More uncertainty for dealmakers

M&A trends in ENRC

Q3'22

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Introduction

Sector outlook remains cautious

M&A volume and deal values continued to decline in Q3'22. The same factors that we saw last quarter—inflation, the Russia-Ukraine war, rising interest rates, and supply chain disruptions—continue to soften the deal market and make even well-established players take a more cautious stance about both buying and selling.

From Q2'22, ENRC deal volume decreased 16.2 percent from 340 deals to 285. Deal value fell 51.6 percent from $53.0 billion to $25.6 billion. The share of strategic deals in the ENRC sector totaled 77.2 percent (220 deals), with strategic buyers accounting for 89.3 percent of total value ($22.9 billion). Among the top 10 deals for Q3'22, seven deals involved energy-related companies, and three deals involved producers of chemical products.

There were a limited number of PE deals in Q3'22, amounting to only 9 percent of total deal value for the sector. This was based primarily on continued uncertainty about interest rate increases by the U.S. Federal Reserve. However, PE deal activity might increase in the near future with PE firms selling high-producing oil and gas (O&G) companies to buyers who want stable, long-term investments.

In the Outlook section, KPMG Economics share their views about the growing likelihood of a recession in Q4'22. They also discuss the risk of rolling over maturing debt in an environment marked by rising capital costs. In addition, a number of key considerations for maximizing deal value are offered, including the need for sellers to highlight critical differentiators; buyers to assess a target's environmental, social, and governance (ESG) exposure; and management teams to trim costs and enhance their hiring strategies.

Key statistics

-16% decrease in total ENRC deal volume from Q2'22 (340) to Q3'22 (285)

-52% decrease in total ENRC deal value from Q2'22 to Q3'22 ($53.0 billion to $25.6 billion)

77% strategic buyers accounted for 77.2 percent of ENRC deals and 89.3 percent of deal value in Q3'22

Chris Rockers on commodity prices

High commodity prices are being driven by multiple factors including global supply, geopolitical disruptions, and uneven global demand as economies recover from the COVID-related downturn in 2020–2021. M&A activity generally prefers stability in commodities pricing, preferably at higher levels, so budgets and planning can be forecast in the short term and long term.

Gillian Morris on the chemicals subsector

Some companies in the chemicals subsector are seeing a softening of the deal flow due to economic uncertainties, access to financing, energy prices, etc. Buyers could be in a better position to raise debt if acquisitions are strategic with strong synergy potential or robust value creation opportunities. However, in this environment, buyers need to provide a lot more granularity than ever before on synergies in order to convince lenders.

Mike Harling
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By the numbers

Deal numbers continue to slide

In Q3’22, M&A activity declined, continuing trends from the previous two quarters. Along with a quarter over quarter (QoQ) decline of 16.2 percent in volume and 51.6 percent in value, the ENRC sector dropped 6.3 percent for domestic deals, 15.7 percent for inbound deals, and 48.5 percent for outbound deals.

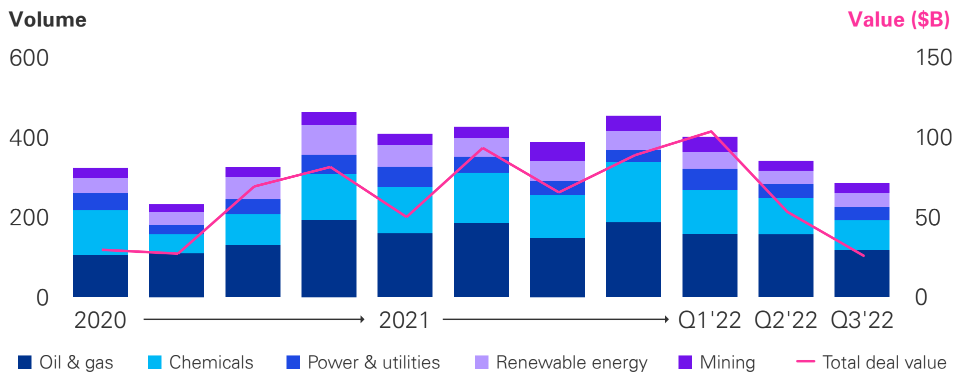
Significant deals were made across the ENRC sector. In September 2022, EQT Corporation entered into an agreement with THQ Appalachia I, LLC (Tug Hill) and THQ-XcL Holdings I, LLC (XcL Midstream) to buy Tug Hill’s upstream assets and XcL Midstream’s gathering and processing assets for $5.2 billion.[1] The acquisition will support an increase in cash flow and net asset value per share, a lower cost structure, and lower business risk.

