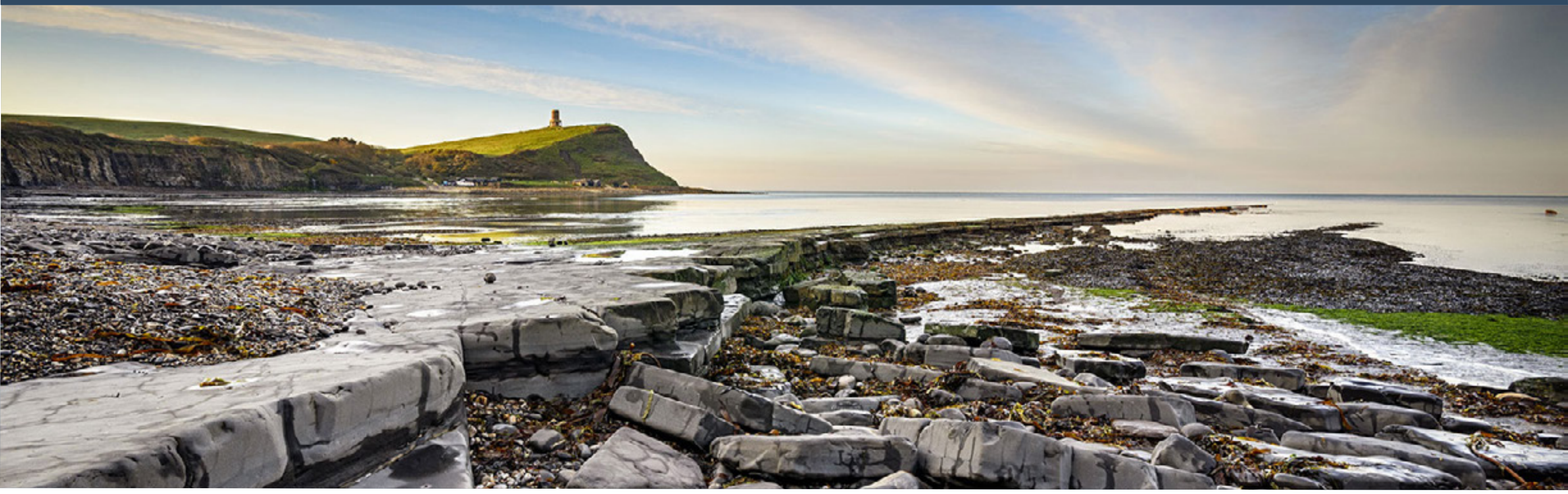

I Still Haven't Found What I'm Looking For

Kimmeridge

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Introduction

The US E&P sector continues to suffer from a supply and demand imbalance. There are too many public companies relative to the degree of investor interest. This imbalance results in depressed valuations as investors arbitrage away small differences amongst increasingly commoditized business models. Scarcity value drives equity market premiums but the only observable scarcity premium is found in companies over $20 billion of market capitalization.

Shale was once a game for smaller companies. The ability to be nimble was an advantage. However, as the industry has transitioned to development mode, the benefits of scale have emerged. Beyond the apparent advantages related to service pricing, overhead costs and operating efficiencies, gaining scale adds new levers to best position the company. Such levers include investing in emissions reductions, obtaining investment grade ratings that are required for connectivity to global gas markets and accessing larger data sets in a world seeking to capitalize on AI. If public shale producers are tasked with delivering the lowest cost and lowest carbon intensity barrel, it is becoming increasingly challenging to compete as a smaller company.

The logical outcome should be that large companies acquire small companies or that small companies combine. Nevertheless, consolidation has yet to meaningfully occur. While disheartening, we cannot say we are all that surprised. In our earlier white paper, "US Upstream M&A: Like Turkeys Voting for Christmas," we warned that the primary impediment to consolidation is management and board incentives. Public company CEOs and directors are rarely incentivized to relinquish their jobs, especially in a mature sector with a diminishing opportunity set for them.

When faced with an entrenched board or management team, the acquiring company merely gives up. These acquisitive buyers typically turn to the private markets where there are more motivated sellers given the natural alignment of the ownership structure. However, the number of high-quality private companies remaining is dwindling and most public companies are at a crossroads: consolidate or continue too far down the road to irrelevancy. This industry has historically shied away from hostile deals, but drastic times call for drastic measures. **If there is a rational, strategic deal being thwarted by an entrenched CEO or board, it should be made public so that the real owners of the business are finally given a voice on the future of the company.**

Admittedly, public consolidation is inherently challenging. There is no perfect deal, but perfection should not be the enemy of good. This paper outlines a framework for increasing the probability of success with four guiding principles and illustrates how these principles can be applied in practice by referencing several recent deals in the sector.

