

The global oil sector is likely to emerge from the credit crisis with a more concentrated pool of players, but power will increasingly revolve around China and India as they tap the markets for cheap assets, finds *Catherine Lacoursière*

Bagging a bargain

★ As global bankers were meeting to stave off a deepening credit crisis at the end of September, China Oil was busy scooping up Syrian heavy oil producer Tanganyika for \$1.9 billion. As the crisis has deepened, merger and acquisition (M&A) activity in the global oil market has slowed to a lull, but China's Syrian play is likely to be the beginning of a consolidation driven by cheap oil assets. As with the last oil market downturn, big cash-rich oil companies such as ExxonMobil, ChevronTexaco and Conoco-Phillips will be at the forefront of deal-making, but this time around they will have more competition from state oil companies.

"Well-capitalised national oil companies, from Asia in particular, have the power of their governments behind them and look at this as a time of opportunity," says Douglas De Filippi, managing director, international at Scotia Waterous, an investment bank and global leader in oil and gas M&A. He believes more compa-

nies will shed assets to finance new projects coming down the pipeline.

To meet growing fuel demand, PetroChina and India Oil Corporation among others have announced plans to take advantage of the current market opportunity to buy oil assets weakened by the credit crisis. The oil companies are consolidating, says Walid Khadduri, editor of *Dar Al-Hayat* and former editor of the *Middle East Economic Survey*. But with demand still falling, there is much uncertainty in the market since the floor price has not yet been determined. Khadduri expects independents to engage in mergers among themselves or be bought out by the majors. It is hard to gauge how independent they will remain at this point in the crisis, he adds.

Khadduri cites the August deal between Iraq and the China National Petroleum Corporation (CNOC) – the first deal between Iraq and a foreign entity since 2003 – as indicative of China's strategic positioning to secure long-term oil supplies. Under the \$3 billion deal, China will supply technical services in exchange for cash (instead of a share in production rights) to the Adhab oil field. The deal has been described as a political foothold in Iraq for China.

Asian national oil companies are comfortable investing in non-OECD markets, where they benefit from less competition. In Syria, CNOC

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has picked up a heavy oil project with large untapped reserves. “Not everybody wants to go to Syria. They have activity there and relations with Syria, and they feel they can grow their business there,” notes De Filippi.

At the same time, there has been a marked increase in Asian companies making acquisitions or joint venturing in OECD regions. The first regions to put operations up for sale are those with the highest capital expenditure costs. Accordingly, a lot of activity is centred around the Gulf of Mexico, where companies are adjusting their portfolios to accommodate for increases in capital expenditure. South Korea benefited from the rationalisations when it bought Taylor Energy this year, one of the largest private exploration and production concerns in the Gulf of Mexico. In a high-cost and difficult financing environment, Taylor viewed it as an opportune time to sell to a joint venture between the Korea National Oil Corporation and Samsung.

The Japanese and Chinese are also actively scouring the Gulf for deals, which are expected to become more readily available. In the higher oil price environment, many companies held on to assets longer than normal and reaped the revenues. Facing higher operating costs and a steep drop in oil prices, they are turning back to the routine rationalisation of portfolios.