In August 2022, Valvoline Inc., a leader in vehicle care services and products, announced that it reached a definitive agreement to sell its Global Products business for $2.7 billion in cash to Aramco.[2] The transaction separates the company’s global products and retail services businesses, transforming Valvoline into a pure-play automotive service provider. Devon Energy Corp, an O&G producer announced in August 2022 an agreement to acquire Validus Energy, an exploration and production company, expanding its Eagle Ford Shale footprint for $1.8 billion.[3] In September 2022, Sitio Royalties Corp. and Brigham Minerals announced a definitive agreement to combine in an all-stock merger, with an aggregate enterprise value of approximately $4.8 billion.[4] The merger joins two of the largest public companies in the O&G mineral and royalty sector, with complementary assets in the Permian Basin.

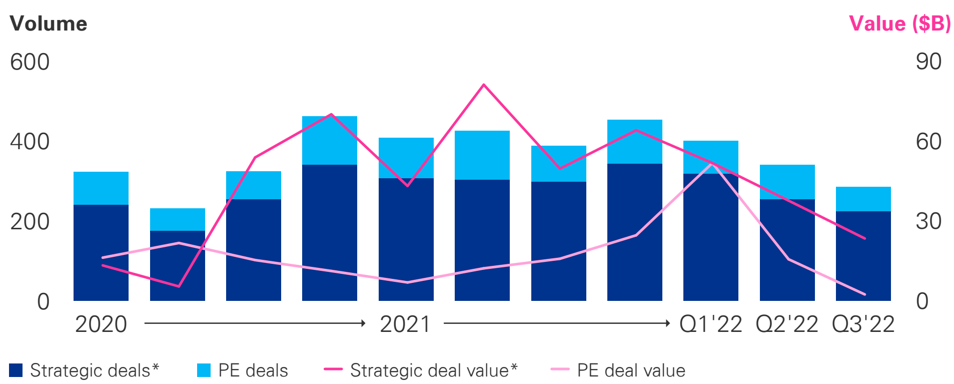
Top ENRC deals Q3’22

Acquirer	Target	Value (billions)
EQT Corporation	Tug Hill and XcL Midstream	$5.2
Aramco Overseas Company B.V.	Valvoline Inc.’s Global Products Business	$2.7
Devon Energy Corporation	Validus Energy Services LLC	$1.8
Sitio Royalties Corp.	Brigham Minerals, Inc.	$1.5

U.S. ENRC activity by sector



U.S. ENRC strategic and PE deals



*Includes SPAC deal value and volume

About the data: Data was sourced from CapitalIQ, Refinitiv, Pitchbook, and KPMG analysis. The values and volumes data cited are for U.S. deals announced during each quarter. Previously published statistics may be restated to incorporate new data and/or changes in deal outcomes.

