

Integrating Acquisitions in a Changed E&P World

“For E&P firms, generating value through acquisitions is becoming less dependent on boosting profitability by cutting costs and more dependent on improving prospects for long-term production through exploration and development. This change affects how acquired assets or companies should be integrated into the parent organisation.”

— Al Escher, Director, North and South America, Schlumberger Business Consulting

Over the past two decades, the success of an acquisition in the exploration and production (E&P) sector has mainly been gauged by its ability to generate near-term growth in profitability. Mergers have typically been followed by a reduction in fixed costs, such as corporate and divisional overheads. Reductions in operating costs followed, first by eliminating overlaps in field operations and, second, by harnessing improved economies of scale in the procurement of equipment and services.

The cost-cutting approach made sense in the business environment of the time: oil and gas prices were fairly low and stable, technical talent was broadly available and production volumes were growing.

Press coverage of acquisitions reflected the cost-cutting rationale of many transactions:

“The companies expect the merger’s economies of scale to cut about \$2.8 billion in costs in the near term. The companies also said they plan to cut about 9,000 jobs out of 123,000 worldwide.”¹

“The combined company ... will realise cost savings of about \$1.2 billion within six to nine months after the deal’s close ... The combined company will shed about 4,000 of its 55,000 jobs...”²

“Managers have identified most of the 10,000 jobs to be cut and slashed costs by \$2 billion a year ahead of schedule.”³

This well-publicised approach led to common expectations and consistent actions

across stakeholders. The investment community modeled the projected cost reductions to set target stock prices. Managers re-organised the company, layer by layer, to remove duplication and find other efficiencies. Workers braced for lay-offs and often became distracted. Outside service providers were frequently brought in to assist with the process, and their presence signaled the repeatability of the pattern. While an efficient process, it focused little on top line growth.

Today’s volatile business environment presents a more complex challenge, that in turn requires a broader approach to merger integration. Surely, some costs can be cut. But multi-year production declines for many producers are leading to concerns about long-term viability, and valuations reflect this. The need to increase near term profitability needs to be addressed in conjunction with establishing long term production growth. So, post-merger integration also needs to improve the quality of the exploration and development programme. This calls for changes in the structure of the integration programme itself.

¹ Exxon, Mobil in \$80B deal, CNN, December 1, 1998.

² Update: Chevron to Acquire Texaco, TheStreet.com, October 16, 2000.

³ BP Amoco: This Giant Sure has a Big Appetite, BusinessWeek, April 12, 1999.

*Change 1:***Motivation, from Profitability to Viability**

Even in this period of volatile prices, the underlying motivation for E&P acquisitions is changing. As with other types of company, E&P firms are valued by profitability and the potential to increase reserves. Historically, access to resources was good and the market could assume steady production growth. As a result, profitability was the primary business concern and this was best improved by cutting costs in the merged entity.

However, profitability is only one issue facing E&P companies today. With access to resources increasingly restricted, investors can no longer be assured of continued production growth; many E&P companies are struggling to stem the decline in production volumes and reserves. This has grave implications for sector valuations, which will fluctuate widely depending on whether investors perceive individual companies as having an inexorably declining asset base or as being a sustainable business with growth prospects.

The value of an acquisition now depends to a much greater extent on being able to demonstrate potential for long-term production growth – long-term viability – as opposed to near-term profitability. It is now at least as important for acquirers to demonstrate that future increases in production are possible than to show evidence of immediate cost-reduction opportunities.

Cost cutting may still be relevant. There will often be redundant assets and services to be consolidated as part of post-acquisi-

tion integration. However, integration programmes which emphasise mainly these opportunities may damage the surviving company. The valuation of firms that focus on existing production at the expense of long-term growth will be constrained by the finite and depleting nature of their resource base.

*Change 2:***Changes in People Strategy, from Reduction to Recruiting**

The people dimension of post-acquisition integration is also going through tremendous change. Historically, headcount reduction was a signal to the market of value-creation potential. In contrast, even with recent price declines many companies have significant vacancies in technical areas. This gap in skilled staff will only intensify as the industry recovers. This gap is a threat to timely, efficient project execution and the market is sensitive to delays that could affect the reversal of production declines. In this environment, the market is unlikely to react positively to headcount reduction.

It is indeed likely that acquirers will need more staff than the two contributing entities. Because acquirers will, increasingly, target companies with undeveloped assets, additional manpower will be required to extract maximum value from them.

The people focus in post-acquisition integration should, therefore, be on recruiting, as well as retaining existing staff. Such an approach runs contrary to the past experiences of most E&P managers, who have generally been conditioned to reduce staff wherever possible. Reversing

conventional thinking and hiring after an acquisition will be a difficult practice to implement and some companies will be more successful at this than others.

*Change 3:***Change in Focus from Operations to Development**

Part of the proved post-acquisition approach was an implied, if not an explicitly stated, planned decrease in exploration and development compared with the activity of the two contributing entities. The assumption was that optimising operations through cost-cutting was the best way to add value; exploration and development activities continued, but were not the focus.

Greater emphasis must now be placed on the quality of the post-acquisition exploration and development programme. Production operations obviously still matter. But as the focus moves from profitability to the ability to maintain long term production growth, companies will increasingly have to improve the quality of their upstream prospects, field development plans and project-development skills. These factors will have a greater effect on viability than incremental increases in the efficiency of existing producing operations.

It could be argued that simply aggregating companies and cutting out exploration and development could be a path to growth in production, profits and value, even in the present environment. However, the valuation of companies will increasingly reflect their future development potential, including upside from improvements in technolo-

gy. Buying companies solely for the value of existing operations will be difficult to do.

This shift in emphasis to exploration and development will be a challenge for many companies to manage. The depletion of staff has been most severe in technical areas and technology-development budgets have, over the years, been reduced or even eliminated. Further complicating matters, the commercially available technology capable of driving improvements in exploration and development has advanced markedly. Companies must redevelop the capability to harness these innovations and improve exploration and development processes in order to secure long-term production growth and provide an economic rationale for acquisitions.

Summary

There must be a shift in merger strategy from easily measured, near-term improvements to harder-to-measure, longer-term improvements. Profitability can be improved within a year by reducing costs, but proving long-term viability takes time and requires investments with an uncertain pay-off.

Whereas reducing staff numbers is relatively easy and can be done quickly, attracting talent to an industry that has been harshly cyclical will take time and involve additional costs. Similarly, while streamlining production operations delivers financial benefits relatively quickly, success in exploration and development is a riskier and costlier undertaking with a longer-term payback.

The increasing complexity of integrating acquisitions in today's business environment creates opportunities for forward-thinking management teams. Companies that can look past their experience and execute post-acquisition programmes that correctly balance cost reduction with production increases – based on intensifying recruitment efforts and improving exploration and development – will stand out from the crowd.