1) Proper differentiation between a merger and an acquisition

2) Valuations that reflect relative inventory depth and quality

3) **Material and credible synergies that include environmental considerations**

4) **Understanding and communicating the potential impact on the cost of capital**

Ultimately, given the lack of progress in addressing the alignment issues between investors and boards, this paper makes the case for publicizing unsolicited offers.

The Case for Public Consolidation

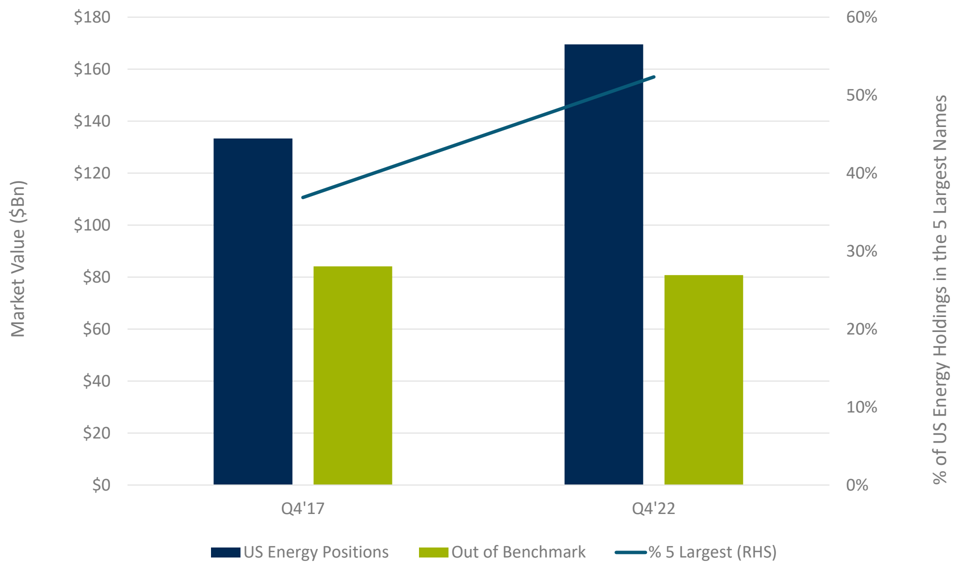
For many institutional investors, 2022 was the year they rectified their multi-year underweighting to the US Energy sector. However, the composition of that positioning looks very different than it has historically. Analyzing the 13F data for five of the largest active managers, we can observe several notable trends in their US Energy holdings since 2017, such as:

1) US Energy holdings rose 27% from $133 billion to $170 billion by the end of 2022

2) Holdings in the five largest Energy companies in the S&P 500 (XOM, CVX, SLB, COP and EOG) expanded from 37% to 52% of US Energy holdings

3) Holdings in US Energy companies outside the S&P 500 index – which we refer to as “out of benchmark” – declined on a relative (25% to 17%) and absolute basis (-19%) despite a material reduction in the number of companies included in the index (32 to 23)

Figure 1: US Energy Holdings by Market Value for Capital Group, Fidelity, JP Morgan, T. Rowe Price, and Wellington Management



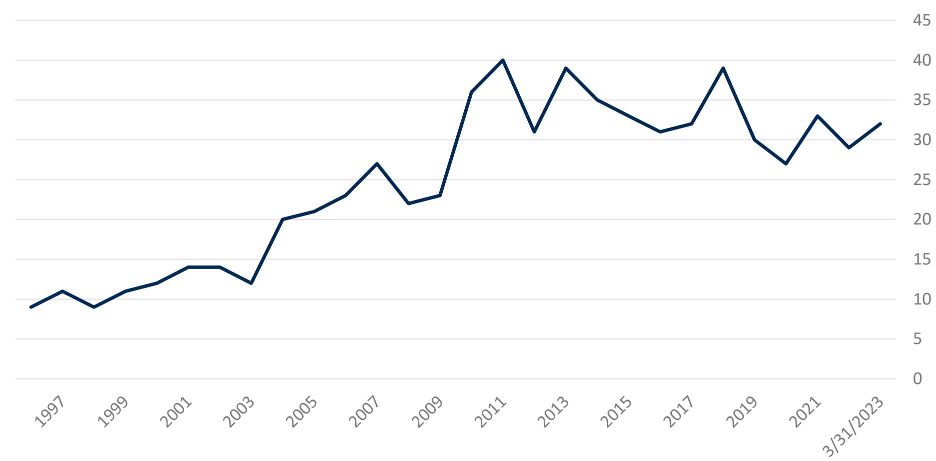
Source: Bloomberg

The eternal hope amongst smaller companies has been that investors would ultimately return when the commodity cycle recovered. In 2022, WTI oil prices averaged $94/bbl, Henry Hub gas prices averaged $6.65/mcf and institutional investors gravitated to larger companies. We ascribe the higher concentration in the largest companies and the shift away from out-of-benchmark names to a combination of factors:

- In an inflationary environment, chasing the impact of commodity prices ("beta") is prioritized over the search for generating excess returns ("alpha")
- Downsized investment teams lack bandwidth and specialization in the wake of asset manager capitulation on the Energy sector
- A greater appreciation for the benefits of scale as the shale industry matures
- An emphasis on ESG engagement and impact has narrowed the focus to fewer high-profile names
- A tendency for asset managers to "rent" versus "own" the sector where size and liquidity are critical for an anticipated exit

Furthermore, at a time when investors are de-emphasizing smaller companies, the number of US listed upstream companies between $1 - 10 billion remains elevated versus history. Since 2013, the number of US E&P companies in that market capitalization range has only declined 18% compared to 45% for companies above $20 billion.

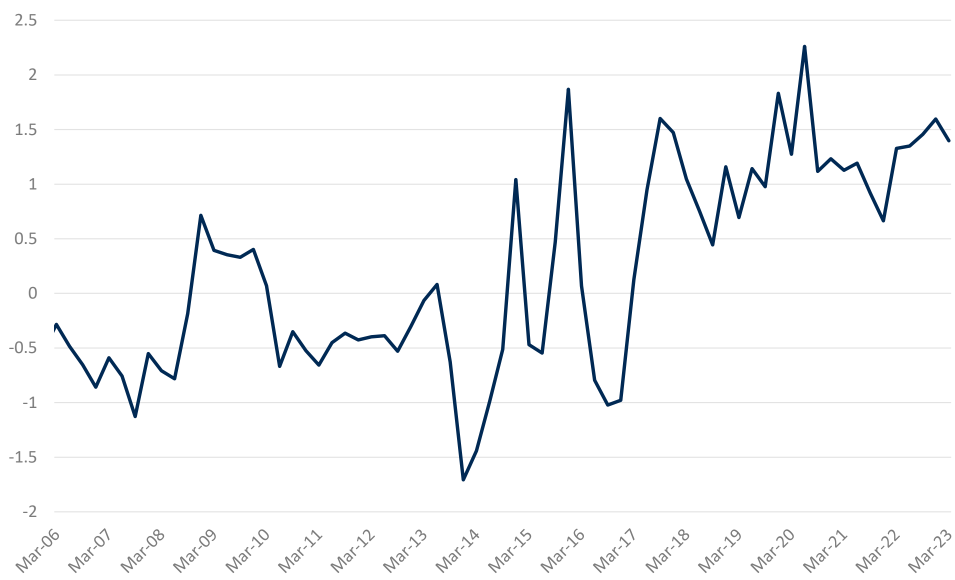
Figure 2: Number of US Listed E&P Companies between $1 - $10 Billion (GICS classification)



Source: Bloomberg

As a result of the growing imbalance between supply and demand, we are witnessing greater dispersion in valuations based on size.

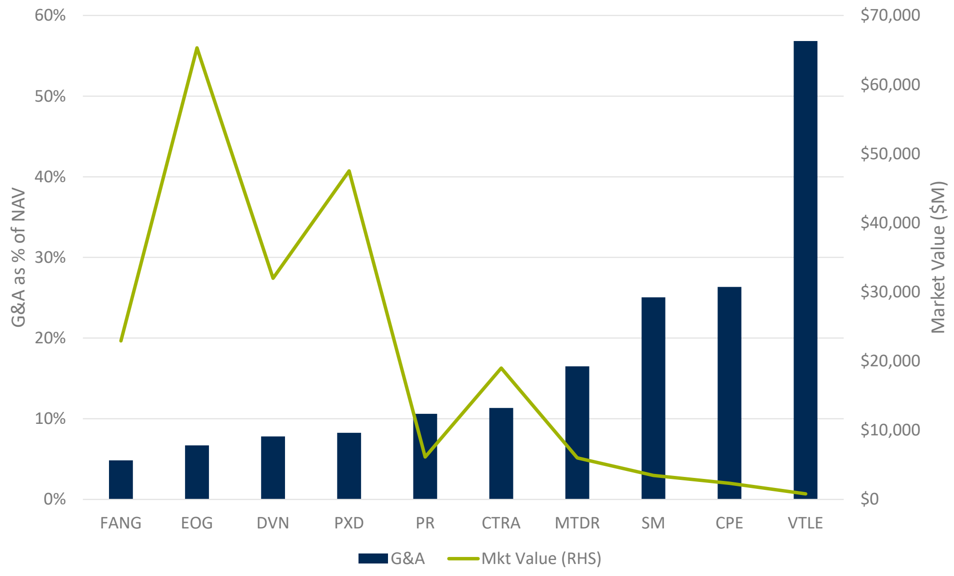
Figure 3: Spread in EV/EBITDA (FY+1) Multiples for S&P 500 E&P vs. S&P 400 E&P Indices



Source: Bloomberg

The natural reaction to a growing premium between large and small-cap stocks should be an acceleration of M&A activity where larger companies take advantage of their premium or smaller companies look to combine. Smaller companies also tend to be disproportionately burdened by overhead costs, as demonstrated by the graph below, so the synergy potential is more meaningful.

