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Petroleum: After the Megamergers

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Recent deals have raised the ante for midsize players without scale or focus

Two recent historic mergers – between Exxon and Mobil, and BP and Amoco – have rocked the global petroleum industry. Much as the oil shock of 1973 ushered in a new era, the underlying forces at work in the industry will stimulate yet more reshaping in the next few months and years.

The "megamergers" have created a new class of company with advantages based on size and scale. Meanwhile, smaller and more focused players like Huntsman in petrochemicals, Landmark Graphics in exploration information technology, and QuikTrip in gasoline retailing have the skills and cost structures to compete with any company in the industry.* Left out in the cold by these two trends are the "mezzo" players: smaller integrated petroleum companies, as well as midsize companies (including the smaller majors) with broad product and geographic coverage but not world-class scale or distinctive skills. These mezzos now find themselves squeezed between the new class of "megamajors," on the one hand, and high-performing specialized players, on the other. As the mezzos seek to gain scale, sharpen their focus, redefine their businesses, or simply get out, their predicament will generate a second wave of mergers and acquisitions, alliances, and divestitures.

Bigger can be better . . .

The megamergers were consummated because size, relationships, and other structural considerations continue to bestow significant economic advantages on petroleum companies in a number of countries where there are few competitors,

* *See* Timothy Bleakley, David S. Gee, and Ron Hulme, "The atomization of big oil," *The McKinsey Quarterly*, 1997 Number 2, pp. 122–42.

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the right to own or access reserves is limited, and capital and risk requirements can't be met through financial markets. In other words, where the status quo still holds, significant advantages flow to the biggest petroleum companies. In addition, Exxon and BP were already outperforming most other majors before they merged with Mobil and Amoco, respectively, and the mergers provide a bigger base for leveraging their exploration and operating skills.

Indeed, the megamergers have created a new category of player, and this raises the bar for world-class scale and scope advantages. In petroleum as in pharmaceuticals, the attractiveness of a company depends on its "pipeline," and the new megamajors have the broadest portfolios and (potentially) the lowest cost structures, as well as dominant positions in many of the most promising well-established basins. Even in low-price environments, the megamajors can sustain substantial levels of investment in a number of growth projects – a crucial point, since exploring a significant arena can involve a bet of a billion dollars or more. Of course, midsize players can diversify their bets by sharing the risks of exploration, but this approach has a cost: it limits the upside of any major discovery.

The megamajors have not only increased their size and improved their performance but also enhanced their clout, for they represent such a large share of industry know-how and downstream capacity that they have improved their negotiating positions against the state-owned national oil companies (NOCs). Moreover, the existence of the megamajors makes it more risky for oil service companies such as Halliburton and Schlumberger to continue encroaching on the business of developing and operating wells. These service players now have fewer customers and must compete with their biggest ones – the megamajors – for international opportunities.

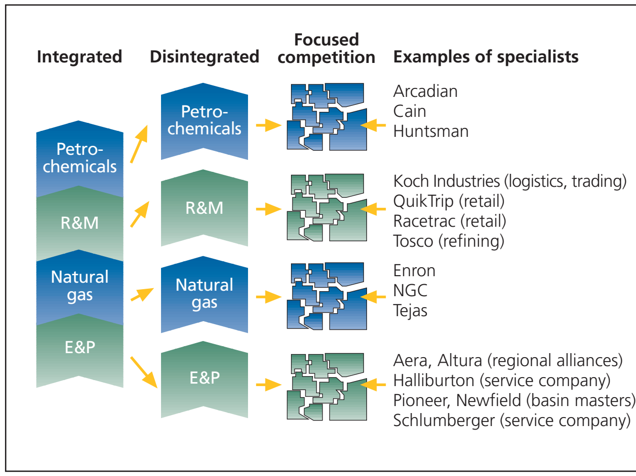
. . . but so can specialization

In the petroleum sector, the emergence of specialist players and "slivers" based on specific products or pieces of the value chain (Exhibit 1) is now reshaping some mature markets, such as the United States, as well as select emerging markets. Consider what has already happened to the once cozy relationship between some NOCs of petroleum-producing states and the major petroleum companies.

