Zero-Premium Mergers: A Proposal for Public E&Ps

Summary

There are too many public E&Ps and many of them are too small. Smaller E&Ps (below $3Bn) do not enjoy economies of scale and are not dominant in their basins. Recently, the capital markets have been less open to smaller E&Ps, so their usual path to grow larger is challenged. Since smaller E&Ps are struggling to grow, they are trading at significant discounts to their larger peers. The perceived view among many of the smaller E&Ps is that by staying the course, their valuation multiples will re-rate. In the case where a small E&P is seeking a strategic move, the typical model is to seek the largest premium possible from an acquirer. We believe that in this environment, staying the course is unlikely to yield a higher multiple, and that selling at a 20-30% premium is unlikely to maximize long-term shareholder value. Since the reward for scale is so great, we believe smaller E&Ps should seek to consolidate with similarly-sized companies, ideally on a zero-premium basis. Counter-intuitively, a zero-premium transaction could end up having the highest uplift.

In this note, we review sub-scale public companies in the Permian Basin, many of which have experienced shareholder pressure and volatile stock price performance over the past year, and discuss the value creation opportunities of zero-premium mergers.[1] There are a few public E&P combinations that would have excellent overlap of Permian acreage, and there would be considerable operating synergies to merging assets. Zero-premium, all-stock mergers should be viewed as the first step in a multi-stage process, where 50,000-acre companies combine to form 100,000-acre companies, which then are either more attractive consolidation targets or can repeat the process to further scale up.

In this note, rather than discuss specific companies, we have modeled mergers between smaller generic companies to demonstrate the value created by scaling up. Clearly each situation is unique, but in principle, the upside to a 50,000 acre company merging with a similarly sized peer should be around 35%, and the upside to original owners from executing two mergers of equals, resulting in a 200,000-acre company, is more than 100%. This potential uplift is far greater than the premium that would be offered in a single transaction.

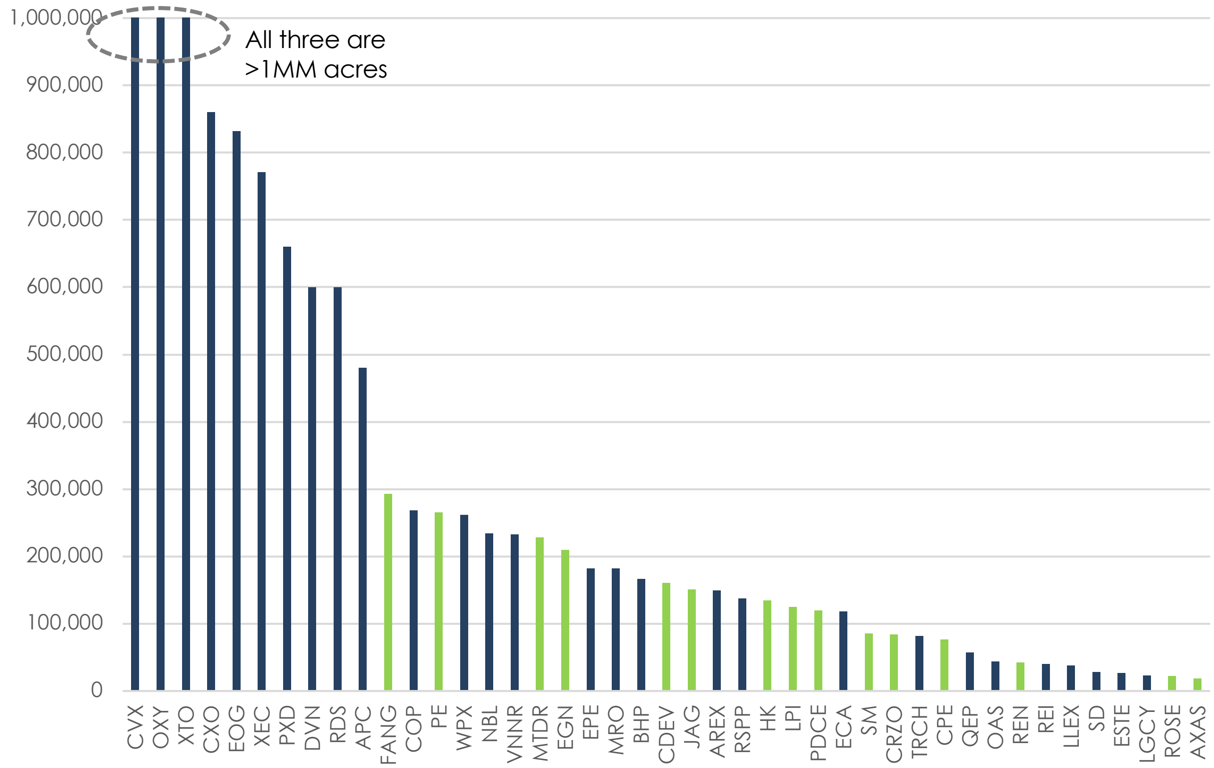
Zero-premium combinations will be a tough pill for many corporate boards to swallow. Management's tendency is to focus on the deal at hand, rather than to think a few chess moves ahead. The motivation of management to support such deals is limited as the main losers from zero-premium combinations would be top executives who would lose their jobs, while the main winners would be shareholders. However, energy has been the worst sector of the public markets over the past three years.[2] Management teams and boards would do well to entertain some new ideas.

