OLIVER WYMAN

Oil and Gas

Business Design: An Indicator for Oilfield Services Opportunities

There is an important rule that should guide the search for opportunities in the oilfield services industry: companies with the strongest business designs will always be more successful. This holds true regardless of whether oil and gas prices are cycling up or down.

Prior to the most recent gyration in energy prices, Oliver Wyman published a commentary that outlined how investors could identify oilfield services companies with the strongest prospects for delivering outstanding results. Since then, the bubble has burst, with oil prices plunging from $150 to less than $50 a barrel—and the businesses we highlighted are still going strong. With a greater need than ever to identify the best investment prospects, the lessons of Oliver Wyman's proven approach are clear: a focus on "effective business design" can lead to better relative market returns, *regardless of where commodity prices may be heading.*

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No segment of the energy industry has been immune from the current slowdown. Across the globe and within every vertical specialty, the collapse of commodity prices has depressed margins and thrown long-term growth plans into disarray. This is a dramatic change from the first two quarters of 2008, when most oilfield service companies' price-to-book and price-to-sales ratios reached levels not seen in nearly a decade.

Amid the carnage, however, a small handful of companies are continuing to produce solid results. From seismic services to contract drilling, these "industry standouts" share a common approach of utilizing their business designs to respond to market trends.

To help illustrate how such effective business designs can be identified, Oliver Wyman has updated its previous commentary focused on the drilling segment. Our commentary pinpoints the forces and strategic patterns reshaping the oilfield services market, identifies emerging customer priorities, and provides an overview of the business designs of winning enterprises.

The Bad News and the Good News

In a protracted slowdown, it is reasonable to expect that oil and gas producers would scale back on their exploration and production projects. The current slowdown is remarkable because many E&P companies appear to be staying the course—and they are turning to oilfield services companies to help them achieve their ambitious production goals.

Consider these facts:

- The past twelve months have witnessed a tremendously steep decline in oil and gas commodity prices. But Barclays Capital forecasts that global E&P spending will only decline by 12 percent in 2009. Supermajors are forecast to cut their capital spending by only 3 percent as a group, and large E&P companies continue to invest tens of billions of dollars annually in projects that are not expected to begin production until the middle of the next decade. These companies are clearly focused on long-term growth.
- Rig counts in the United States are down more than 50 percent from their 2008 highs—but the level of gas reserves (proven, probable, possible, and speculative) has climbed by 35 percent since 2006 according to the Potential Gas Committee. Without the gas shale reserves, however, the potential volume of gas in the United States would have been less than estimated in 2006. This is significant: without the effort to unlock gas shale resources, we would have seen a continued pattern of generally flat gas resource volumes since the start of this decade, despite an active drilling effort. As Oliver Wyman predicted in 2008, oilfield services firms that offer the best combination of highly skilled workers and the newest equipment continue to find a demand for their products and services.

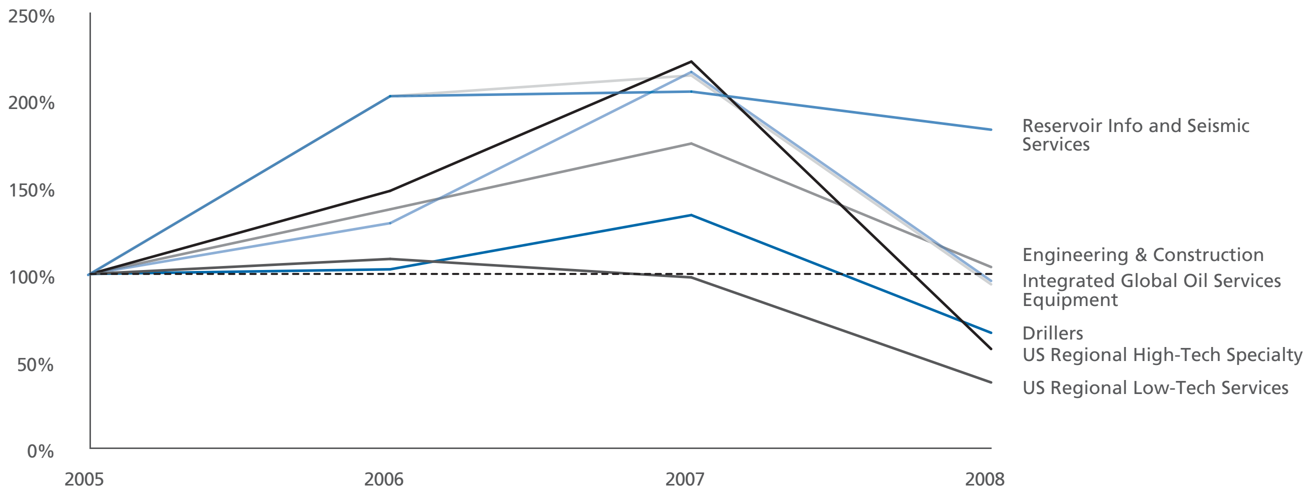
A substantial amount of work is obviously under way in the drilling segment—and a number of companies are participating in it. But something more than a review of the Oilfield Services Index (OSX) is needed to identify those firms that are prospering in the current environment. Oliver Wyman believes investors should work to understand the specific roles of companies operating in the E&P value chain—and confirm which companies have crafted the best business designs.