Rather than work more broadly with those companies, NOCs in such nations as Mexico are enlisting specialists to develop huge projects, notably the Cantarell field. Increasingly capable independents like Kerr-McGee and Apache in China are pursuing opportunities (formerly the exclusive domain of the major petroleum companies) to develop parts of the energy industry value chain – particularly upstream exploration and the development of assets. In addition, a number of NOCs (Petrobras in Brazil, for instance) are actively developing their capabilities in deepwater development and moving into new territories, potentially putting pressure on companies that take the specialist approach.

Exhibit 1

Industry atomization



Several other factors have also spurred the growth of specialized companies. Opportunities in emerging markets have increased substantially: the quantity of reserves open to competition, for example, has expanded sixfold since 1990 with the opening of arenas in Asia, South America, and the former Soviet Union. Control over technology, once the preserve of the majors, has diffused as computing power and software have become cheap and standardized. Along with innovations in risk markets, the development of spot and forward markets for many products has reduced the need for vertical integration among the producers of crude petroleum, intermediates, and final products, such as gasoline and distillates. Despite all this, many large petroleum companies still view these small but effective competitors as "ankle biters" and are therefore overly casual about selling the seemingly unattractive assets that have fueled their growth.

The petroleum industry is not the only one now being reshaped; industries as diverse as personal financial services (see "Personal financial services goes global" in the current issue), beer,* and electric power† are following similar patterns: formerly integrated industry value chains are breaking up, competition is increasing, and consumers are benefiting from lower prices. Typically, as these developments take hold, companies exploit their distinctive skills and specialized operations to create big businesses in relatively narrow slivers.

In the long term, more and more nations will open their markets to foreigners, who will at least receive access to petroleum resources and the right to participate in other infrastructure projects. As in a number of industries, opportunities for focused players will increase.

Big, specialized, or squeezed

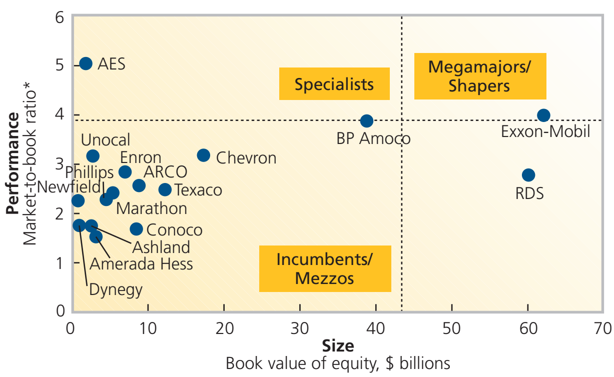
The endgame – if there ever is one – might lie just around the corner if specialization and the creation of slivers were the only forces acting on the industry. But petroleum is a special case because the straightforward evolution

* *See* "Global beer: What's on tap?" *The McKinsey Quarterly*, 1999 Number 1, pp. 110–21.

† *See* "World Power & Light," *The McKinsey Quarterly*, 1999 Number 1, pp. 122–32.

Exhibit 2

Strategic-control map for petroleum companies



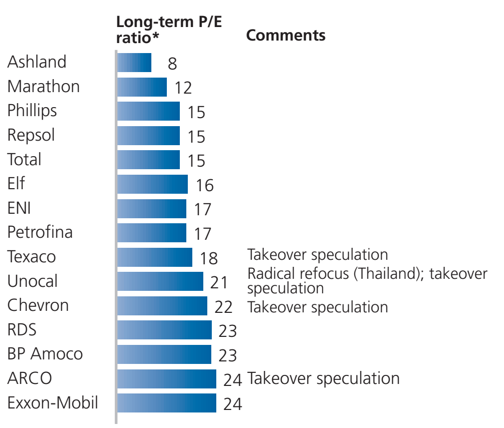
* Market value of equity as of December 31, 1998, divided by book value of equity as of September 1998.