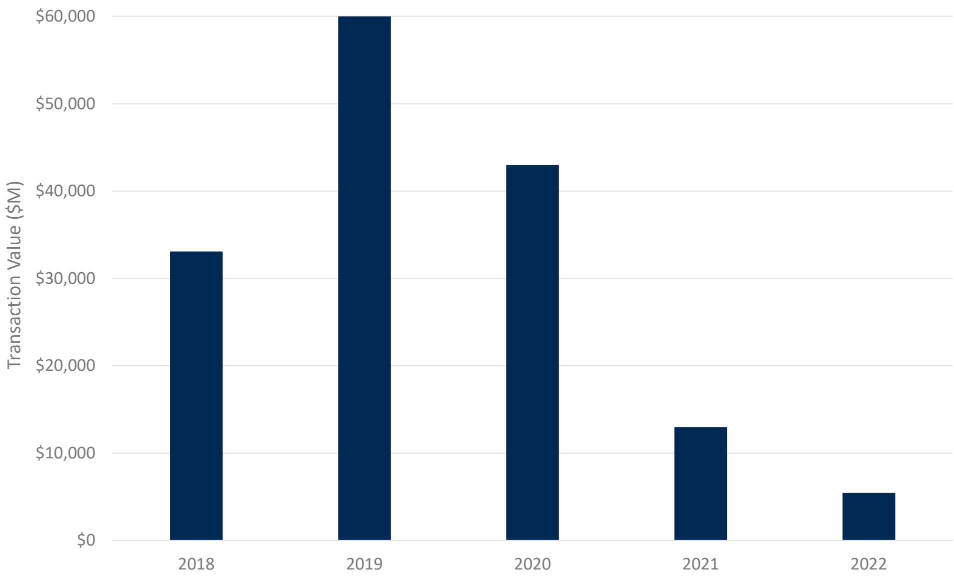
Figure 4: Future Expected G&A as % of Net Asset Value for Permian Producers



Source: Enverus

However, we have yet to see an inflection in deal activity. In fact, public-to-public consolidation reached its lowest in the last five years during 2022.

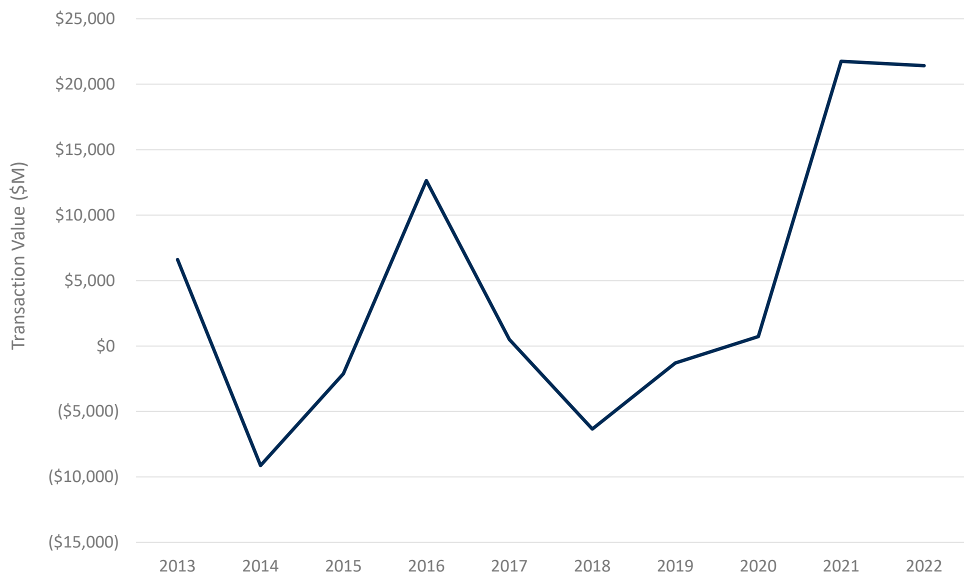
Figure 5: Public-to-Public Upstream Merger Transaction Value



Source: Enverus, Bloomberg and Company Filings

Instead, the industry has seen a notable uptick in public companies buying private assets. In 2022, there were $33.3 billion of transactions with public buyers and private sellers compared to $11.8 billion with private buyers and public sellers. This represented the second consecutive year where public companies were net buyers of over $20 billion of private assets. Not only was there a 3:1 ratio between buying and selling during a period of elevated commodity prices, but the percentage of the transaction value financed with equity dropped from 55% to 35% in 2022. These deals are inherently riskier because of the timing component associated with largely paying cash and can be seen as another example of the pro-cyclical behavior that has historically plagued this industry.