[1] Source: “EQT to Take in Tug Hill-THQ Appalachia’s 800 MMcfe/d for $5.2B,” Hart Energy, September 6, 2022

[2] Source: “Valvoline Announces Agreement for Sale of Global Products Business for $2.65 Billion in Cash, Valvoline press release, August 1, 2022

[3] Source: “Devon buys Validus Energy for $1.8 billion, expands Eagle Ford footprint,” S&P Global Commodity Insights, August 9, 2022

[4] Source: “Sitio Royalties and Brigham Minerals to Combine in $4.8 Billion All-Stock, At-Market Merger, Forming a Premier Consolidator of Oil and Gas Mineral and Royalty Interests,” Financial Times, September 6, 2022

By the numbers

ENRC M&A trends

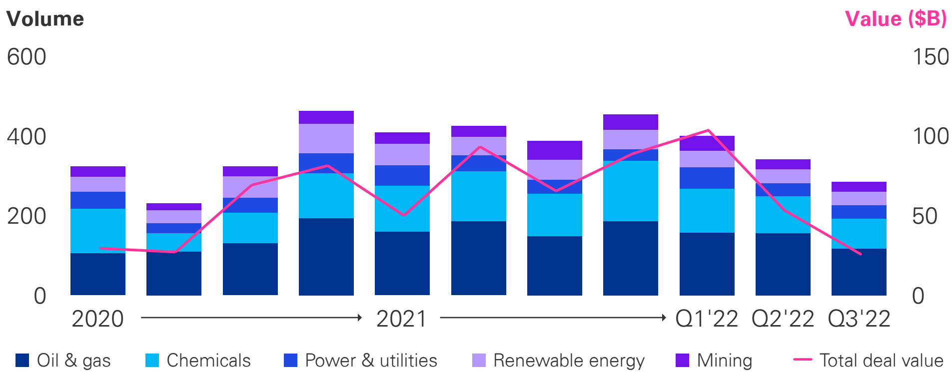
Dealmaking shifts as markets tighten

U.S. ENRC subsector deal volume and value

Q3'22

285 deals	$25.6 billion
-16.2%	-51.6%

U.S. ENRC subsector deal value and volume



Subsector deal volumes in 2022	QoQ change %
Oil & gas	-25.0%
Chemicals	-18.5%
Power & utilities	0.0%
Renewable energy	-2.9%
Mining	+8.3%

Looking at M&A activity by subsectors, we see deals taking a number of different approaches to maximize value.

In chemicals, building supply chain resilience is a key focus area. Recent geopolitical conflicts and fluctuating fuel prices have led to supply chain disruptions, volatile raw materials prices, and transportation issues, all of which are proving to be major challenges for chemical manufacturers.

In August 2022, for example, United Energy Corporation, a diversified energy company, announced the acquisition of Integrity Terminals, a greenfield facility and bulk storage project, which will reduce its dependence on foreign sources and provide a strategic supply chain facility.[5]

Power and utility players are replacing their carbon-intensive fossil fuel assets with cleaner alternatives to support their carbon reduction programs and net zero goals. In August 2022, Evergy Inc. announced the acquisition of 199-megawatt Persimmon Creek Wind Farm for approximately $250 million.[6] The deal further expands the company's renewable portfolio and supports its plan to add 3,500 MW of renewable energy capacity in the next 10 years, while retiring more than 1,900 MW of coal-based energy generation.

O&G buyers are attempting to capture as much value as possible in U.S. shale to further scale up their presence. In July 2022, Ascent Resources, a producer of natural gas in the U.S., announced the acquisition of XTO Energy, an American energy company, in the Utica Shale region of Ohio, for a total purchase price of $270 million.[7]

In the renewable energy subsector, companies are aggressively intensifying their footprint in Texas because of the state's lucrative incentives, which provide property tax benefits to companies that build new infrastructure and support job growth in the area. In July 2022, Cypress Creek Renewables, an independent power manufacturer that generates and distributes power across the U.S., acquired the rights to four energy-storage projects in Texas from Black Mountain Energy Storage, which operates and develops battery energy-storage facilities.[8] Cypress Creek will continue project development, entitlement, engineering, procurement, financing, construction, and operation once complete.