Source: Compustat

to slivers assumes preconditions that are not fully in place here: relatively unregulated national economies, foreign access to ownership of reserves, fully efficient risk and capital markets, and limited advantages to integration and the ownership of physical assets. As a result, scale and scope are still immensely important in a number of markets, and a growing gap in size and competitive power separates the megamajors from the rest of the industry.

Exhibit 3

Significant growth premiums



*Calculated by subtracting the present value of 1999–2001 earnings per share from the current share price and dividing the residual share price by the present value of 2001 earnings per share (using each company's cost of equity as the discount rate).

Source: Zacks; team analysis

Two paths to distinctiveness have therefore evolved in the current era: huge scale and scope, on the one hand, and specialization, on the other. Trends in book value and relative performance (as reckoned by market-to-book values) reflect the degree to which the megamajors and the specialists have outdistanced the rest of the pack – that is, smaller majors and ordinary midsize players (Exhibit 2). In consequence, the megamajors and specialized players are more attractive to equity markets than their midsize, broad-based competitors. In fact, if you disaggregate the share value attributed to near-term earnings and cash flow, on the one hand, and to long-term growth prospects, on the other, the equity market's perspective is even more compelling: the long-term price-to-earnings ratios of the megamajors are strikingly better than those of the mezzos (Exhibit 3).

To be sure, the rise of the megamajors has created some opportunities for other companies. Acquisition and alliance possibilities will emerge as the megamajors adjust their portfolios. Better-performing and well-capitalized smaller players will also have opportunities to take advantage of industry shakeouts as price and competitive pressures persist. But we believe that the gap between the megamajors and midsize players is too wide to be closed through a me-too strategy of medium-sized mergers or acquisitions. The share prices of the megamajors rose after they were formed, but unions of small and midsize players have generally not been well received by the market.

Even if midsize players believe they can meet the huge challenges facing them, a look at recent shareholder value performance casts further doubts. From 1996 to 1998, it declined by 10 percent for smaller majors and midsize players and rose by 14 and 6 percent, respectively, for the megamajors and specialized players (Exhibit 4). These economic and value trends, and the resulting squeeze on the mezzos, have appeared in many industries, including aerospace, banking, automobiles, and airlines.

The dominance of the megamajors, increasing competition from specialists, uncertainty about oil prices, and increasing pressure from equity markets all raise several urgent questions:

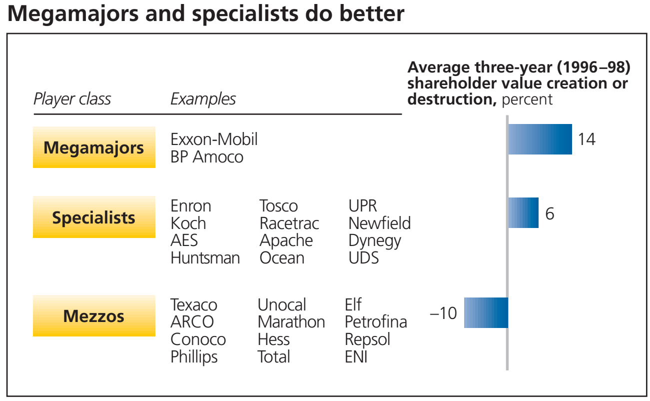
1. Should the remaining smaller majors, such as Chevron and Texaco, tighten their belts, take advantage of shakeouts, and wait for a longer-term improvement in prices and a return to business as usual? Given the additional petroleum supplies that can flood world markets as prices rise above $15 a barrel, is there really a good chance that higher prices offer salvation – or is it better to take the actions required to survive if oil prices stay in the $12 to $15 range (*see* text panel, on next page)?

2. Would it be wise, on the contrary, for the smaller majors to combine with one of the megamajors or to partner with an NOC or a country belonging to the Organization of Petroleum Exporting Countries (OPEC)?

3. Can the industry's mezzos, such as Arco, Conoco, and Phillips, survive a prolonged price squeeze? Even if they can, should they reshape their strategies toward "specialist" roles focusing on businesses and regions where they now have or can attain distinctive scale and skills? What are the implications for share value of failing to undertake bold repositioning moves?