Figure 6: Public Buyer/Private Seller vs. Private Buyer/Public Seller



Source: Enverus

Other challenges with private transactions are the lack of meaningful synergies in the context of lower overhead costs, as well as opaque valuations in the absence of proper public disclosure. Private operators have increasingly looked to maximize short-term production to justify accretion based on a next twelve-months (NTM) EBITDA multiple. The acquiror subsequently guides to a cut in rig activity to maximize short-term free cash flow. Finally, a series of non-GAAP measures are sprinkled in to enhance the perception of the deal, including PV-10 metrics that are not comparable to the SEC standardized measure of oil and gas. In 2022, it also became popular to imply accretion by comparing hedged vs. unhedged EBITDA in a single year or relying on per share metrics in largely cash deals. These are all relatively meaningless metrics in the context of shareholder value creation. At a minimum, investors should be afforded a reconciliation of the impact on the SEC standard measure, proved developed reserves, underlying decline rate and future development capital required to sustain production.

Framework for Successful Public Consolidation

The benefits of public consolidation where there are greater redundancies, as well as regulated disclosure on both sides of the transaction are generally underappreciated by investors. We attribute this to a history of failed deals that have cast a shadow over the industry and tempered investor enthusiasm for further consolidation. With that perspective, we outline a framework that we believe will increase the probability of success and highlight some of the missteps of the past.

1) Proper differentiation between a merger and an acquisition

The terms “merger” and “acquisition” are often used interchangeably but are fundamentally different outcomes. A merger effectively creates a new company through the combination of similarly sized businesses that often entails some degree of integration of the board and management team. In an acquisition, a larger company simply absorbs a smaller one. In our 2018 white paper, “Zero-Premium Mergers: A Proposal for Public E&Ps,” we argued that “smaller E&P companies should seek to consolidate with similarly sized companies, ideally on a zero-premium basis.” The key variable in the zero or low-premium merger equation is the premise of “similarly sized” companies. The assumption is that the advantages of greater size and scale accrue equally between the companies. However, if a smaller company is being acquired by a much larger company where the ownership split is wider than 65%/35% and the benefits for the selling shareholders are diluted, then a higher premium *is* warranted.

Many investors scratched their heads at PDC’s recent sale to Chevron for what amounted to an 11% one-day premium. While this looks like a great deal for Chevron given the valuation arbitrage and operational overlap in the DJ Basin, we struggle with what the PDC board and management team achieved for its shareholder base apart from swapping into a more diversified company with a lower beta to commodity prices. This is something shareholders could have easily done themselves and PDC effectively crystallized the lowest multiple in the sector.[1] Importantly, with PDC representing less than 3% of the combined enterprise value, any benefits from the operational synergies in the DJ basin assets will be diluted within the broader organization. We contrast this to the successful merger between Oasis and Whiting in 2022, where the single-digit premium and 53%/47% ownership split allowed the anticipated synergies from their adjacent operations in the Bakken to accrue evenly to both sets of shareholders.

2) Valuations that reflect relative inventory depth and quality

The fundamental outlook of a company should be captured in its relative valuation. Within upstream oil and gas, the depth and quality of a company’s remaining inventory is often the primary driver of its relative valuation amongst a peer group of similarly sized companies. Therefore, any analysis of accretion or dilution must be made through the perspective of asset quality.

The merger between Cabot and Cimarex in May 2021 has been widely criticized by investors and sell-side analysts. At a high level, the lack of operational synergies between Permian and Marcellus producers was challenging, but the primary issue was relative valuation. Leading up to the merger announcement, there was a growing appreciation for the differentiated depth of Cimarex’s low-cost Permian inventory as well as the increasing maturity of Cabot’s Marcellus position. Despite deteriorating well productivity, Cabot still traded at a premium multiple, largely based on its historical track record of capital discipline and free cash flow generation. No longer

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[1] Capital One weekly valuation summary following the deal announcement (5/24/23) shows that PDCE trades at the lowest 2024 EV/EBITDA multiple amongst the 33 E&P companies in their coverage universe at 2.5x

[2] Heikkinen Energy Advisors Research Note dated 5/24/21

possessing a differentiated business model and veering towards a blow-down case, Cabot was at risk of a further de-rating and made the prudent decision to merge. The key question is why Cimarex would participate in such a dilutive transaction. As one sell-side analyst wrote at the time, "terrible deal for XEC" and "we don't like combining a higher multiple, lower inventory Cabot with a lower multiple, higher inventory Cimarex."[2] According to the S4 filing, one of the ways that Cimarex's board justified the near-term dilution was Cabot's "longer-lived PDP reserve contribution." Just over a year after closing, however, the surviving company (Coterra) announced an expected 32-36% decline to its proved Marcellus reserves. Almost unprecedented in its magnitude, the massive reserve write-down further amplified the relative mispricing of the deal as it largely negated the difference in proved developed reserve life between the companies. That deal may have been an extreme example of when inferior asset quality afforded a premium multiple, but it highlights the importance of focusing on long-term asset quality.