Drilling Down into the Oilfield Services Industry

The OSX aggregates values across several segments that make up the oilfield services industry. It is a useful guide for some applications, but it fails to illuminate critical distinctions among companies and their business designs. If guided only by the OSX, investors gain limited insights about how a particular segment within the oilfield services industry has performed in the past—and will glean few clues about how a company will perform in the future. A more effective approach is required; namely, an *opportunity assessment* that drills deeper into the nuances of the industry and highlights the business designs that elevate specific companies above their competitors.

Exhibit 1 **Market Value Growth in Oilfield Services Segments, 2005-2008**

As a percent of 2005 weighted average market value, aggregated by segment



Source: Compustat, Oliver Wyman analysis. Note: Market values as of December 31 each year.

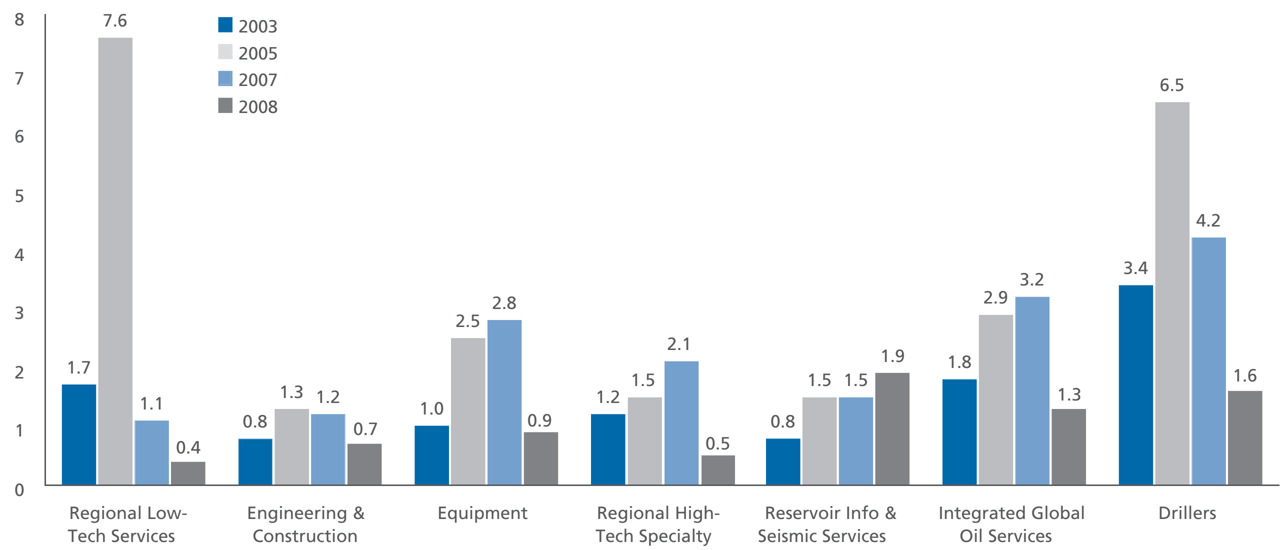
It is not clear, from reviewing the OSX, the extent to which oil and gas prices impact the various segments of oilfield services. Over the past few years, for example, equipment manufacturing and reservoir information and seismic services firms have enjoyed spectacular increases in market value and EBIT. At the same time, however, results from other oilfield segments have been lukewarm at best (Exhibit 1). These include lower-tech well servicers and pressure-pumping service providers who cater primarily to the US onshore E&P industry. Over time, the ratio of market value to sales—a key indicator of value flows—has also varied considerably from segment to segment (Exhibit 2).

What drives value flows within these segments? Oliver Wyman's experience suggests that winning oilfield services companies benefit from forward-looking and flexible business designs that allow them to anticipate shifts in market trends and customer priorities. When market conditions and customer needs change—as they are certain to do—these companies have the tools to quickly adapt to new opportunities.