Exhibit 4

Megamajors and specialists do better



ARE HIGHER PETROLEUM PRICES SUSTAINABLE?

As the *Quarterly* goes to press, the Organization of Petroleum Exporting Countries (OPEC) has agreed to withhold production in an effort to raise the price of oil. But oil prices are never certain, and it is very dangerous for mezzos and midsize companies to count on being bailed out of their current predicament by $18-a-barrel oil.

More and more, microeconomic fundamentals rather than decisions by the cartel will determine the economics of petroleum: there are just too many resource-rich nations outside OPEC with low production costs and a pressing need for cash. Moreover, at $15-a-barrel levels, specialists and other players, assisted by advances in technology, can continue to add new supply, even from inherently high-cost basins.

In the past, periods of peak demand tended to draw in production from regions with relatively high costs, which in turn drove high and volatile price levels as OPEC switched from market-share to price-maintenance strategies. We expect that pattern to continue. But this time around, improvements in technology and cost structures have made it possible for the industry to yield significant new supply at price levels as low as $15 a barrel. Our supply side view suggests that in the absence of a discontinuity – a war, for example – looking to higher prices for salvation is a dubious bet.

4. Should the NOCs, in developing their own national resources or expanding their operations to other countries, go it alone? Or can they speed up these strategies by allying with or acquiring a remaining major, midsize player, or service firm? What about constructing a consortium of several of these players?

5. Would cash-strapped but resource-rich OPEC countries improve their positions by teaming up with the megamajors for capital, know-how, downstream access, political security, and, perhaps, more orderly crude markets?

Repositioning strategies

As for the remaining majors and midsize players, their strategic responses are likely to follow four patterns. They can create global slivers through superior intangibles (skills and brands, for example); reshape relationships with the industry's assured survivors (the megamajors, NOCs, and OPEC countries); build geographic franchises by creating and leveraging insider relationships, knowledge, and positions; and create or enter new but related businesses.

Global slivers

As we suggested earlier, sliverization strategies have already taken hold across the petroleum industry. Most major petroleum companies will have to decide whether to stay in the gas-retailing sliver, for instance, since they face intensified competition from such new entrants as hypermarkets and grocery stores. Those that remain in the game will likely pursue alliances and acquisitions to build the necessary skills and scale.

Tosco, to give just one example, has expanded in the United States for well over a decade. The company has acquired refining assets from the majors and added value by aggressively optimizing costs and assets and by purchasing Circle K and improving that preexisting major network of gasoline stations through leading-edge convenience store merchandising and site management skills. Tosco, a world-class organization in its chosen sliver of gasoline refining and marketing, is poised to expand into new markets when regulatory barriers decline in Europe and elsewhere.

Other emerging global slivers include downstream gas, consumer motor oils, marine fuels, and jet fuels. In the downstream gas business, Shell Oil, Tejas, and Bankers Trust collectively built an entity that took advantage of deregulation and evolving customer demand for expanded risk management and other services at lower cost. To enter the gas-marketing arena in the United Kingdom, Amerada Hess and other companies have built new trading, pricing, and customer-service-driven businesses, largely through outsourcing and alliances.

Petroleum companies that find ways to leverage their intangibles – brand equity, as well as new marketing and risk management skills – can consider making broader forays into gas and power marketing. Both alliances and acquisitions will play an important role for companies that pursue specialist strategies.

Reshaping relationships

For a very long time, the foundation of the petroleum business has been a complex network of relationships among oil service firms, specialists, NOCs, and the majors. Alliances will also play an important role for companies that pursue a second strategy: remaking these old relationships around the industry's new competitive logic.

The real opportunities for developing profitable relationships lie upstream: exploring for resources, drilling, and operating wells. Specialist players are forming partnerships with NOCs and OPEC nations to offer broader, more integrated packages including not only these services but also risk management. It seems equally likely that the best service companies will build their intangible strengths in exploration, drilling, and information technology. At least one major service company has outlined a vision combining dynamic reservoir modeling, economic optimization, and "smart" well technologies to create a "downhole factory" that can automatically optimize oil and gas production throughout the life cycle of a field.