When companies announce a deal, they should communicate the valuation accretion and dilution through the lens of inventory depth and quality. Importantly, companies should not be reluctant to pay through their near-term multiple if it enhances the depth and quality of their inventory.

3) Material and credible synergies that include environmental considerations

Investors are naturally cynical of merger synergies. Apart from headcount reductions, operating efficiencies and capex savings are more difficult to quantify in advance. As a result, companies typically provide limited details at deal announcements and fail to track their progress relative to their targets. In a recent report, "Beyond G&A: Maximizing Synergy from Oil and Gas Mergers," McKinsey argues that "there is a lost opportunity here for firms to raise their synergy aspirations and look beyond G&A, as M&A deals pursued for operational synergies typically outperform those based on G&A savings." They also found that "companies that announced synergy targets outperformed those that did not by an incremental 7 percent TSR over a median of two years."[3] The market tends to reward deals with material synergy announcements, but it requires credibility – credibility involves transparency, which boards and management teams are often reluctant to provide investors. Comparing three similarly sized Permian mergers below, we highlight the important differences in how synergies were communicated:

Date	Buyer	Seller	Deal Value ($Bn)	7 day Premium %	Premium ($Bn)	PV of Deal Synergies ($Bn)	PV as % of Premium	% G&A/ Interest	Timeline for Operational Synergies
3/28/2018	Concho	RSP Permian	$9.5	27%	$1.6	$2.0	124%	25%	N/A
8/14/2018	Diamond-back	Energen	$9.2	18%	$1.3	$2.3	180%	28%	Early '20
10/20/2020	Pioneer	Parsley	$7.9	10%	$0.4	$2.0	482%	54%	YE'21

[3] https://www.mckinsey.com/industries/oil-and-gas/our-insights/beyond-g-and-a-maximizing-synergy-from-oil-and-gas-mergers

From 2018 to 2020, Concho, Diamondback and Pioneer each announced deals where the advertised synergies carried a present value of around $2 billion. While material relative to the size of each transaction, there were fundamental differences in the composition and credibility of those synergies. The Concho/RSP Permian deal was the most challenged given the forecasted synergies were largely offset by the premium paid. It carried the lowest percentage of synergies attributed to direct corporate costs and was the least transparent around the drivers and associated timeline for the operational synergies. The Diamondback/Energen deal had a similar reliance on operational synergies but was afforded a larger cushion through the lower premium paid and transparency they provided to investors. They shared a reconciliation of the development costs per foot between the two companies and a timeline to achieve the cost savings. The Pioneer/Parsley deal screens most favorably given the ~5x ratio between the expected synergies and the premium paid with over 50% of the savings coming from direct corporate costs. However, given market conditions in October 2020, that deal should likely be viewed as an outlier that will be difficult to replicate.

We recommend companies communicate any deal through the ratio of synergy value to the premium paid and quantify the specific drivers of operational synergies rather than rely on generic statements regarding economies of scale, efficiency gains and shared infrastructure. We also believe it is increasingly important to build the narrative around the environmental impact of consolidating operations with specific emissions reduction targets. In our 2022 white paper, "Why Net Zero Should Be the Standard for the E&P Sector" we highlight how consolidation could play a vital role in improving the emissions profile of the industry while reducing the associated costs through various measures:

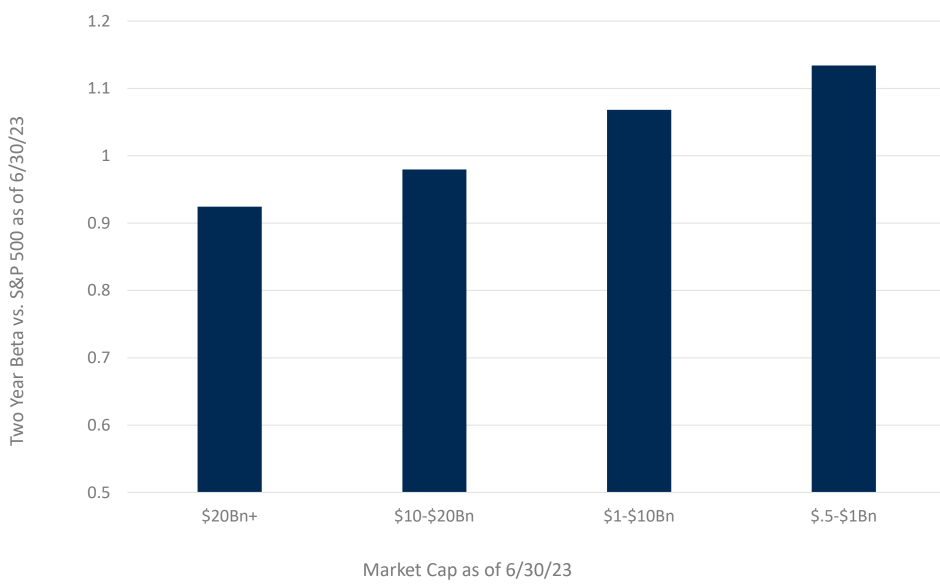
- Reducing flaring through shared facilities
- Eliminating redundant truck traffic and its associated emissions
- Drilling fewer wells by accessing longer laterals
- Capitalizing on scale for operational electrification and field digitalization
- Participating in large-scale, low-cost inset projects