Business designs comprise a set of deliberate choices that a company makes in five distinct but interrelated areas (Exhibit 3):

- **Customer selection and value proposition:** Which customers and market segments are targeted? What products and services are offered?
- **Value capture/profit model:** How does the company generate profits and value? On what basis are customers charged for services and equipment?
- **Strategic control:** How are future profits protected against competitive pressure?
- **Scope of activities/assets:** Does the company possess the critical set of activities, assets, and capabilities needed to execute the business model?
- **Organizational systems:** Are the company's resources organized to create the most value? Do the company's organizational structures and processes support the business model?

Exhibit 2 **Market Value/Sales Ratios: 2003, 2005, 2007, and 2008**



Source: Compustat, Oliver Wyman estimates and analysis. Note: Market values as of Dec. 31 each year.

Well-constructed business designs position companies to stay ahead of market changes, satisfy customers' key priorities, and can weather even the most volatile business cycles.

Business Design Review in Action: US Onshore Contract Drilling

Oliver Wyman has worked with clients throughout the world to help them identify how market opportunities are closely aligned with winning business designs. To illustrate our approach, we will look at a specific oilfield services segment in depth: US onshore contract drilling.

Contract drillers are currently working through a bottleneck that first formed in 2005 when high-spec rigs were "locked up" by the big independent oil and gas producers looking to exploit new opportunities in a number of geological basins. When smaller E&P companies went looking for rigs from their traditional sources, they were turned away. Some responded by acquiring their own rig fleets. Contract drilling services and exploration and production are two very different businesses, however, and in recent months some of the E&P companies that had purchased drilling rigs decided to focus instead on their core competencies and started to divest themselves of these assets.

A number of clients have approached Oliver Wyman for our views on which companies are making the best strategic moves as they acquire and manage drilling rigs. Our counsel continues to be that to properly evaluate business design choices, investors must first understand customer needs and develop a baseline understanding of contract drilling market dynamics and underlying trends.

Drilling contractors vary widely in their business designs, in terms of the customers they serve, the services they provide, the kinds of contracts they require, the degree of specialization they offer, and the assets they own. They also differ widely in their performance. For example, drillers specializing in deepwater applications have enjoyed markedly better market value growth than companies specializing in other areas (Exhibit 4).

The contract drilling segment has always been volatile, subject to the cycles of oil and gas prices and E&P spending. But the recent downturn in prices has begun to reshape the segment, prompting service provid-

Exhibit 3 **Oilfield Services Business Design Choices**

ers to carefully consider how they can prosper in an era of lower prices. Key market considerations and strategic patterns for the US onshore contract drilling segment include:

- **Switching from oil to gas:** In the past 20 years, the number of producing crude oil wells has plummeted, and the size of the average discovery has declined. Over the same period, however, the number of natural gas producing wells has jumped from just over 250,000 in 1990 to more than 450,000 today. As of this year, the drilling of natural gas exploration and development wells made up about 70 percent of all US onshore drilling activity. Many of these wells fall into the "unconventional" category—and these natural gas projects have a very different set of technical requirements than oil projects. Service providers armed with the best business designs recognized how they needed to match their equipment inventories to the needs of their customers—and these are the companies that are positioned to prosper in the current market.

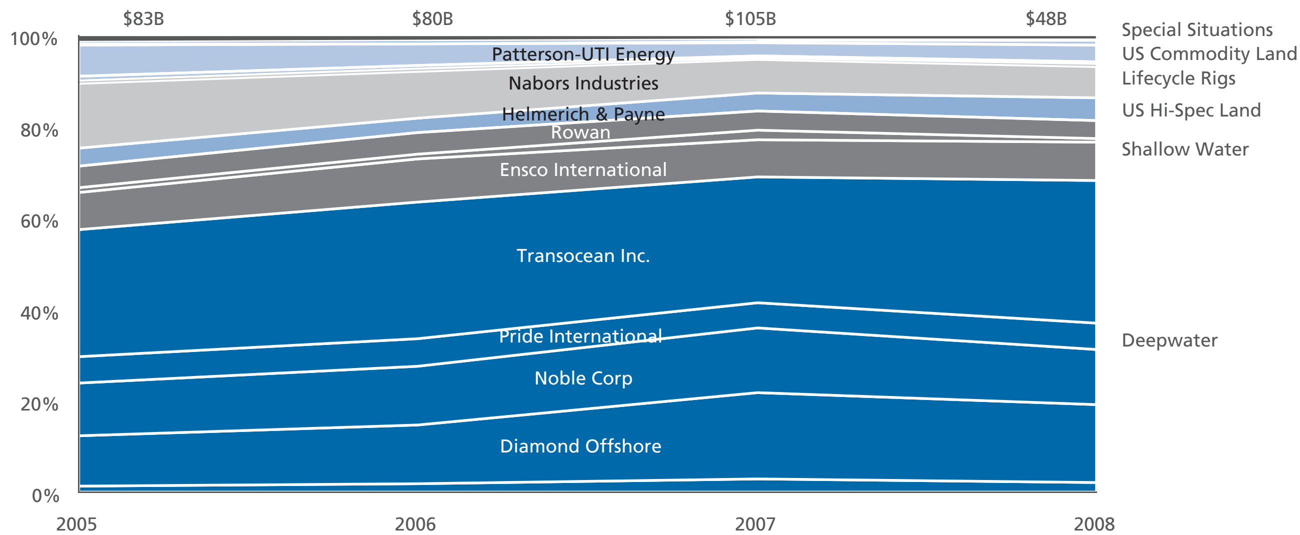
- **Responding to margin squeeze:** Overall fleet utilization during the "price boom" surpassed the 80 percent threshold that traditionally triggers significant increases in day rates—the daily work rates that drillers charge their producer customers. But the subsequent collapse of prices forced most of these contract drillers to prepare for a prolonged margin squeeze. Guided by their effective business designs, some firms took the initiative to introduce new technologies that can enable their E&P clients to unlock gas reserves from "tight shales" and other formations that have previously proven difficult to develop.

