

What It's Worth:

Valuing Oil, Gas, and Alternative Energy Assets

Second Edition

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A BVR SPECIAL REPORT



1000 SW Broadway, Suite 1200, Portland, OR 97205
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5. The Oilfield Services and Equipment Industry: Seven Key Value Drivers

By Steve Sprenger, CFA

The oilfield services and equipment (OFSE) industry provides equipment and services to oil and gas (O&G) exploration and production (E&P) companies worldwide. Where there are oil and gas reserves, you'll typically find drilling, completion, well monitoring, stimulation, and various other services associated with extracting the oil and gas. Several key value drivers are listed below, and there is overlap between some of them.

1. *Upstream capital spending.* OFSE revenue is heavily dependent upon E&P capital spending, which in turn is heavily influenced by future commodity price expectations. E&P companies are directly affected by declines in oil and gas prices, as their asset values (e.g., reserves, exploration land) are based on market expectations of future oil and gas prices.

The E&P industry is cyclical: When oil and gas prices increase, there is greater exploration and drilling activity, which in turn results in increased supply. If demand does not increase with that supply, prices will decline, and exploration activity will eventually decrease. Given this reality, the OFSE industry is cyclical as well.

2. *Location.* Demand for oilfield services and equipment varies depending upon the location (as well as the production history) of a particular play. Different plays have different break-even prices, and there are also differences in profitability within plays. Additionally, due to the capital costs and necessary lead times, offshore equipment and service demand is less volatile than onshore demand. While demand declined worldwide, the global OFSE market was considered to be healthier than the North American OFSE market, due to project types and lead times.

3. *Fixed costs.* The oilfield services and equipment industry can be capital-intensive, though this is dependent upon the type of services offered. Drilling companies, for example, may own land rigs, jack-ups, submersible rigs, and drill ships, the cost of which can be substantial. Lead times for some of these assets can be several years. In addition, a substantial amount of related fixed assets accompany drilling and related services, such as drill bits, pipe, fluids, and trucks, which are also expensive. In periods of low demand, the value of certain OFSE firms may be limited to the value of this equipment on the market.

4. *Cost efficiencies.* In response to lower oil and gas prices, E&P companies seek to lower their costs, which in turn places pressure on OFSE companies to lower theirs. Due to surging demand in past years, and expedited efforts to enter or expand in the market, a good number of OFSE providers were not as lean as they could have been. Therefore, companies that can find ways to cut costs and operate more efficiently are far more likely to survive the downturn.

5. *Technology.* Technology and technological know-how are significant value drivers. The surge in U.S. shale play production over the last decade was the result of improvements in drilling methods and technology. Years ago, it was necessary to drill a substantial number of conventional vertical wells to

extract quantities that can now be extracted from fewer wells with horizontal and directional drilling methods. Further, multiwell pad drilling has dramatically reduced the costs associated with disassembling and reassembling rigs to move to other locations. In addition to these improvements, there have been continual improvements in seismic surveying, artificial lift, and other technologies over the years.

6. *Customer relationships.* The largest oilfield service companies, such as Schlumberger and Halliburton, account for a substantial

Services OFSE Companies Provide

Oilfield services and equipment companies provide the following:

- Seismic imaging and geological modeling;
- Drilling rigs and related equipment;
- Drilling/coiled tubing;
- Directional services;
- Well completions:
 - Cementing and casing;
 - Perforating;
 - Pressure pumping; and
 - Hydraulic fracturing.
- Wellhead equipment;
- Well stimulation;
- Specialty chemicals;
- Artificial lift; and
- Logging and well monitoring.

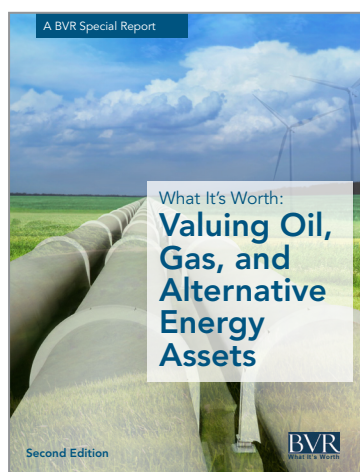
portion of industry revenue. These companies offer a full suite of integrated services to E&P companies. As a result, customer relationship value can be more significant than in the smaller firms, who tend to have fewer service offerings and face greater competition in the fragmented market.

7. Balance sheets. Because OFSE companies can be capital-intensive, many of them had a significant amount of debt on the books.

Due to the downturn in demand for oilfield services and equipment, various assets were impaired (especially customer relationships and goodwill), and debt ratios rose in the absence of refinancing. Financially distressed companies face a number of limitations and may face bankruptcy or acquisition.

Steve Sprenger, CFA, principal at RSM US LLP, can be reached at 303-298-6485 or steve.sprenger@rsmus.com.

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