[5] Source: "United Energy Announces Major Corporate Advancements," United Energy press release, August 5, 2022

[6] Source: "Evergy to purchase 199 MW Persimmon Creek Wind Farm from Scout Clean Energy and Elawan Energy," Evergy press release, August 9, 2022

[7] Source: "Ascent Resources, LLC announces Utica Shale Bolt-On Acquisition, Extension Of Revolving Credit Facility Maturity And Borrowing Base Increase," Ascent Resources press release, July 1, 2022

[8] Source: "Cypress Creek Renewables Acquires 400MW from Black Mountain Energy Storage," Cypress Creek Renewables press release, July 25, 2022

By the numbers

ENRC M&A trends

Strategic deals dominate the quarter

Strategic deal volume saw a QoQ decline of 11.6 percent, from 249 to 220. Strategic deal value dropped 33.8 percent, from $34.6 billion to $22.9 billion.

However, the primary share of deals for the quarter were strategic, due in large part to the fact that strategic buyers have longer time horizons that are less contingent on near-term or midterm interest rate fluctuations, changes in global oil markets, supply chain disruptions, and other factors—an important advantage in an uncertain global economy.

Along with the top deals by EQT Corporation, Aramco Overseas, Devon Energy and Sitio Royalties described on page 3, several other strategic deals were announced in Q3’22 that underscored the range of deal opportunities available in the sector.

In August 2022, Trelleborg Sealing Solutions US, signed an agreement to acquire Minnesota Rubber and Plastics (Quadrion LLC) from KKR Americas Fund XII LP for $950 million.[9] Trelleborg, which develops and manufactures polymers, will gain access to Quadrion’s existing customer base in North America, while Quadrion will benefit from the resources of Trelleborg’s global sales channels.

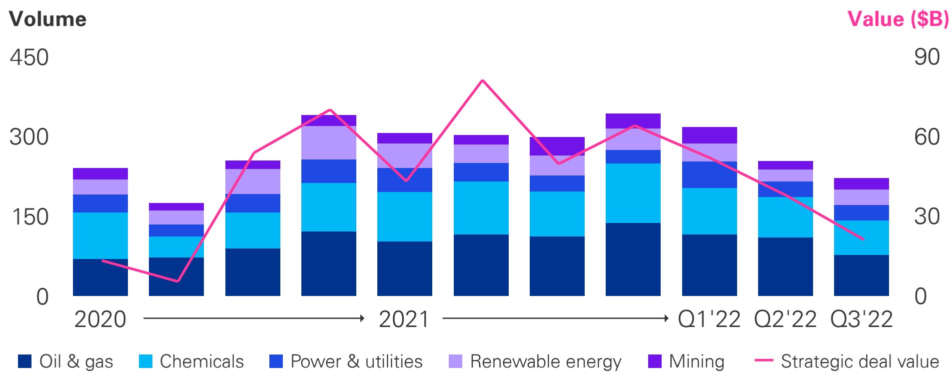
In September 2022, XL Fleet Corp. acquired Solar Service Experts, LLC from HPS Investment Partners, LLC for approximately $600 million.[10] XL Fleet intends to change its corporate name and introduce a new brand identity based on providing subscription-based solutions for rooftop solar, energy storage, EV charging, and other energy-related products to homeowners and small businesses.

U.S. strategic deal value and volume

Q3’22

220 deals
-11.6%

$22.9 billion
-33.8%



Top strategic ENRC deals in Q3’22

Acquirer	Target	Value (billions)
EQT Corporation	Tug Hill and XcL Midstream	$5.2
Aramco Overseas Company B.V	Valvoline Inc.’s Global Products Business	$2.7
Devon Energy Corporation	Validus Energy Services LLC	$1.8
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Ginkgo Bioworks, a leading horizontal platform for cell programming, announced in July 2022 the acquisition of the biotechnology company Zymergen in an all-stock transaction that values Zymergen at a $300 million market capitalization.[11] Ginkgo plans to integrate Zymergen’s core automation and software technologies for scaling strain engineering capacity into its organism engineering tool set. This includes Zymergen’s machine learning and data science tools for exploring known and unknown genetic design space.

