BEING PROACTIVE IN A REACTIVE MARKET:
Oilfield services firms have the opportunity to implement sustainable operational efficiency improvements during the downturn

OVERVIEW

Another downturn in the price of oil is upon us, and cost cuts are underway yet again, with one of the hardest hit sub-sectors in the oil and gas industry being oilfield services (OFS). In the last major downturn, OFS companies made cuts to expenses with a broad brush that proved to be unsustainable once demand for oil increased again. In addition to temporary expense cuts, OFS companies began consolidating, with the larger, more efficient companies acquiring those less efficient. However, data shows that perceived gains in efficiency were only temporary, as synergies were lost with time. It is no longer 2008, yet we are again seeing acquisition announcements, as two of the largest OFS companies have become targets for acquisition.

History has shown repeatedly that companies with perceived lower operational efficiencies can be tempting acquisition targets for larger companies. History has also shown that any gains in operational efficiency are often short lived after an acquisition is deemed "complete."

THERE IS AN OPPORTUNITY TO INCREASE OPERATIONAL EFFICIENCY ON A MORE SUSTAINABLE BASIS BY FOCUSING ATTENTION ON CRITICAL PERFORMANCE AREAS. AS WINSTON CHURCHILL SAID, "NEVER LET A GOOD CRISIS GO TO WASTE."

2009-2013: PROSPERITY AND GROWTH

Following the crash of 2008, OFS companies began to experience a period of hyper-growth. Industry growth was mainly driven by a steady increase in worldwide demand for petroleum products, with a sharp increase taking place in 2010. With this growing market demand came an increase in the need for production, while increasing oil prices and advancements in technology allowed E&P companies to financially justify large-scale shale investments. These factors led to a spike in working oil wells, enabling OFS companies to flourish.

LOST OPPORTUNITIES WITHIN MERGERS AND ACQUISITIONS

All too often, post-transaction integration proves to be superficial in nature, with the purchasing company mainly focusing its attention on the newly acquired tangible assets. When comprehensive integration is attempted, momentum often declines quickly and integration teams are delegated to subordinates, or disbanded long before the acquisition's full potential is realized[1]. In either case, the acquired company is integrated with little or no

[1]Haspelagh, Phillippe C., and David B. Jemison. "Acquisitions – Myths and Reality." Sloan Management Review: n. pag. Print

synergies, and minimally implemented improvements to streamline operations. Over the recent boom years, this has been especially true in oilfield services as firms have been almost wholly focused on gaining market share and meeting order demand.

We can see quantifiable examples of lost synergies by looking at three of the largest OFS acquisitions from 2009 to 2013. To measure company efficiency, North Highland utilizes an Operational Efficiency Ratio (OER). OER divides a company's expenses by its total revenue, essentially answering the question: "how much does each dollar of revenue cost?" Consistently using these numbers across each company normalizes the financial data and enables us to accurately compare companies. It is important to note that because this ratio is expense/revenue, a high OER (high expenses/low revenue) is less favorable than a low OER (low expenses/high revenue).

- *Baker Hughes Acquires BJ Services Company*. While initial OER levels decreased for BHI post-acquisition, they quickly increased upwards as synergies were lost. This can partially be attributed to a large reduction in headcount as part of the integration process.

- *NOV Purchases Robbins & Myers*. At the time of acquisition, Robbins and Myers had undergone significant operational efficiency improvements, becoming more efficient than NOV. These improvements did not seem to slow NOV's upward trend, however.

- *Schlumberger Procures Geoservices S.A.* While Schlumberger's total OER has remained flat after the acquisition, Geoservices' OER levels skyrocketed to well above 1, indicating it operates as a loss. Should Geosciences work to get OER levels to that of Schlumberger, it would equate to an increase in operating income of at least $41 million.

MERGERS AND ACQUISITIONS STRONGLY RELY ON PROPER INTEGRATION TO CAPITALIZE ON IDENTIFIED SYNERGIES AND REALIZE THE FULL VALUE OF THE TRANSACTION.

Oil price fluctuations clearly place increased pressure on net income and increases the need for OFS companies to cut costs. While some argue that crude price drops present an opportunity to implement sustainable cost-cutting measures, most chose to undertake significant layoffs instead. The negative results from this are numerous: negative public perception, damage to employee morale, and ultimately exposure to the same mistakes companies made during the drop of 2008.

Taking a structured, detailed, top-down financial look at the organization to find key performance areas is a necessary step in ensuring sustainable operational effectiveness. Next, a bottom-up approach should be implemented to identify the detailed processes within each key impact area, streamlining operations wherever possible. This method creates sustainable cost-cutting measures that generate a positive image, internally and externally. Within the company, morale increases with perceived job security. Externally, the company can avoid negative

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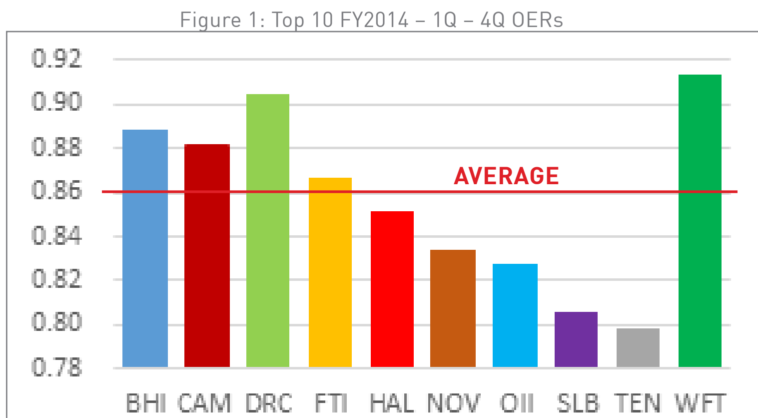
press associated with layoffs and often see positive financial coverage from analysts looking favorably at increased efficiency. Further, it makes the company stronger, and much better prepared for the rebound in oil prices and related demand.

WILL HISTORY REPEAT ITSELF?

In the fall of 2014, when the price of oil was in the middle of its steep decline, two large-scale acquisitions were announced within the OFS industry. Interestingly, the two companies being acquired were significantly above the Top 10 OER average at that time.

Figure 1: Top 10 FY2014 – 1Q – 4Q OERs



OFS M&A activity following the 2008 oil crash has provided a cautionary tale. A swift reduction of immediate head count, followed by quickly disbanding integration teams is not enough to create the sustainable improvements needed to truly deliver full value to stockholders. Rationalized efficiency improvements can be a difference-maker within OFS.

After the oil price drop of 2008, the OFS underwent a large consolidation followed with sharper focus on increasing market share with little regard to the long-term operations. Are companies willing to take a different approach this time around and come out of the downturn better positioned for the rebound?

NORTH HIGHLAND BELIEVES THAT THIS IS THE PERFECT TIME FOR COMPANIES TO INCREASE THEIR FOCUS ON RUNNING EFFICIENT ORGANIZATIONS, INSTEAD OF AGGRESSIVELY ADJUSTING HEADCOUNT OR RELYING ON BROAD-STROKE BUDGET CUTS IN AN ATTEMPT TO KEEP UP WITH THE MARKET.

ABOUT NORTH HIGHLAND

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