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Burner Tips: The Steps Before the Negotiation Room

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In the first half of 2015, Chesapeake trailed only ExxonMobil as the top producer of natural gas. At the time, Natural Gas was down over half from the $6.15/mmBtu peak seen in the previous year, sliding daily. Highly hedged, $10 billion in debt, and looking at 14 bonds due beginning in 2017, Chesapeake leadership decided to hold steady as an independent entity. A year later, in February 2016, rumors started to spread that it had hired restructuring attorneys, dropping the natural gas giant's already slumping stock over 50 percent in a single day. Leadership saw the writing on the wall – months, if not years, too late.

To avoid the same fate for your natural gas company, you have to accept a harsh reality. Due to the unrelenting oversupply of natural gas, the price is unlikely to recover until 2018. While some gas executives may be stalling this inevitability in hopes of a price recovery, astute executives have read the cards. With looming debt maturities and declining liquidity, passive leadership is in a worse place by the day.

Don't let a history of strong prices or the reluctance of stakeholders distract you from the facts. You need enough liquidity to stand for the next two years without a change in current profits, or you should be pursuing M&A opportunities. Among those needing an acquisition or a merger to survive, the most successful will have one thing in common: preparation. Before approaching a merger or acquisition discussion, consider the following:

Evaluate Your Situation

Determine your marginal cost of production, and evaluate just how much operating capital you would need to survive the next two years. If you're losing money daily, then you are in the unenviable situation of needing to sell at a loss. If you know this before stepping foot into a negotiation room, you'll be better able to play up other aspects of your business.

However, there are many gas companies whose proven reserves could offer a better outlook. With capitalized players eager to make a deal in a down market, it's very possible that you could maintain a moderate equity stake while getting the liquidity you need.

The bottom line is that you need to know how well capitalized you are. Arm yourself with a realistic market value of your organization's assets, including depletion rates. Base your expectations on whether you'll be able to maintain equity value or be a distressed seller based on these numbers.

The market price for gas is constant, but the cost of extraction can vary greatly between regions. For example, Eagle Ford in South Texas is approximately $4/mcf, while Bossier in Louisiana is just over $6/mcf. In markets where extraction costs are low, the value of a gas company's assets are higher.

Geography can also refine your list of potential partners. Is there a key player in your geography that might benefit from a consolidation of resources or lesser competition?

Determine the Players

We've already begun to see an uptick in consolidation, but there's much more to come. According to a recent M&A webcast poll by Deloitte, 60% of participants think M&A in oil and gas won't pick up until the second half of 2016 or later. As negotiations can take normally take 6 to 9 months, time is of the essence.

Large, well-capitalized E&Ps and vertically integrated super majors are always looking for assets in the American gas space, but that doesn't mean they consist the entirety of potential partners. There is currently over $80 billion in private equity capital seeking investments in the E&P sector. Buyer-led deals are creating a culture of consolidation, and as a potential seller, you want to lead the conversation to get the best deal.

It pains me to utter these words as much as it pains you to read them, but it's true: look for synergies. This isn't just limited to geography, though the most apparent commonalities are among players in the same region. Could your finance and accounting systems be easily consolidated? Do you have the same infrastructure model? Synergies make the deal.

Take for instance Shell's $70 billion acquisition of BG Group completed earlier this year. Months into negotiations, Standard Life Investment, which had a stake in both companies, blocked the deal, saying it was bad for Shell shareholders. It was only after identifying $3.5 billion in pre-tax cost synergies, mostly in the form of operating and administrative overlaps, that the deal received full shareholder support.

Check for Potential Constraints

While there are rarely challenges to market concentration when a large company buys a more thinly capitalized one, depending on size and atmosphere, regulation can become a core issue of a potential partnership. Take a look at the most recent regulatory climate.

The more likely scenario when it comes to M&A challenges is one of capital structure. If the price of a distressed company doesn't clear all liabilities, or if equity holders think that the value should be higher, there could be a costly, lengthy blockade of the deal. We often see this in middle market companies, though the Shell example shows it can happen in deals of all sizes.

To prevent these hurdles, especially in the middle market, try to gain support from your board before exploring strategic partnerships. Too often CEOs begin the process on their own, making a handshake agreement before mentioning a potential deal to key stakeholders. In these cases, the CEO could raise the board's ire, and the board rejects the agreement. Bringing in an experienced investment banker early on can make these board conversations go more smoothly, as the outside expert can demonstrate the value more articulately.

You may be facing a mountain of debt. You may have shareholders questioning your value. You may be wondering if or when prices will recover. Take this moment to remember the words of Winston Churchill, "If you're going through hell, keep going" – and then do so.

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