[1] Note: A fund managed by Kimmeridge is currently a large shareholder in both Resolute Energy and Carrizo Oil & Gas, and has filed a 13D in Carrizo. This piece is not intended as a specific plan for either Resolute or Carrizo, but is meant as a general illustration of the potential uplift from zero-premium deals.
[2] Source: Sector Select SDPR research as of 3/31/18. Of the 10 major sectors tracked, energy was the worst performer over 3-, 5- and 10-year periods.

Sub-Scale – A Look at the Permian

There are more than 40 public companies with acreage in the core of the Permian Basin (both the Delaware and Midland sides). We are particularly focused on sub-scale companies defined as having less than 100,000 acres to develop.

Exhibit 1: Permian Acreage by Public Company



Source: Corporate Reports
Note: Green bars reflect companies included in the merger analysis (see below)

We have collected detailed information on 15 E&Ps with core acreage within the Delaware Basin. Two of these, Parsley and Diamondback have large Midland positions in addition to their Delaware positions and are scale players with the ability to be future consolidators. Both have grown through a combination of organic and acquisitive growth (Parsley acquired Double Eagle in 2017, Diamondback acquired both Brigham and Luxe in 2016). However, the other 13 companies, all public, lack scale and clear paths to growth. Combined, the 13 companies control nearly a million acres of core Permian acreage. However, each of these companies alone is too small to lead a consolidation effort.

Table 1: Sample of 15 Public E&Ps with Core Delaware Acreage

Ticker	Name	Enterprise Value	Permian Acreage	Multi-Basin or Permian Pureplay	EV/EBITDA
		$Bn	*Midland + Delaware*	*MB / PPP*	*2019 Est.*
PE	Parsley	12.9	215,000	PPP	7.6x
FANG	Diamondback	14.6	188,719	PPP	7.3x
EGN	Energen	7.3	148,987	PPP	5.5x
LPI	Laredo	3.1	124,382	PPP	4.6x
MTDR	Matador	4.5	117,500	MB	7.5x
SM	SM Energy	5.1	82,500	MB	4.4x
CDEV	Centennial	5.9	80,100	PPP	6.6x
JAG	Jagged Peak	3.1	77,700	PPP	5.5x
HK	Halcon	1.0	60,216	PPP	3.0x
PDCE	PDC Energy	5.1	60,000	MB	4.4x
CPE	Callon	3.5	57,481	PPP	6.1x
CRZO	Carrizo	3.8	38,600	MB	4.5x
AXAS	Abraxas	0.6	25,607	MB	4.4x
REN	Resolute	1.4	21,000	PPP	3.4x
ROSE	Rosehill	0.4	11,150	PPP	1.7x

Source: Bloomberg and Corporate Reports

Bigger is Better – Why?

In shale plays like the Permian, there is significant industrial logic to being bigger. The major reasons are better oilfield service pricing, leverage on completions and drilling, more efficient use of services, the ability to drill longer laterals and lower per barrel and footage completed costs of overhead and other fixed costs.

The first, improved service pricing, is the most obvious. If you are an important customer for Halliburton or Schlumberger, they will offer you better pricing. They will also send better crews to work for you, which over time will lead to lower well costs through the avoidance of errors, delays and sub-par execution. It's not just the big service companies whose pricing will improve. Large producers have more influence in negotiating takeaway contracts and pipeline agreements.