[9] Source: “Trelleborg Sealing Solutions US, Inc. signed an agreement to acquire Quadion LLC from KKR Americas Fund XII LP, managed by KKR & Co. Inc. for $950 million,” Market Sceener, August 2, 2022

[10] Source: “XL Fleet Corp. (NYSE:XL) acquired Solar Service Experts, LLC from HPS Investment Partners, LLC for approximately $600 million,” Market Sceener, September 12, 2022

[11] Source: “Ginkgo to Acquire Zymergen,” Zymergen press release, July 25, 2022

By the numbers

PE M&A trends

PE deals fall in volume and value

The number of PE deals dropped QoQ from 87 in Q2’22 to 62 in Q3’22, representing a decline of 28.7 percent. Total deal value amounted to $2.3 billion, a QoQ decline of 85.1 percent.

The decline in PE deals can be linked to a number of factors, the greatest of which is continued uncertainty about interest rate hikes by the Federal Reserve over the next several years. While many PE firms have dry powder to spend, the interest rate uncertainty makes near-term valuations and exit planning more difficult. PE investors are therefore less willing to take on risk involving M&A transactions.

The largest PE deal of the quarter was the acquisition by Momentum Midstream LLC of Midcoast Energy LLC’s East Texas business from an affiliate of ArcLight Capital Partners LLC and Align Midstream LLC from Tailwater Capital.[12] The deal was announced in July and closed on September 22, 2022.

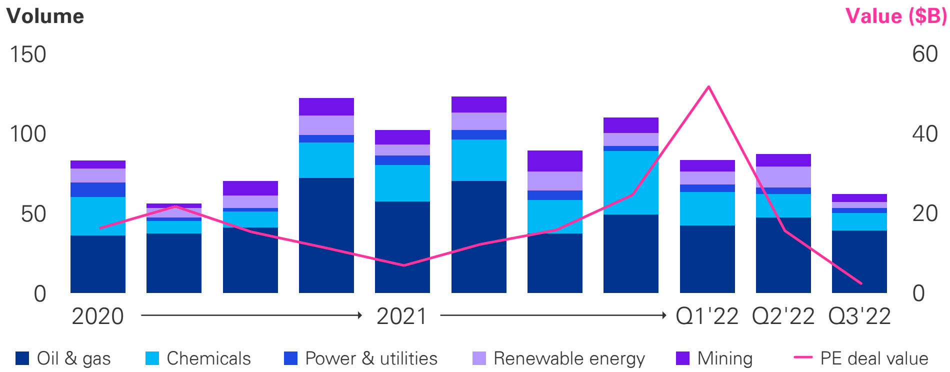
Momentum’s financial partner, EnCap Flatrock Midstream, came together with several institutional energy investors including Yorktown Energy Partners, Martin Sustainable Resources, Ridgemont Equity Partners, Bengas Midstream Partners and Blackstone Credit to support Momentum’s Haynesville Shale growth plans. These plans include a new carbon capture project, according to EnCap Flatrock managing partner and founder, Billy Lemmons. The acquisition of Midcoast’s East Texas business, known as Midcoast ETX, and Align Midstream was announced by Momentum alongside a new natural gas gathering and carbon-capture project in the Haynesville Shale.

U.S. ENRC PE deal value and volume

Q3’22

62 deals
-28.7%

$2.3 billion
-85.1%



Top PE ENRC deals in Q3’22

Acquirer	Target	Value (billions)
Momentum Midstream LLC	Midcoast Energy East Texas business	$1.3

Steve Binz on current PE deal activity

The current decline in transaction and exit volume is leading to longer hold times for entities. PE firms are also using funds to restructure multiple, small entities of older vintages into a single entity to gain scale.

[12] Source: “Momentum Midstream Establishes Leading Haynesville Presence with Latest Acquisitions,” Hart Energy, September 25, 2022

Deep dive

A resurgence in PE deals?