Companies should undertake this analysis as part of their due diligence process so that it can be effectively quantified and communicated to investors upon deal announcement.

4) Understanding and communicating the potential impact on the cost of capital

Companies rarely speak to their cost of capital and if they do, it is strictly around their cost of debt. The cost of equity is often overlooked and underappreciated. The "beta" or volatility of the equity relative to the broader market is a critical component within any valuation construct as it quantifies the premium required over the risk-free rate to justify an investment. While forecasting the future volatility of a company's equity is challenging, there is overwhelming evidence that larger companies trade with a lower beta. In analyzing the E&P constituents in the Russell 3000 index, we found a consistent relationship between the market cap and beta of the underlying equity:

Figure 7: Historical Two-Year Beta vs. Market Cap Ranges for Russell 3000 E&P Companies



Source: Bloomberg

In discussing the merits of a merger, companies should speak to the objective of lowering the volatility of their share price, as well as the potential for any credit rating changes and equity index inclusion. Empirical evidence demonstrates that ETF index inclusion can drive higher share prices and enhanced liquidity.[4] With an understanding that the timing and predictability of index inclusion is uncertain and beyond the control of the company, companies could provide comparability across key metrics typically used for inclusion relative to peers on a post-merger basis. Furthermore, the benefits of an investment grade rating extend beyond lower borrowing costs, as more companies look to sign long-term gas supply agreements to gain exposure to LNG net-back pricing. However, of the 52 E&P companies within the Russell 3000 index, only 11 currently have an investment grade rating.

In many ways, the merger between Devon and WPX was a model example of successful US shale consolidation with a low-premium merger of similarly sized companies with offsetting operations in the Permian. Devon came into the deal already included in the S&P 500, but it ranked as the ninth largest oil producer out of 10 E&P companies. Following the merger, the combined company moved up to number three, building scale and relevancy. From an equity valuation standpoint, the company experienced multiple expansion within a year of the deal closing compared to multiple contraction for the broader S&P 500 E&P index. Not surprisingly, the relative multiple expansion coincided with a decline in the beta to the S&P 500 E&P index. Prior to the

[4] Duffy, John and Friedman, Daniel and Rabanal, Jean Paul and Rud, Olga, The Impact of ETF Index Inclusion on Stock Prices (May 24, 2022)
Baran, Lindsay, and Tao-Hsien Dolly King. “Cost of Equity and S&P 500 Index Revisions.” *Financial Management,* vol. 41, no. 2, 2012, pp. 457–81.

deal, the two-year beta for the companies was 1.26x, which fell to 1.12x for the two years following the closing of the deal.

EV/EBITDA (NTM)	Day Prior	Year Post Close	Change
WPX	4.18x		
DVN	4.24x	5.14x	0.9
S&P 500 E&P	5.64x	4.68x	-1.0

Source: Bloomberg

On the debt side, WPX benefited from Devon's investment grade rating and immediately saw its bonds trade from yielding 6% to 4%:

YTW (mid)	Day Prior	Day of Merger	Year Post Close
WPX 9/15/24	6.0%	4.0%	2.7%
DVN 12/15/25	3.2%	3.2%	2.2%

Source: Bloomberg

In contrast, Occidental's (OXY) $58 billion acquisition of Anadarko (APC) in May 2019 was one of the most ill-fated deals in recent history. Not only did OXY pay a 62% premium, but also the deal carried a 78% cash component. OXY's long-term debt increased from $10 billion to over $35 billion by the fourth quarter of 2019 while the net debt/EBITDA ratio ballooned from less than 1x to over 3x. OXY was inadequately prepared for the sell-off in oil prices in March 2020 and experienced a credit downgrade to junk status by all three major rating agencies. One year after closing the deal, OXY's share price had fallen by 67%, almost twice the decline of the S&P 500 Energy index. With a high-premium, large cash component deal that jeopardized the balance sheet, OXY's management team and board failed to account for the unpredictable nature of commodity prices. The hope is that OXY's near-death experience serves as an enduring lesson for the industry in taking such a cavalier approach to the potential distribution of outcomes around the future cost of capital.