Second, consolidating overlapping acreage positions has significant advantages in lowering operating costs. By controlling larger contiguous land positions, operators can drill longer laterals, and at the margin execute more of their drilling through the efficient use of super pads, thereby lowering the cost per foot drilled and completed. Larger overlapping land positions also facilitate the optimization of infield gathering infrastructure and by being in a position to dedicate larger acreage positions, better midstream contracts can be obtained, thereby improving market access and lowering differentials.

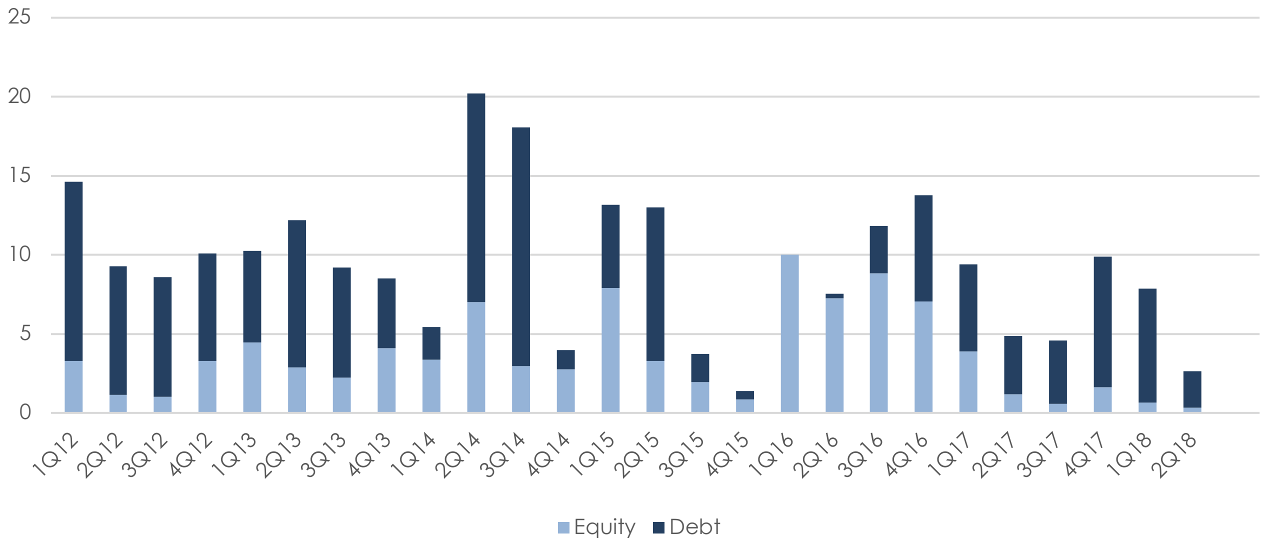
Third, in horizontal development, flexibility is helpful. Smaller companies can end up paying frac crews or drilling crews to remain on standby if the next well or frac isn't ready. Having a larger number of active rigs means resources can be balanced across the portfolio on an as-needed basis to reduce wait times and mobilization and demobilization costs.

Fourth, there are many overhead functions that are required even if a company is running only a single well. Some of these are administrative, like back office accounting, division orders and title opinions. Others are technical. E&P companies need operational geologists and engineers and these people are able to acquire more experience if they see a larger activity set. It is very hard to become the most efficient driller in a basin as a company that operates only a few rigs for a limited drilling program.

Capital Markets – Unlikely to Be the Solution

If bigger is better, the question is how can small companies grow? Over time, the growth solution for companies that lack scale has been to tap the capital markets and either outspend cashflow to grow volumes or make acquisitions. However, primary issuance of equity for E&Ps has dried up considerably in the past few quarters. Although there have still been a few high yield offerings, for many of the companies in our universe, debt levels are already stretched and more high yield issuance is not an option.

