The new normal

Finding opportunity in a constrained energy services market

For energy service companies to survive and grow, status quo must be avoided. Strategies for savvy businesses include identifying acquisitions to expand their market share in existing business lines, grow through geographic diversification, or move into other industrial sectors.

Energy services companies achieved improved results in the first nine months of 2017, after two years of major declines in oilfield activity and falling service pricing. Operators were encouraged to modestly increase their capital budgets by rising oil and stable natural gas prices.

Energy services companies are now facing an altered landscape. General industry consensus says oil and gas prices will trade in a tight band for the short-to-medium term. Capital expenditures by oil and gas producers will be tied to cash flow resulting in similar oilfield service activity levels in 2018 to that of 2017. Oilfield service pricing may see a slight improvement over 2017. Access to investment capital for the sector is expected to remain challenging, and free cash flow to invest in growth will remain a rarity in this new normal.

But for energy services companies with the right strategies in place, there is opportunity to grow.

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"The sentiments were that 2018 would be a smoking year," says Rhys Renouf, KPMG's National Energy Services Industry Leader and a Managing Director of KPMG Corporate Finance Inc. "We're now hearing that in 2019 there will be a supply shortage."

Oil prices have recovered from lows of around $30 USD per barrel in January 2016, to the $50 USD range for most of 2017. Meanwhile operator capital expenditures climbed 16 per cent in 2017, and are expected to climb by another 6 per cent in 2018, says Renouf citing CIBC World Markets numbers.

Despite the tight market, industry experts say there are opportunities for the right companies to make deals. Douglas Freel, Managing Director at ARC Financial Corporation, believes now is "as good as it gets." Buyers and sellers are starting from the same basis, and that brings better alignment making it easier to make deals.

But the lack of new investment in the sector is forcing companies to make share-based deals with little cash involved, said Matt Colucci, co-founder and a managing partner of PillarFour Capital Partners. This can be challenging when private companies are involved with the current climate of short cash and private equity outside of energy specialists

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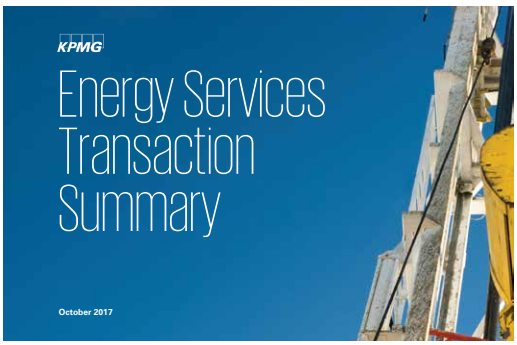

gone from oilfield investment, because most owners are looking to "cash out". Colucci notes though, it may be advantageous for sellers to "take the paper deal and ride the potential upside." This situation could also be considered risky because vendors and investors are "putting their lives in the hands of another management team."

Diversifying from the drillbit

Diversification can also breed good opportunity. Colucci says that PillarFour invests in companies that have a clearly defined competitive advantage and new technology. They look for geographical diversification (especially with access to the U.S.), those with leverage towards production and completions, and companies that are ready to act fast and can reduce costs tomorrow.

"Diversifying our revenues has been a big focus the last several years," says Andy Pernal, President and CEO of Strad Energy Services. Pernal says Strad has been "diversifying from the drill bit" and focusing on providing rig mats and surface rentals to the energy infrastructure market, a business that has grown from nothing five years ago to now representing 35 per cent of Strad's revenues. Strad has done a few deals over the past year, including the acquisition of Got Mats, a Manitoba-based mat manufacturer.

"Our priority for the last five years has been to chase more industrial kinds of projects," says Pernal. This has meant looking for "companies that have services that can be used in other applications to help manage cycles."

Beyond their ability to diversify, Strad also looks for a good cultural fit as bringing two companies together can be a challenge.

"A service company is a people business and if you haven't got that, it's a fatal blow. Things can look good on a spreadsheet but you need people that can operate in the field, often in remote locations," says Pernal.

"Most oilfield services are not in balance, and we're looking for ideas that work with these constraints," says Freel. While ARC has traditionally focused on financing startups with great ideas, exceptional management and real capital, in the current market they are looking for companies that can compete and win in a market with limited growth potential.

Pernal said the lack of balance in the industry has kept price increases under pressure, and the situation will ultimately solve itself as supply and demand come back into balance and service rates rise. But companies need to continue to drive costs out of the business.

"Companies need to be lean, mean and efficient because price is everything today," Pernal says. "We have to offer more value, more efficiency, at a cheaper cost every day to try to drive costs out of the business."

Operators need to be innovative and open to new ways when it comes to doing business, agrees Freel. Some tasks currently undertaken by operators may be better executed by service companies allowing for the win-win situation where they take part of the business at lower cost to the operator.

Creativity vs. caution

This is the new normal, and here growth remains imperative to survive and prosper. With oil and gas prices expected to stay at current levels, the impact on energy service mergers and acquisitions is evident by the declining volume of transactions.

Constraints on financing means that creating the right deal that provides value to both buyers and sellers is paramount. But energy service companies that can identify acquisition opportunities, build strategies to expand their market share, grow through geographic diversification or move into other industrial sectors, have a real opportunity to get ahead.

Ready to talk? KPMG's Deal Advisory team can counsel you through the multiple options available to maintaining your business in a cyclical industry. Our forward-looking specialists have business acumen, deep sector knowledge and technical know-how to help you stay ahead of the issues and make the best decisions to meet your goals.

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