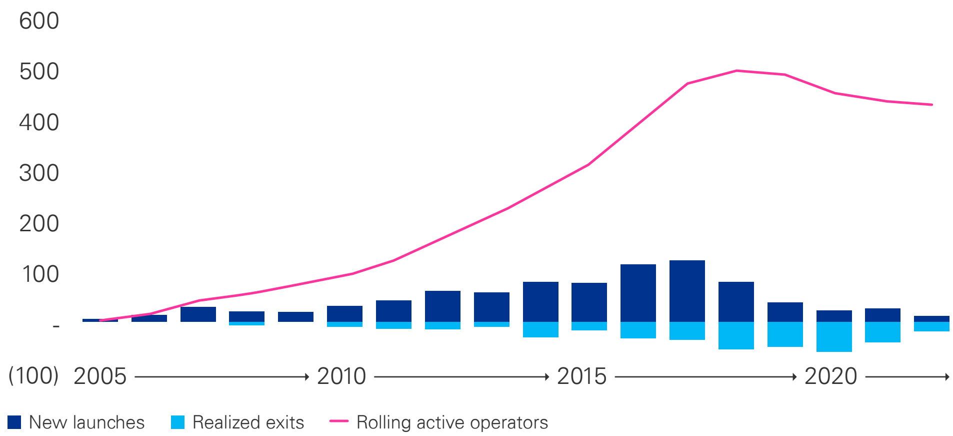
Even though PE deals in the upstream O&G subsector have steadily declined over Q3’22—following a trend that began in Q1’22—we believe a resurgence is in the offing. Most currently active PE-sponsored operators were originally funded during a period of cheap money, with active PE-sponsored entities growing from 265 in 2014 to 515 in 2018 (see chart).[13] Many of these companies are now ripe to be sold or merged with other companies, but who will the buyers be?

Capital has been flowing away from the O&G space—the number of newly launched PE-sponsored entities has declined by 80 percent from 2017 (121 starts) to 2020 (22 starts). A decade of debt-fueled fracking expansion combined with recent boom-and-bust commodity cycles (with shorter durations and more volatility swings from high to low prices) has led to an increase in bankruptcies. Furthermore, traditional sponsors are now looking more closely at the ESG posture of their portfolios and trimming their ongoing exposure to O&G companies. Public operators have moved toward capital discipline, which has tempered the appetite of public companies to make transactions that are not immediately accretive or highly valuable to their core operating areas.

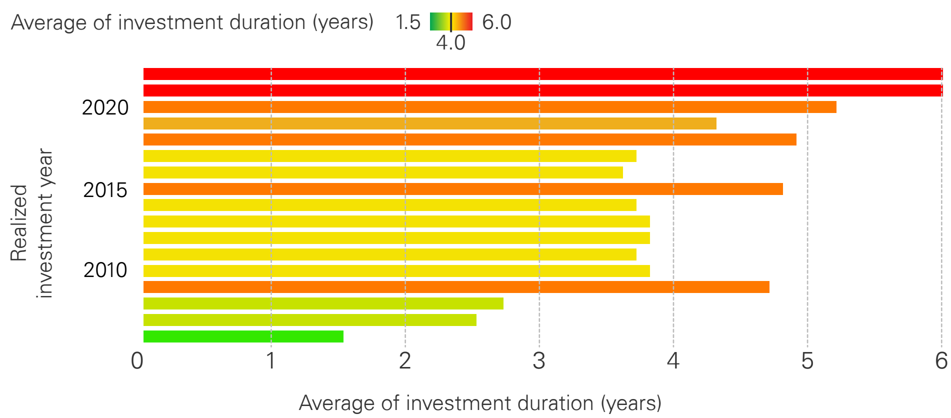
While recently higher commodity prices have temporarily reduced the pressure on companies with reserve-based loans (RBLs) to find exits and provide positive cash flows, the backwardation of the oil commodity markets—when the price of a near-month contract is far above the prices of those contracts further in the future—has incentivized more potential sellers to keep their companies off the market.