Exhibit 2: Primary Capital Raised by E&P by Quarter (2Q18 is partial)

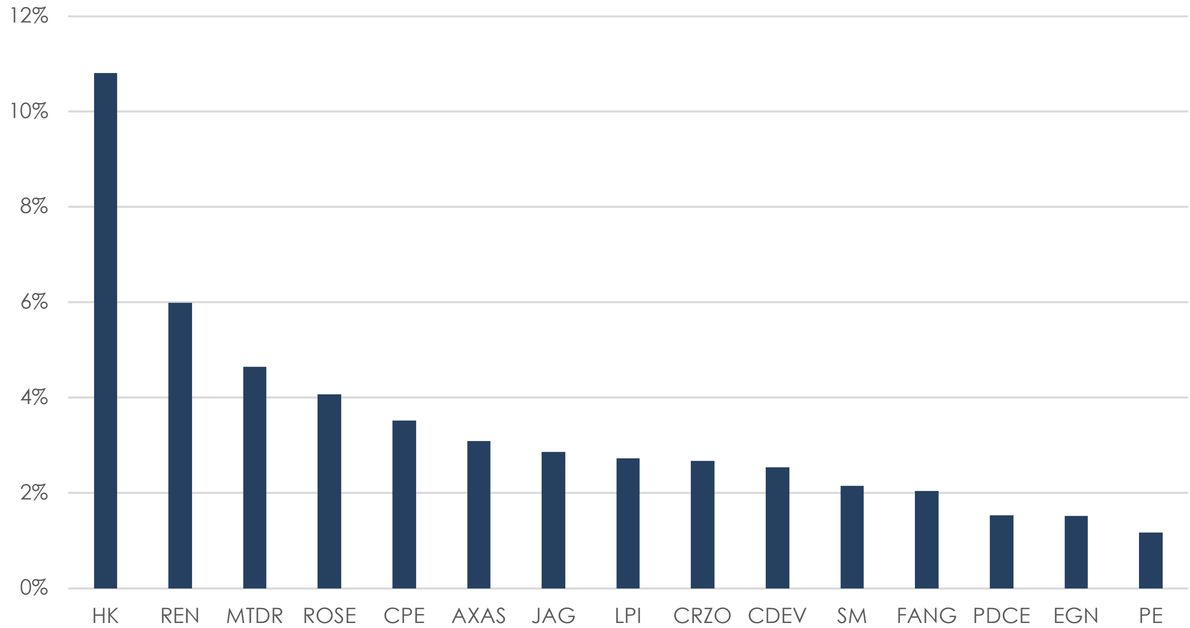


Source: Bloomberg, Corporate Reports, Dealogic

Management – A Source of Obstruction and A Source of Value

Another reason it's hard to run a small E&P is that compensation of top executives eats up too large a proportion of operating cashflow. Compensation of the top executive officers as disclosed in the proxy statements is over 25% of SG&A for half of this peer group. For the smaller companies, this means that top executive pay is a significant portion of EBITDA (and unlike revenues, not subject to movements in commodity pricing). For 12 of the 15 companies, top executive pay is over 2% of EBITDA and for four companies it's over 4% of EBITDA.

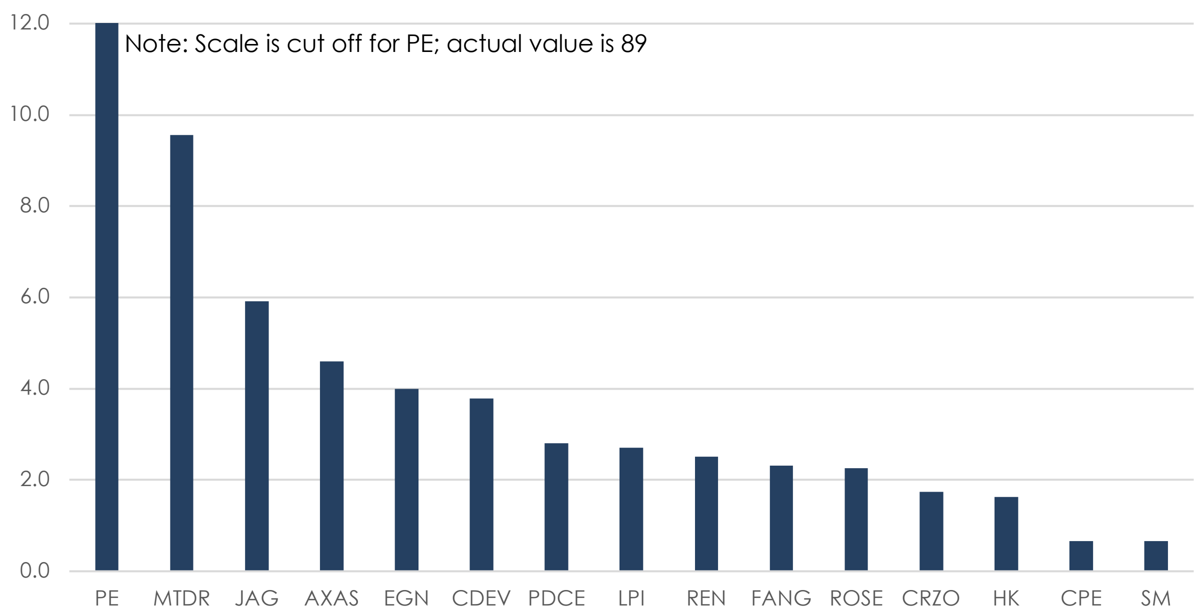
Exhibit 3: Total 2017 Named Executive Officer Compensation as a % of 2018 Consensus EBITDA