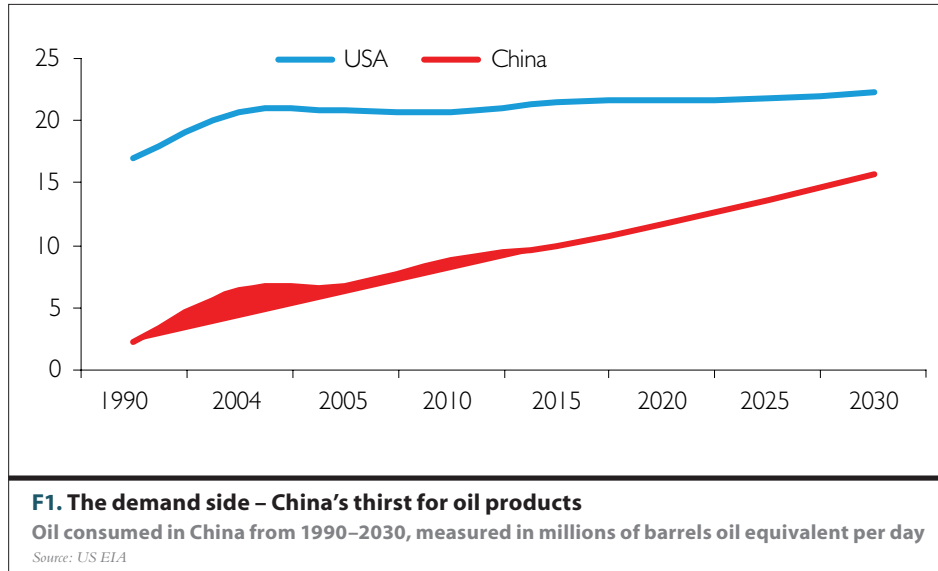
In Latin America, Jeremy Martin, energy programme director at Institute of the

Americas, a public policy foundation focused on Latin American trade, is watching the so-called ‘juniors’ across the region and particularly in Colombia and Argentina. He cites as an example the merger last year of Pacific Stratus and Petro Rubiales in Colombia. “This will be increasingly the case as the international credit market tightens and ‘smaller’ companies have less access to capital. Energy is a capital-intensive industry.”

Worldwide, the property divestiture market remains active, says Don Rawson, vice president and director, institutional research of Tristone Capital, a global energy advisory firm with head offices in Calgary. He is seeing interest in exploring divestitures around the world and expects more properties to come on the market. With North America being the most liquid market, a number of sellers will look here to try to raise capital to fund other projects that are deemed to be more core to the company. Smaller companies facing funding challenges are looking at rationalising their portfolios, especially where they require significant near-term capital investment. “Capital-intensive projects offshore would be likely candidates. But with fewer buyers able to afford deals, there is less certainty with respect to closing transactions,” he adds.

M&A activity itself may also come under threat due to a lack of financing, experts say. “M&A activity may slow down because of financing but how much we do not know

IOCs will find competition from NOCs as they search for attractively priced assets



yet,” says Khadduri. Oil market analysts say numerous deals are being discussed but market uncertainty has caused many to hold back on deal announcements. While falling demand in the US will force rationalisation in the oil industry, Khadduri says oil-hungry countries such as China and India will continue with their expansion programmes abroad aimed at directly controlling more oil resources.

Locking in supply

While many independents welcome acquirors in a more difficult financing environment, with stock prices halved even the big oil companies are vulnerable. In response, some oil companies and economies are putting up defences. EnCana shelved its planned spin-off of an oil sands division, citing fears that the two separate entities would be more vulnerable to a takeover in a weakened credit environment. The Canadian natural gas producer planned to separate into two public entities focused on natural gas and integrated oil sands. ConocoPhillips was expected to be its joint-venture partner in the new oil sands company.

Historically, oil and gas producers have spun

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Don Rawson, Tristone Capital

off small exploration companies with higher-risk assets but high growth potential into public companies to unlock value and take advantage of related tax benefits. “There has been a trend toward consolidation and investors generally want future investments in bigger more liquid names,” says Rawson. “That trend has worked against spin-offs.” Moreover, many companies spun off in 2004, 2005 and 2006 did not meet high market expectations.

Governments are also putting up defences to

protect their national interests. As oil prices fall, national oil companies are facing more political risk in non-OECD regions. The October resignation of Ecuadorian oil and mining minister Galo Chiriboga amid the renegotiation of foreign oil contract terms and the ensuing threat of nationalisation by his replacement, has created a political landmine. Sinopec, which recently bought Andes Petroleum from its Canadian owners in Ecuador, has signed the new agreements with Ecuador but others continue to hold out.