[13] Source: Enverus

Active PE operator count by initial funding year



Average duration of investment by realized investment year



Despite how these factors have discouraged sales, many O&G companies funded between 2014 and 2018 are now of a vintage that makes them strong candidates for market sales. There are more than 430 PE-funded entities still active, and top-tier companies that have significantly increased their production levels and/or learned to control their costs and generate consistent cash flows represent an attractive target for buyers seeking to expand their O&G holdings. Attracting the interest of the currently limited buyer universe and striking a balance between exit value against the hold case will be key for these companies.

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Outlook

More of the same but no hard landing yet

For M&A transactions in the ENRC sector, Q3’22 has been more of what we saw in Q1’22 and Q2’22—a steady decline in the volume and value of deals across all subsectors. Ongoing demand for energy and chemicals will largely shelter the ENRC sector from economic pressures that might result in a downturn, but global issues such as supply chain disruptions, the Russia-Ukraine war, and a recession will continue to have a dampening effect on dealmaking.

KPMG Economics expect a recession to begin in Q4’22. The downturn should be mild, though more abrupt and deeper than previously forecast. To reduce inflation, the U.S. Federal Reserve has already hiked interest rates at five straight meetings this year. KPMG Economics forecasts that the Fed will hike rates again by 0.75 percent at each of its remaining meetings in November and December and by another 0.25 percent in early 2023. These rate increases will almost certainly raise unemployment, but we expect unemployment in 2023 to only reach about 6 percent. During the pandemic in 2020, unemployment rose to 14.7 percent, and during the Great Recession of 2008–2009 it rose to 10 percent.

These higher interest rates will lead to increased capital costs, encouraging a more cautious approach to dealmaking in the U.S. Globally, a strong U.S. dollar will make certain deals attractive to investors who want to buy foreign assets, but global economic uncertainties will continue to discourage many deals. Global M&A volume reached only $642 billion between July and September this year, a 42 percent decrease from the prior quarter and the lowest Q3 figure in a decade.[14] U.S. deals were down by $278 billion.

Although we expect a mild recession, we can’t ignore the possibility of a hard landing in 2023. Equity markets are already seeing selloffs, and valuations are softening. The 10-year bond yield nearly reached 4 percent, increasing almost four times since January of 2021. Corporations have become accustomed to historically low interest rates, and rate increases by the Fed will require a significant change in investment strategies for ENRC investors.

Another issue to keep in mind for the next quarter is rollover risk. Corporations rolling over their maturing debt will face a much higher capital cost environment. They will either have to accept the new cost of borrowing, or not borrow as much as they would like, which could hamper their operating results.

The economic factors that are now affecting global markets will most likely persist for the rest of the year and well into 2023. ENRC players need to keep this in mind as they prepare for another quarter of economic uncertainty.

Key concerns as we look ahead

To successfully navigate a more uncertain deal landscape, companies should focus on the following requirements:

1. Sellers need critical differentiators to achieve maximum valuations and enhance their exit options. Differentiators might include exclusive or in-house developed software, patented equipment and processes, or exclusive long-term contracts.
2. Buyers need to know the target’s ESG exposure and benefits of current operations, including total carbon footprints and plans for lowering carbon emissions.
3. Management teams need to monitor costs, mitigate the effects of inflation, and develop executable plans for hiring in tight labor markets.

Margaret Xu on the Inflation Reduction Act

We haven’t seen any major effects so far from the Inflation Reduction Act on the volume of M&A transactions. Foreign infrastructure investors and pension funds coming to the U.S. are making a greater impact. However, the Inflation Reduction Act sends a positive message to investors that the U.S. remains a good market for long-term projects.

[14] Source: Refinitiv. Quoted in “Global M&A just suffered its worst Q3 in a decade,” Axios, September 22, 2022

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How we can help you

KPMG helps its clients overcome deal obstacles by taking a truly integrated approach to delivering value, leveraging its depth in the ENRC industry, data-supported and tools-led insights, and full M&A capabilities across the deal lifecycle.

With an ENRC specialization, our teams bring both transactional and operational experience, delivering rapid results and value creation.

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