Navigating the Power Dynamics of Stock-for-Stock Mergers in Upstream Energy

By Shawn Winkler

Starting in early 2020 through mid-2021, the energy industry grappled with historically low oil and natural gas prices coupled with challenging investor sentiment and an associated decrease in available capital in the upstream sector. During this period, the industry saw dwindling transaction volumes for mergers, acquisitions, and divestitures as restructurings and bankruptcies dominated headlines.

However, upstream sector transaction volumes are primed to make a comeback in the second half of 2022. One of the areas where we expect to see heightened activity is in stock-for-stock mergers and "mergers of equals" in which similarly sized companies consolidate for mutual benefit.

The appeal is clear. For companies that are just emerging from prolonged survival mode, these types of deals can help them achieve their goals (efficiencies of scale, access to capital, lower cost structures) without the need for significant capital raises to facilitate transactions. The challenges of these types of mergers, once a mutual valuation framework is agreed upon, center on the social dynamics and governance of the newly combined organization. However, consistent investor sentiment focused on improved cost structures, modest growth, and a return of capital to shareholders will incentivize both management and boards to overcome social issues. When effective consolidation is achieved, the organization is positioned to realize significant operational synergies that may help to carry them through any future disruption.

Global Impacts on the Upstream M&A Market

In early 2020, at the start of the COVID-19 pandemic, the oil and gas industry experienced a historic downturn, driven largely by pandemic-related expected demand decreases and insufficient actions taken by the Organization of the Petroleum Exporting Countries (OPEC) to stabilize oil prices. On April 20, 2020, oil recorded negative prices for the first time in history. Benchmarked by West Texas Intermediate (WTI) in the U.S., oil prices fell from $17.85 to minus $37.63 in one day — a 300% drop.

As low commodity prices sustained through 2020 and into early 2021 combined with headwinds in financing available for the upstream sector (especially punitive for companies with current debt maturities), bankruptcies and restructuring events increased. And those companies that survived were forced to downsize staff, reduce their capital budgets, and hunker down for the foreseeable future.

Late 2021 saw prices rebound substantially and price volatility decrease, mostly due to increasing demand as impacts from the global pandemic began to wane. Less volatility for both buyers and sellers can provide a common set of price expectations, leading to less challenging valuation discrepancies between parties when valuing oil and gas properties. This shift, combined with a preference among both debt and equity providers in the sector for investing in larger entities with sufficient scale and liquidity to survive the turbulent price environments experienced in the not-so-distant past, kicked off a wave of consolidation that provided for increased scale and better access of capital to the surviving entities. This dynamic is reflected in the fact that total upstream M&A deals exceeded $181 billion globally in 2021, a 70% increase over the previous year.

Global M&A activity topped out at about $14 billion in the first quarter of 2022 but stalled in March with Russia's invasion of Ukraine. This conflict is once again skewing the supply-demand balance of oil and gas, resulting in a return to higher-than-average commodity prices. In the face of these headwinds, the industry is poised for flat or reduced M&A activity throughout this year, especially when it comes to asset-based deals.

Power Dynamics in Mergers of Equals

A "merger of equals" transaction may be an attractive option for companies looking to ensure long-term access to capital, lower operating cost structures, and the diversification of their asset bases to be positioned for success when market dynamics change. In these transactions, companies exchange one another's stock rather than one entity purchasing another for cash (and/or stock, in some instances). Oil and gas transactions that include stock as a part of the total package increased nearly 20% from 2016 to 2021.

To emphasize the equality of these transactions, they are often characterized by conciliatory provisions like combined names, dual headquarters, shared leadership, or split CEO and chairperson roles. The reality of these integrations, however, often results in "governance-related social issues" related to combining workforces, which each have unique cultures and concerns about future workforce reductions. In extreme cases, these power dynamics can tank an otherwise successful negotiation.

Guidance for Companies Engaging in a Merger of Equals

There are a variety of actions leaders can take to ensure the new, consolidated organization is positioned for success and the integration runs smoothly, including:

- **Dividing leadership responsibilities between organizations:** To maintain the perception of equality, management teams from both companies should be present in the new entity's leadership. One of the most common models for this involves splitting the CEO and board chair roles between the organizations. This ensures both companies have a voice at the executive level.

- **Clearly communicate from the outset:** Ensure all parties are aware of the action plan for achieving operational synergies and the process through which a reduction in combined headcount, if applicable, will be determined — ideally, this plan will be enacted at or before transaction close to reduce employee concerns with regard to potential layoffs and job responsibilities going forward.

- **Developing clear roles and responsibilities among teams:** Because disparate teams will be consolidated throughout the integration, it is critical to have a clear understanding of each individual's roles and responsibilities on the team to avoid confusion and frustration.

- **Using change management principles to help employees navigate the transition:** Intentionally implementing a change management strategy from the start of a merger of equals can help to ensure a smooth transition that makes employees feel heard and respected.

- **Deploying frequent and timely communication:** Especially during periods of major upheaval, team members will require near-constant communication to keep them aligned.
- **Creating a unified vision of the future:** To ensure the combined organization will be successful in the long term, leadership should work together to develop a set of shared goals, founded on a cohesive strategy, that will drive growth for years to come.

The Bottom Line

COVID-19 likely accelerated permanent systemic changes in the upstream sector, which was already challenged by investors' increasing preference for greener, more eco-friendly energy sources. In the face of the reduced bank and institutional capital available for the sector and the focus of energy investors on free cash flow generation (as opposed to growth), companies have judiciously pursued modest drilling activity levels despite robust oil and natural gas prices.

Consolidation is one method to better position the upstream sector to deal with these market dynamics, and merger of equals transactions can be an elegant path forward. However, the social dynamics for both companies need to be carefully considered and planned. These preventive measures help to ensure management and employees are motivated and productive in pursuit of the operational synergies driving such a transaction.

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