At the same time, as the credit crisis worsens, these oil economies are wooing investment from the national oil companies. “Technological capital is increasingly desirable as the financial crisis plays itself out,” says Martin. Due to the dominance of national oil companies, direct acquisitions are harder to carry out. Throughout Latin and South America, Martin has observed an increase in Chinese companies entering into joint ventures. Worldwide, there is an increase in investment in heavy oil. Sinopec has several memorandums of understanding for work in Venezuela’s Oranoco heavy oil belt. China’s oil major was also after heavy oil in Syria with the Tanganyika project.

There has also been a notable increase in joint ventures among Latin America’s national oil companies, including those in Venezuela and Argentina, and Big Oil such as Petrobras and Exxon Mobil’s JV in Brazil. Many of these countries have rewritten the rules of oil exploration and production in recent years, says Martin, including Venezuela, Ecuador and

Bolivia, requiring national oil to be a majority in big projects.

Indian companies are also buying up Latin American assets. In an effort to lock in supply, India Oil Corporation has indicated its intention to increase its global activity. Following India Oil's \$2.59 billion acquisition of UK-based Russian oil explorer Imperial Energy, several senior officials from the Indian oil and gas producer, have publicly stated the company's intention to seize the opportunity created by the credit crisis and buy more depressed oil assets. Its reserves for acquisitions, says India Oil, are two to three times the value of the Imperial deal.

Inside China

If the push to privatise China's national oil companies is successful, China's foreign investment activity is likely to increase significantly. China's oil imports are projected to increase from 3.4 million barrels per day (b/d) in 2006 to 12 million b/d in 2030, according to the Institute of Energy Economics, Japan. However, to secure long-term reserves, China's national oil companies need to privatise to allow its foreign oil portfolio to be managed on a more competitive basis, says Farzam Kamalabadi, president and chairman of Future Trends International, a group of investment funds primarily focused on energy in China. "For national security, they need to increase the number and function of national oil companies (NOCs) to become more like international oil companies because NOCs have been unsuccessful in obtaining oil blocks abroad."

Over 20 years, China has spent \$50 billion in 20 countries and 52 projects yet produces less than 800,000b/d from these investments, and not all of that production comes back to China, contends Kamalabadi.

As China continues to increase its imports, managing its foreign investments more productively will become more important. The world's number three oil importer, China imported 45% of its consumption in 2007, and is forecast to import 55% in 2008.

The argument of those who support privatisation is that the privatised assets will be managed more competitively. China has three state oil arms – China National Petroleum Corporation, the China National Offshore Oil Corporation, and the China National

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Petrochemical Corporation – which are large conglomerates with overseas operating rights. In addition there are two national oil companies, and each of them has between 300 and 500 second- and third-tier subsidiaries, in addition to China's 10,000 oil and gas stations.

Within China's oil sector, wholesale storage distribution, which is 75% privatised, and refining, 35% privatised, are in expansion and acquisition phases. For those areas that are open to private and international investment, local know-how remains more of a barrier than policy in a country where opportunities are spread throughout 33 provinces and thousands of projects.

Chinese independents are steadily increasing their foreign exposure. For example, a number of Future Trends' investments are increasing their strategic buying of shares in oil projects. Ginkgo in Africa has purchased three oil blocks in Zhongrong, China, as well as oil blocks in Canada and Oman. Many of China's privatised companies still benefit from political connections and access to sources of influence in China. Pano Sino, for example, a company held in Futures Trends' portfolio is run by former high-level officials of the Chinese energy department.

Driven by depressed asset values, analysts in the major oil regions around the globe are forecasting a pick-up in M&A activity. The next 18 months will be the most attractive buying time, says Scotia Waterous's De Filippi. He expects Opec to try and put a floor under prices at \$90 a barrel. "People will start running their economics on \$90 versus the heady \$110s or \$130s of a month ago," he says.

To restore confidence in the market, a re-evaluation of energy investments made overseas and in local markets is required to assess their economic viability given current oil prices and the spectre of a recession, says Khadduri. Once the oil price becomes more stable it could pave the way for a lot more M&A activity in the oil sector. [ER](#)