E&P Strategy

For Smaller Companies, It’s Different

by Daniel López, Stuart Groves, and Philip Whittaker

Exploration and production (E&P) companies are facing tougher times. Intensifying competition; larger, more complex, higher-risk projects; and a steady transfer of value away from the industry are making it increasingly difficult for these businesses to simultaneously grow and create value without taking on significant risks. The challenges are particularly acute for small and midsize companies—those that produce less than 100,000 barrels of oil equivalent per day and lack the scale advantages, cash flow, and reputation that support the strategies of their larger competitors.

Smaller E&P companies have to find new, differentiated ways to grow profitably and sustainably. To do so, they will have to make critical decisions regarding their business models, growth objectives and portfolio structure, operatorship targets, risk appetite, and financing approach—and get those decisions right. This is, admittedly, a tall order for smaller companies. But staying their present course, or attempting to emulate the strategies of the industry’s larger players, is a surefire recipe for stagnation, marginalization, or worse.

Industry Participation Alone Is No Longer Enough

For more than a decade, the E&P industry has enjoyed relatively attractive results. From 2000 through 2013, the industry had returns on average capital employed (ROACE) of roughly 24 percent. Moreover, its risk-return profile has been consistently superior to that of the downstream oil and gas industry and the overall industrial sector.

Structural factors supporting the oil and gas industry will remain largely positive in the medium term. But companies will find it increasingly difficult to maintain profitability levels. Growing numbers of competitors are entering the fray and, simultaneously, bidding up the prices of assets and acreage. In addition, with the continuing depletion of relatively easily exploitable resources, companies have been forced to un-
dertake increasingly complex projects, such as deepwater development and the development of unconventional resources. By their nature, these projects are often larger and carry greater technical, financial, and environmental risk. In concert, sustained cost inflation, higher taxes, and a scarcity of needed capabilities have resulted in a steady transfer of value away from E&P companies.

These forces are increasingly evident in the industry’s numbers. Annual ROACE, for example, fell from an average of 27 percent from 2000 through 2008 to 18 percent from 2009 through 2013, despite a tripling of oil prices from 2000 through 2013. The decrease in ROACE was driven by relatively slow growth in after-tax income coupled with a rapid increase in capital employed: from 2000 through 2013, the industry’s post-tax income doubled (though it had been flat, at best, since the mid-2000s), while capital employed per barrel of production more than tripled.

In response to the changing landscape, many larger E&P companies have announced major divestments of noncore assets, aggressive cost-reduction programs, and plans for more disciplined deployment of capital in the years ahead. Given their strong base of legacy assets, these companies have sufficient scope to both concentrate and scale back, refocusing on their most attractive opportunities.

But what about smaller companies? What moves can they make to ensure profitable growth in this new, structurally tougher environment? In the recent past, simply participating in the industry was sufficient to guarantee attractive growth. In the future, that will not be the case.

To succeed, smaller E&P companies will have to strike a challenging balance. They must focus growth in areas where they have a competitive edge and can build scale. Simultaneously, given the industry’s high and increasing risk and uncertainty, they will have to pursue value-added diversification and ensure effective risk management.

**Five Key Questions for Smaller E&P Companies**

As smaller E&P companies weigh their options and work to define a growth strategy, they should ask themselves five basic questions. These questions—a subset of those we typically recommend to larger companies that are formulating strategy—are particularly relevant to smaller businesses, which face a distinct set of opportunities and constraints. (See the sidebar, “For E&P Companies, the Questions Vary Depending on Size.”)

**What do we want to be known for in the future?** Distinctiveness—in reputation, capability, performance, relationships, or portfolio—is critical for small E&P companies. Companies lacking in distinctiveness are less attractive candidates for participation in the most promising joint ventures. They are also more likely to be forced to chase low-quality or overpriced opportunities in pursuit of growth. We see six specific business models in the market today that can offer the necessary distinctiveness. (See Exhibit 1.)

- **Integrated E&P players** (such as Anadarko, Premier Oil, and Apache) seek to develop a balanced portfolio of assets across technologies, geographies, and phases of their assets’ life cycle.
- **Explorers** (such as Cairn Energy, Kosmos Energy, and Cove Energy) concentrate on exploration of frontier areas and early monetization of discoveries.
- **Regional specialists** (including Pacific Rubiales Energy, Afren, and Pluspetrol) emphasize specific countries or regions where they have an established presence and a high degree of familiarity.
- **Nonconventional specialists** (such as Chesapeake Energy, Canadian Oil Sands, and Husky Energy) focus on the development of nonconventional resources, such as heavy oil, shale oil and gas, and oil sands.
- **Operations specialists** (including Perenco, Black Elk Energy, and Occidental Petro-
leum) emphasize efficient extraction of resources from existing fields.

- **Nonoperator E&P players** (such as Mitsui & Co. and Galp Energia) use their relationships with national oil companies and governments to gain access to high-quality assets. They manage those assets but do not act as operators.

How big do we want to be? Scale can obviously be a powerful lever in E&P, and some small and medium-size players define their ambitions primarily in terms of size targets. This makes for an easily communicated, potentially compelling message to stakeholders—but one that is also dangerously simplistic and can drive growth without creating value. We believe that smaller E&P players would be better served by defining their portfolio ambitions in terms of a combination of scale, financial value creation, and sustainability.