OPEC nations, the NOCs, and even operating companies all offer potential markets for life cycle service packages. Who will supply them? At present, Baker-Hughes/Western Atlas, Halliburton-Dresser, and Schlumberger market innovative resource-management offerings that are developing along these lines. Mezzo operating companies might be wise to take the same route, perhaps through joint ventures with service firms. In any case, these developments mean that the roles of resource owner and resource manager will probably separate in the end.

Other opportunities to reshape relationships might center on OPEC or on the new megamajors. Saudi Arabia, for instance, recently talked with several midsize and major players about its hopes of developing a gas business, including transportation and distribution (and perhaps, ultimately, gas resources). On the other hand, a smaller player may find it beneficial to reposition itself as the partner of choice of the megamajors by exploiting its assets, such as specialized skills or special relationships that would be of value to them.

Geographic franchises

Among traditional midsize operating companies, Unocal may be the best example of an organization that has repositioned itself through yet another strategy: geographic integration. The company has developed a strong franchise in Southeast Asia by focusing its investments on that region, building its management bench there, and exploiting its insider relationships, regional scale, and infrastructure advantages. Starting from an initial upstream position in Thailand, the company expanded its presence across the value chain by establishing a broad regional footprint of upstream and upstream-related activities, especially in gas.

Less traditional players are pursuing similar strategies. Petronas, for example, in Malaysia, used the resources and markets of its home country to create resource development skill-building and -learning ventures. Then it exploited these new skills to expand around the world, typically in Muslim nations. Although the company's growth franchise is not constrained within narrow geographies, it rests on a foundation of insider relationships and preferred access to opportunities. National oil companies that seek to build geographic franchises will probably use learning alliances to build their skills or to enter markets and then acquire other companies to expand their positions. Ultimately, a geographic specialist may ally with a megamajor as its regional partner of choice.

New businesses

Finally, traditional operating companies can use their skills, assets, brands, and relationships to enter businesses related to petroleum. Electric power immediately comes to mind because most petroleum companies have marketed gas and built infrastructure for it. The global market is being roiled by the convergence of the gas and power markets, deregulation, the divestiture and privatization of assets, and the need to develop new infrastructure in emerging markets. In such an environment, the mezzos have many of the skills, brands, relationships, and assets needed to broaden their participation in the power industry.

Another serious possibility is the water business, which Enron recently entered. Despite a lack of obvious linkages to energy, the industry offers an enormous international market opportunity, as well as a chance to leverage intangibles such as project management, network operations, and infrastructure development skills. Virtually all of these related market entry strategies will rely on joint ventures with, or acquisitions of, current players.

The future of the industry

On the whole, we anticipate very dynamic times: more mergers, alliances, divestitures, and restructuring. But the wave of megamergers has passed: BP Amoco, Exxon-Mobil, and Shell will dominate the industry, and no additional companies (even in combination) are likely to amass the financial power needed to make comparable plays in the full global arena.

NOCs are the industry's sleeping giants; should Saudi Aramco and several other NOCs expand their operating roles, they would surpass even the megamajors if all of these companies were valued in the same way. An NOC or two might conceivably put itself in the first rank by purchasing an operating company and broadening its economic and operating clout. Or the NOCs might parlay their strength in their home markets to build regional franchises by acquiring companies in nearby nations through roll-ups or regional joint ventures.

The remaining mezzos will reposition themselves by allying or merging with one of the megamajors, by focusing on slivers, by forging new kinds of relationships with petroleum-producing nations, or by otherwise repositioning their energy businesses or geographic portfolios. The best specialists will control their own destinies by developing distinctive performance strengths in their chosen slivers. Many of these companies will ally with or acquire other specialists to cement their competitive niches.

Exciting times lie at hand. As the winners of the future craft new strategies to build scale or distinctiveness, the megamergers will create aftershocks: mergers and acquisitions, alliances, and divestitures. Companies that fail to act may lose control of their destiny, becoming acquisition or breakup targets.