Source: Bloomberg and Corporate Reports

Perversely, management at the smaller companies is less aligned with shareholders than at the larger ones. For 9 of the 15 sub-scale companies, as told in the proxy statements, the ownership stake of the named executive officer group is less than three years' annual compensation. With a multiple like that, the value of the job is much greater than the value of a premium uplift on a sale. (The one notable exception to this is Parsley, where the management team owns 13% of the company, which works out to 89x times their annual compensation.)

Exhibit 4: Named Executive Officer Stock Ownership as a Multiple of Total 2017 Compensation



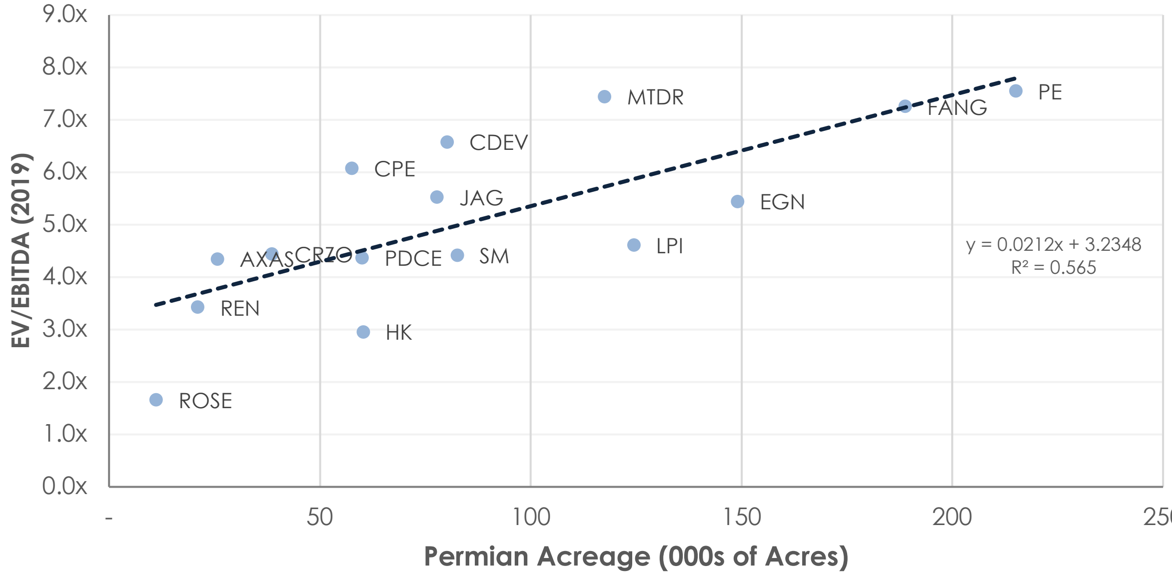
Source: Bloomberg and Corporate Reports

The combination of modest stock ownership and high annual compensation is why management teams are not clamoring for mergers with other public companies in which many of them risk losing their jobs. However, for shareholders, removing a redundant management team (and its contribution to SG&A) is also one of the main synergies in a merger.

Translation to Valuation – Size Versus Multiple for Permian Pure Plays

Their small scale, inability to grow, and bloated C-suites yield an unsurprising result – small companies are valued at a significant discount to larger ones. In Exhibit 5, we plot Permian acreage versus the EV/EBITDA multiple for the group of 15 Delaware public companies. The trendline is clear and linear – bigger is more highly valued. The difference between owning 200,000 Permian acres, where forward multiples are over 7x, and owning 50,000 Permian acres, where forward multiples are closed to 4.3x, is a premium of 80%.