### FOR E&P COMPANIES, THE QUESTIONS VARY DEPENDING ON SIZE

Larger and smaller E&P companies differ vastly in terms of asset base, risk tolerance, access to financial resources, opportunities for diversification, and other critical considerations. This should be reflected in a company’s strategy design.

Below is the list of ten questions we typically pose to larger E&P companies that are formulating strategy. The first five are particularly germane to smaller players and merit their focused attention.

- **What do we want to be known for in the future?** What are our aspirations regarding our reputation, capabilities, and performance?

- **How big do we want to be?** What should our targets be for production and reserves?

- **What is our target balance between operatorship and nonoperatorship of portfolio assets?** What mix will help us best realize our growth ambitions? Are we restricted by limitations in our in-house capabilities?

- **What is our appetite for risk?** How much exposure to geopolitical, technical, commercial, and other risks are we willing to take on?

- **Which financing approach is needed to support our growth strategy?** What is the right balance between debt and equity? How should we finance capital expenditures?

- **How should we structure the E&P portfolio?** Do we want to place greater emphasis on gas or oil? Where should we position ourselves along the value chain?

- **Which countries and regions should we emphasize?** What are the optimal locations for key focus areas, opportunistic plays, and seed projects?

- **How should we define and measure performance and value creation?** Which metrics (for example, earnings, return on capital employed, or projects’ internal rate of return) should we emphasize?

- **Which governance model should we employ?** Do we need a customized model? Should we organize by asset or by function? What should the role of the center be?

- **Which capabilities and conditions are critical to our success?** What skills and decision-making capabilities do we need to develop or acquire?
portfolio assets? The range of choices here varies widely among smaller E&P companies. There is no single right answer.

We believe that decisions regarding operatorship versus nonoperatorship should ultimately be made by looking at the company’s desired pace of growth, on the one hand, and its capabilities, on the other. Nonoperating investment remains the fastest and the least complex way to build scale. However, it often fails to create externally credible expertise that can help drive future growth and differentiation. Operated investments, in contrast, build credibility, capability, and resources that can be deployed in future opportunities—but they can also bring added organizational complexity and a heavy fixed-cost base, in addition to the responsibilities of operatorship.

Intermediate paths are emerging that could provide attractive options for smaller E&P companies. Long-term outsourcing of operations and maintenance has been successfully deployed for some years by companies operating in the North Sea; increasingly, companies are outsourcing well engineering and geoscience functions as well. And the reputation of nonoperatorship in general is improving as leading international oil companies begin to take an increasingly structured and active approach to the management of their nonoperated investments.

Many smaller companies rely heavily on nonoperatorship in order to build initial scale. They should recognize, however, that this approach, unless accompanied by long-term capability building and, ultimately, some operatorship, tends to yield an undifferentiated competitive position.

What is our appetite for risk? Risk is a fundamental issue in E&P, but it is often underappreciated by smaller companies. Our research reveals that from 2005 through 2012, the average annual growth rate of the more than 300 companies we tracked was 3 percent, a rate that seems sustainable. However, there is wide variability. Only 62 percent of smaller upstream businesses had positive growth, and almost a third had negative growth. In fact, 4 percent of these companies exited the business, their failure driven by such factors as financial overextension, a string of failed exploration bets, and growth unaccompanied by value creation. All of these failures hold valuable lessons for smaller E&P companies, many of which tend to focus more on the success stories than on the potential downside.

Risk tolerance should be carefully assessed as a company chooses its growth strategy. Successful exploration is, of course, the most value-creating growth pathway. But it carries significant risk—few remember the string of failed exploration specialists that litter the industry’s history. Geographical
diversification, meanwhile, can appeal to businesses whose opportunities in their home market are limited. But it can bring exposure to risks related to individual countries that are often difficult to understand or quantify.

In reality, smaller companies’ appetite for risk, and the resulting growth options available to them, is ultimately determined to a large extent by their size. For many businesses, the most pragmatic approach will be acquired production to build low-value, low-risk cash flow, combined with careful growth in project and exploration investments.

**What financing approach is needed to support our growth strategy?** For smaller E&P companies, the growth strategy is often far more tightly bound to the financing approach than it is for larger players, and the linkage between the two must be explicit in order to ensure adequate funding. A high-growth strategy often demands large up-front investments that are difficult for smaller businesses to access through external funding sources. Cash flow from early production can be small or nonexistent, putting demands on working capital.

Smaller companies that have larger corporate parents (be they utilities, downstream players, or large industrials) may, in theory, have access to internal funding sources. But the reality can be different. Parent companies with a small E&P division but no E&P heritage can find it hard to fund the riskier, higher-reward opportunities intrinsic to E&P. And in recent years, many of these larger companies’ core businesses have not been profitable enough to fund such external “adventures.” Moreover, for many of these parent companies, their value proposition in the E&P space is unclear. For the smaller, upstream divisions of such companies, acting as a confident independent may be the best approach.

**Five Questions, Many Answers**

As noted, the coming years are likely to be decidedly less friendly to the E&P industry, particularly to the industry’s smaller players, which have far less room for error than their larger brethren. Smaller companies will need to make a cold, reasoned assessment of their prospects and possibilities and choose a course wisely. There is no single solution: the best answer will always hinge on where the company is today, where it hopes to be tomorrow, and what it
deems the best risk-adjusted means of getting there.

The most critical thing for smaller E&P players is to start thinking actively about their future now, if they are not already doing so. The questions discussed above can be a valuable part of that process.

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