You Say You Want a Revolution

The US shale industry has evolved and should be commended for transforming its business model. Public E&P companies have prioritized capital discipline and accelerated the return of capital while increasingly embracing the importance of net zero emissions from their operations. Nevertheless, they have failed to address the underlying issues of shareholder alignment that are impeding public company consolidation.

In our 2020 white paper, "Bringing Alignment and Accountability to the E&P Sector" we offer several recommendations such as increasing CEO change of control payments with restricted stock in the combined company, equity-only director fees and ownership thresholds based on board tenure. Companies such as Civitas and Sitio

Royalties, where Kimmeridge was instrumental in instituting governance practices, established director term limits, zero cash retainers and mandatory hold periods for the duration of board tenure. However, the rest of the industry has been reluctant to follow. Boards are generally far too complacent and unwilling to deviate from the pack. They also often misinterpret the passive nature of their largest shareholders as tacit support for their governance practices. Certainly, the lack of alignment within public boards is not sector specific, but entrenched boards and management teams in the Energy sector benefit from the pervasive opposition to hostile deals.

While potentially messy, hostile deals are the most direct way to hold an entrenched board or management team accountable. In 2010, French pharmaceutical company, Sanofi-Aventis, was interested in acquiring the biotechnology company, Genzyme, but Genzyme's CEO of nearly three decades rebuffed the overture without any discussion of valuation. Sanofi followed up with a written proposal to the board outlining a $69 per share offer, representing a 27% premium. The offer was rejected. Sanofi publicized the offer, which Genzyme publicly rejected the next day. Without any guidance around a potential deal price from Genzyme's CEO or board, Sanofi made a tender offer directly to Genzyme's shareholders. After several months during which Sanofi extended the tender offer, Genzyme agreed to due diligence and reached a basic agreement around deal terms. Genzyme's shareholders ultimately accepted a bid of $74 per share plus contingencies on post-acquisition performance.[5] The public nature of the transaction provided Sanofi with the necessary leverage to overcome a high degree of entrenchment while Genzyme shareholders were afforded the appropriate degree of price discovery. Genzyme was forced to make the case for why it was more valuable as a stand-alone company while simultaneously providing an opportunity for any competing offers.

Given the potential benefits of going public, why aren't hostile deals more popular? As highlighted in the 2020 article, "The Comeback of Hostile Takeovers," unsolicited takeover offers for US companies fell from 160 in 1988 to 15 by 2019. The author offers several potential reasons for the decline in hostile activity since 2010:[6]

1) *Board-friendly case law on takeover defenses*

2) *Antitrust concerns amongst companies with large market shares that would require cooperation*

3) *An 11-year bull market that drove up valuations and made target companies too expensive to acquire*

In the context of #2 and #3, the US E&P sector is relatively advantaged given the fragmented nature of the industry and dislocated valuations relative to both history and the broader market. From that perspective, there should be an even greater rationale for hostile deals amongst smaller producers. While entrenched boards will undoubtedly deploy defensive measures, exposing the façade around their

[5] https://www.reuters.com/article/genzyme-sanofi-timeline/timeline-sanofis-account-of-its-contacts-with-genzymeidUSN0417529520101004
[6] https://corpgov.law.harvard.edu/2020/11/08/the-comeback-of-hostile-takeovers/

governance practices through public disclosure will amplify the case for change. Admittedly, hostile deals carry a higher risk profile given the information asymmetry and challenges associated with quantifying synergies when the target company is uncooperative. Nevertheless, those risks can be mitigated by focusing on in-basin consolidation with overlapping acreage positions where the acquiring company shares intimate knowledge of the assets and operating practices. In essence, it boils down to finding the right deal at the right price, wherein the management team can effectively convey the synergy of "one plus one equals greater than two." If the shareholder base of the entrenched target can be successfully persuaded, then a value-destructive premium can be avoided. To that effect, we summarize our recommendations around deal communication as follows:

- Communicate valuation accretion and dilution through the lens of inventory depth and quality
- Quantify the ratio of synergy value to the premium paid as well as the specific drivers of operational synergies
- Discuss the relative cost of capital and the potential impact from the deal on beta, credit ratings and index inclusion
- Quantify the environmental impact of the combined operations with specific emissions reduction targets

While a company making an unsolicited offer should expect a short-term negative reaction due to the associated uncertainty, we ultimately believe that investor support will rally behind a compelling deal. This industry desperately needs a company that is willing to challenge an entrenched board or management and publicly propose a deal that serves the best interests of both sets of shareholders. All it takes is someone willing to spark the revolution.

Who will take their offer public and give shareholders a voice?

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