share to non-OPEC countries and to alternative fuels, something they will most likely not allow to happen.

The industry will continue to have trouble raising funds during periods of low oil price, and even during periods of higher oil prices if capital markets don't believe price stability. Mergers and acquisitions allow for growth, for the larger entity to attract capital for larger projects and, at the same time, it provides an avenue for additional cost-cutting, an area where there is very little "self-help" left for companies.

As we've seen, Mergers, Acquisitions and Alliances have been a part of the oil industry from the beginning, and I suspect they will continue to be an important part of the industry's future. My crystal ball says, hang on, we are in for a bumpy ride. But I also see a light out there ..... it's called "demand". With the recovery of Asia in progress and the Former Soviet Union not far behind, with the energy needs of emerging nations and the ever increasing needs of an ever expanding world population, and as you can see by this slide, the earth's population growth will be a significant factor, the longer

term outlook for oil companies is good. For sure, it will be a future with fewer independents, fewer mini-majors and fewer major oil companies and, as a result, fewer employees. The companies with the best management teams, brightest and most talented staffs, strongest financial balance sheets and best resources will emerge as the successful and healthy oil companies of the next millennium. I should add, the survivors will also have successfully incorporated Mergers, Acquisitions and Alliances into their strategic thinking.

Will there be only half the number of niche E&P oil companies remaining in 10 years as predicted by Jack Taylor in a recent issue of *Oil and Gas Investor*? I don't know. But a recent article in *Forbes Magazine* points out that even in merchandizing, the most cutthroat industry of all, there is still room for the specialized boutiques to be profitable while working next door to mega-giant department stores. I believe this analogy is good for the petroleum industry as well. The independents, mini-majors, majors and super-majors will all find their place in the industrial "pecking order" and they will find a way to be profitable. The process will be enlightening for some and painful for others. As I said earlier, it will be a bumpy road but, in the end, we will have a healthier, stronger industry. The future is out there, and so will be the answers. In the meantime, as Captain John Luke Picard of *Star Trek* would say, "Engage, we are going where no person has gone before." I would add, you'd better tighten your seat belt!

With that, I conclude my presentation and I thank you for your kind attention.