- **Specialization:** Other drillers have adopted a different strategy, preferring to distinguish themselves as specialists. For example, some firms are focusing on providing the directional (horizontal and angled versus straight hole) drilling required to navigate shale and other unique geological features of the North American landmass. But success within this specialized segment derives from something more than equipment and the personnel to operate it: The best performers are following a business design that continues to *meet the needs of their customers.*

Investors contemplating investments in drilling companies or rig fleets can learn much by analyzing the business designs of winning rig contrac-

Exhibit 4 **Market Value Increases for Contract Drilling Segments, 2005-2008**

Percentage of market value by company



Source: Compustat, Oliver Wyman analysis. Note: Analysis includes 17 publicly traded drilling companies.

tors—and determining precisely how they differ from less successful business designs. Oliver Wyman research suggests that a single variable—*the characteristics of a company's rig assets*—is the key component of the best business designs in the US onshore contract drilling industry. Companies that offer higher-spec, fit-for-purpose rig fleets are typically larger than their competitors and focus on serving major oil producers or large independent E&P firms that are interested in long-term contractual relationships. The business designs of these top performers have allowed them to achieve maximum utilization of their rig fleets even during this downturn in oil and gas prices, resulting in greater market value growth and more favorable market value/sales ratios than realized by their peers (Exhibit 5).

By contrast, drilling contractors who have been less successful at creating market value cater primarily to smaller independents and do not offer specialized services. Moreover, they are trapped in a difficult situation: they are unable to win premium contracts because they lack the technology and experience producers want, but they cannot afford the technology or acquire the experience without first gaining a premium contract—a situation that works to prevent market entry by would-be competitors.

Will the business designs of top-performing drilling companies continue to generate superior returns in the future? Our analysis strongly suggests that the answer is "yes"—and the proof can be found in fleet utilization rates. Although the overall rate currently stands at nearly 40 percent, the broader market figure masks a relative shortage of high-spec rigs, which is good news for drilling companies that have stocked up on this specialized machinery. Why? Partly because low-spec land rigs can be fabricated virtually anywhere a drilling company can find welders. But high-spec equipment requires more sophisticated design and fabrication as well as drilling contractor crews who know how to outfit and commission the rigs. When new projects demand high-spec rigs, E&P companies have no choice but to find a contractor who can supply them—and pay the higher day rates they command.

Case Example: Translating Business Designs into Investment Opportunities

A case example of how business design information can be used to develop investment opportunities is to look at the characteristics of the drilling segment in combination with recent market data from oil and gas producers that have owned rig fleets. As noted earlier, E&P executives have realized that running a drilling operation differs markedly from running an E&P operation. Even if it has the right drilling personnel and assets, an oil and gas producer cannot expect a healthy return on investment until a rig is fully assembled and drilling efficiently.

These trends may signal an opportunity to create a contract drilling company built from divested rig fleets. A "road map" for such a play could include the following strategies:

- **Assemble the right leadership team:** Identify experienced contract drilling managers and bring them together as a team to lead the new company.

- **Acquire the right assets:** Acquire 30 or more high-spec, fit-for-purpose rigs. The best potential sellers are producers who have learned that the challenges of running a contract drilling business are greater than they had previously considered. Position the rigs in basins where drilling activity is increasing and where the new company can quickly establish a "top three" market share position. This will enable the company to achieve the economies of scale needed to ensure equipment availability, lower overall costs, and boost the bottom line.