Exhibit 5: Plot of EV/EBITDA (Consensus 2019 forecast) versus Core Permian Acres (Delaware and Midland)



Source: Bloomberg and Corporate Reports

The 80% premium illustrates why the larger companies could acquire some of the smaller ones at 20-30% premiums and have the transactions still be highly accretive on EBITDA multiples.

However, It's a Multi-Step Process

To look at the actual value uplift from zero-premium mergers, we consider three model Permian companies.

- Alpha Company has 40,000 acres, Beta Company has 60,000 acres and Gamma Company has 100,000 acres.
- Alpha has an EV of $2Bn, Beta is $3Bn and Gamma is $6Bn.

- Each company trades at the implied EV/EBITDA multiple derived from Exhibit 5 above, based on the relationship between size and valuation. Each company has debt of 25% of EV at the outset. The basic numbers are shown below.

Table 2: Illustrative Example of Three Permian E&Ps

	Permian Acres	EV / EBITDA	EV	Debt to Cap	Debt	Market Cap	EBITDA
	Net		*$Bn*	*%*	*$Bn*	*$Bn*	*$MM*
Alpha	40,000	4.1x	2.0	25%	0.5	1.50	490
Beta	60,000	4.5x	3.0	25%	0.75	2.25	666
Gamma	100,000	5.4x	6.0	25%	1.5	4.50	1,120

Source: Kimmeridge Analysis

The first zero premium merger would be between company A and B. Our only assumptions for value increases are that EBITDA increases by 2% for the combined company, due to reductions in senior management, and that the multiple increases to the appropriate multiple for a 100,000-acre company. This yields an equity uplift to shareholders of Alpha and Beta of 35% each.

Step 1 – Combine Alpha and Beta to form AB Company

EBITDA Increase 2%

	Permian Acres	EV / EBITDA	EV	Debt to Cap	Debt	Market Cap	EBITDA
	Net		*$Bn*	*%*	*$Bn*	*$Bn*	*$MM*
AB Company	100,000	5.4x	6.3	20%	1.25	5.06	1,179

Value to Original Shareholders	Split	Market Cap	Uplift
Alpha	40%	2.02	35%
Beta	60%	3.04	35%

Source: Kimmeridge Analysis

Note that because of the value uplift, the new debt-to-cap of the merged company would fall to 20% from 25% initially. The combined market cap of AB would now be just over $5Bn.

The next step would be to take this merged company, AB, and combine it with Gamma Company on a zero-premium basis, yielding a 200,000-acre company. Like the first merger, we assume a 2% increase in EBITDA for the new combined company versus its predecessors, and a multiple uplift commensurate with its increase in size. At its new multiple of 7.5x, the company of ABC Corp would have an EV of $17.5Bn and a market value of $15Bn. The uplift to Gamma shareholders would be 55%, and the cumulative uplift of both mergers to shareholders of Alpha and Beta would be 109% upside.

Step 2 – Combine AB Company and Gamma

EBITDA Increase 2%

	Permian Acres	EV / EBITDA	EV	Debt to Cap	Debt	Market Cap	EBITDA
	Net		*$Bn*	*%*	*$Bn*	*$Bn*	*$MM*
ABC Corp	200,000	7.5x	17.5	16%	2.75	14.78	2,345

Value to Original Shareholders	Split	Market Cap	Uplift
Alpha	21%	3.13	109%
Beta	32%	4.69	109%
Gamma	47%	6.96	55%

Source: Kimmeridge Analysis

Conclusions

The challenges facing small E&Ps are stark. They have no path to grow other than to hope that commodity prices rise, which is not a strategy. Equity capital is in short supply, and compensation of top executives is a significant drag on cashflow. As a result, these companies trade at heavily discounted multiples versus their larger peers, despite owning good assets in core areas. Small companies can seek, and may find, deals at premiums of 20-30% in an acquisition by a much larger peer, but a far more valuable and executable strategy would be to merge with similarly sized companies on a zero-premium basis. Through one or two such turns, companies could scale into materially larger companies trading at much better valuations. The upside of 50-100% or more from these transactions would far exceed what could be negotiated in a singular sale.

There are strong institutional impediments to effectuating zero-premium mergers. Board members don't want to be seen as having given up control for an insufficiently large premium and management teams are not incentivized to sell companies, but rather, to keep running them. The push will need to come from shareholders.

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