- **Ask for long-term contracts:** Forge long-term (3-plus years) agreements with oil and gas producers; for example, firms that are considering divesting their rigs. These firms will value the secure availability of the new company's services, and the new drilling contractor will benefit from the stability of guaranteed cash flow.

- **Anticipate growth:** The newly created company will benefit from a well-designed growth strategy. Such a plan can be developed by determining where value is migrating in the market and then building a business design around these insights, backed up by an organizational system

Exhibit 5 **US Onshore Drilling Business Design Comparison**

Company	Long-Term MV Increase (Jan '01 - Jul '08)	Medium-Term MV Increase (Jan '06 - Jul '08)	Short-Term MV Increase (Oct 1 '08 - Mar 31, '09)	MV/Sales (Mar 31, '09 TTM)	High-Spec Equipment	Scale: Regional Leadership, Visibility of Future Revenues
Helmerich & Payne	374%	122%	(37%)	1.1		
Nabors	73%	25%	(53%)	0.5		
Grey Wolf	60%	13%	–	–		
Patterson-UTI	113%	10%	(43%)	0.7		
Pioneer	555%	(1%)	(71%)	0.3		
Union	na	42%	(56%)	0.3		
Bronco	na	(23)%	(47%)	0.5		

● = Highest levels

○ = Lowest levels

Source: Bloomberg, Oliver Wyman analysis and estimates. Note: Grey Wolf was acquired by Precision Drilling on December 31,2008.

and culture that can properly support the company's strategic goals over the long term.

The energy industry will always be volatile. But "volatility" does not necessarily translate into a negative—especially for investors with the ability to identify new possibilities and develop them into profitable enterprises. The critical requirement is to understand and adopt the most effective business design choices—and remain consistent and true to those strategic decisions. ❖

Oliver Wyman's Oil & Gas Practice

Oliver Wyman's Oil and Gas Practice assists clients across the breadth of strategic, organizational, and operational issues, delivering value growth strategies and improved operations with *measurable results* to clients. Our professionals help investors with deal targeting, assessment/diligence, and post-acquisition integration and growth strategy development.

For more information, please contact **Bob Orr**, Oil and Gas practice leader. He can be reached at bob.orr@oliverwyman.com.

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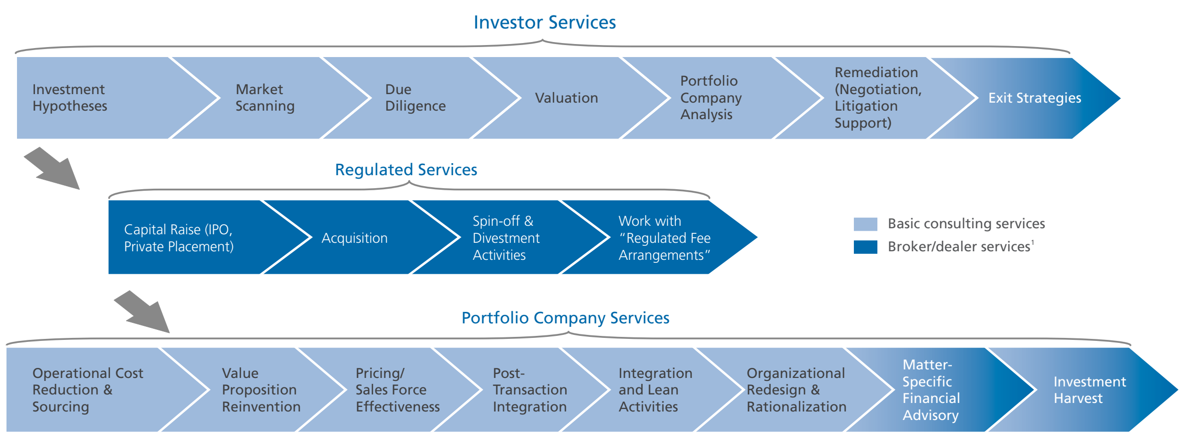
For more information, please contact **Allan Kaulbach**, Corporate Finance & Restructuring practice leader for Manufacturing, Transportation, and Energy. He can be reached at allan.kaulbach@oliverwyman.com.

Oliver Wyman's Corporate Finance & Restructuring Consulting Services



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This white paper was prepared by **Ryan Isherwood**, a Houston-based associate partner in Oliver Wyman's Oil and Gas practice. He can be reached at ryan.isherwood@oliverwyman.com or 713.276.2245.

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