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Oil & Gas

Success in the M&A rebound: Riding the coming wave of upstream deals

February 24, 2023 | Article

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Historically high cash generation across the North American upstream industry could create the perfect market conditions for accelerated M&A activity for market leaders.

The oil and gas industry has a long and storied history of M&A transactions and strategic deal making. Inorganic investment decisions have shaped the portfolios of industry players and determined the ultimate success and long-term growth trajectories of these companies. With the industry on the precipice of historically high cash flows, we expect another wave of M&A to dominate near-term actions.

This article explores the cash-flow landscape and major cash-flow deployment levers and shows how the stage has been set for an upstream M&A wave. We introduce the M&A strategies driving consolidation and what it takes to succeed in the coming M&A wave.

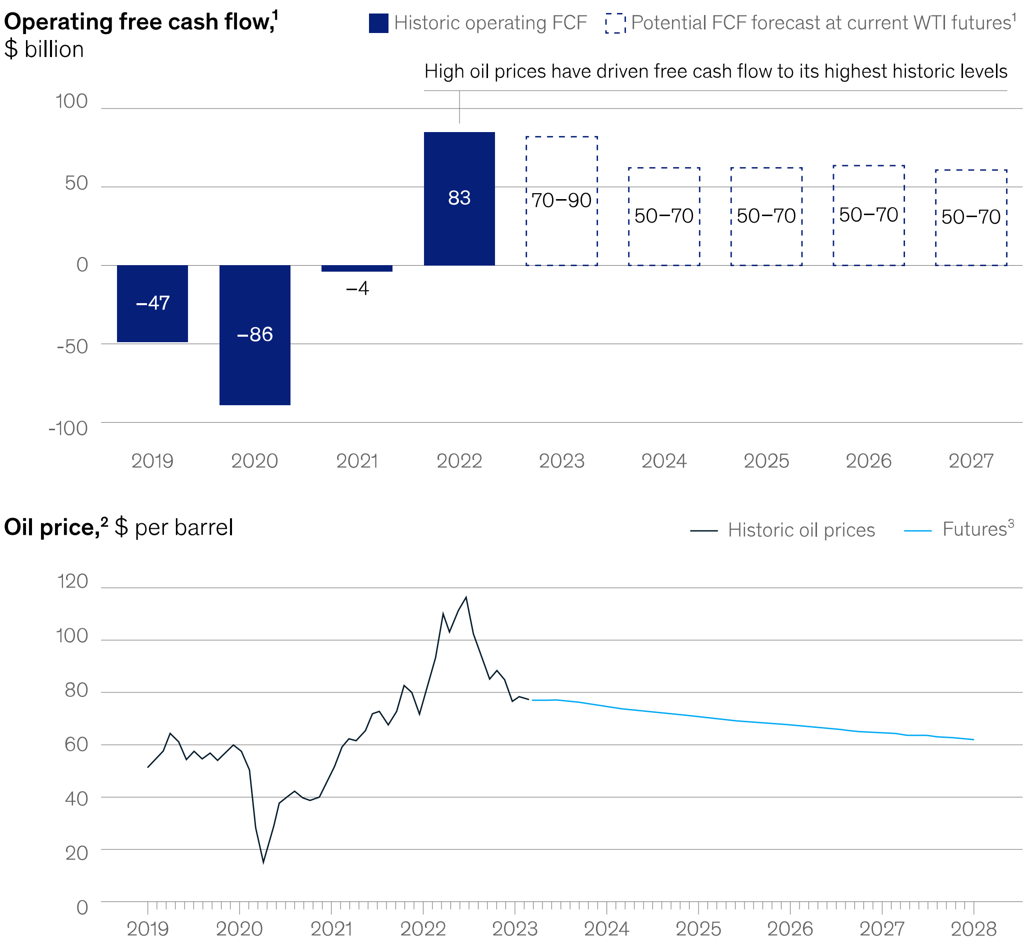
Cash flow is king

Long gone are the days of "growth at all costs" with expanding capital budgets, acreage acquisition campaigns, and associated negative cash-flow realizations funded by inexpensive debt.[1] Over the past few years, investor sentiment has driven the oil and gas industry to practice capital discipline and prioritize financial resiliency and cash-flow generation above growth.[2] When prices surged in 2022, upstream companies maintained their strategy of "no-to-low" capital growth. This focus on capital discipline and cash generation has resulted in record cash flows.

We examined historical cash flows and projected operational and financial performance for 25 leading North American exploration and production companies (E&Ps), and the results are impressive: operating free cash flows (FCF) reached approximately $85 billion in 2022, with a year-end cash balance of $70 billion to $100 billion (Exhibit 1).[3] This industry turnaround is dramatic, given negative cash generation the previous three years. Free cash flows are projected to remain high, with levels of between $70 billion and $90 billion in 2023 and between $50 billion and $70 billion for the following four years—even if oil prices drop to around $65 to $70 per barrel over the coming years.

Exhibit 1

High oil prices and capital discipline drive impressive oil and gas cash flows for the foreseeable future.



[1]Cashflow analysis of 25 North American independent E&Ps. Forecasted cashflow assuming current trends in production, operating expenditure, capital expenditure, debt repayments, share repurchases, dividends, and other cash expenses for 25 companies analyzed.
[2]West Texas Intermediate (WTI) oil price.
[3]WTI futures as of February 22, 2023.
Source: US Energy Information Administration; CME Group

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"Even after these uses of cash have been exhausted, the industry is likely to remain cash-flow positive in 2023 and beyond, with a "war chest" of hundreds of billions of dollars in 2023 alone for the 25 North American E&Ps analyzed, including estimated current cash balances. The primary tool left in the

corporate finance toolkit is deployment of cash through M&A."

Making all the right moves . . . until there's only one option left

Operators are taking advantage of their high cash flows by pulling all the traditional levers of capital management, shoring up their balance sheets, and returning value to shareholders (Exhibit 2). However, there is so much cash coming in that many of these levers are hitting a natural cap or are already exhausted. We analyzed how these companies are using operating cash flow across key levers, including:

- **Capital expenditure (capex) re-investment.** E&Ps across the sector have explicitly announced their intention to maintain capital discipline going forward, only increasing in line with inflation, even if prices remain high.[4] If this trend continues, capex will likely be constrained to current guidance issued by these companies, indicating a cap on future cash flow allocation for this purpose.
- **Debt reduction.** Debt load for the 25 E&Ps decreased by $25 billion from 2021 to 2022 and is forecast to decrease by another $15 billion to $20 billion by 2027.[5] Forecasted net debt for many operators may approach zero—an outcome unthinkable just a few years ago. Payments are expected to be capped at expiring notes only, reaching up to $10 billion in 2023.
- **Shareholder returns.** With debt burdens reduced, direct returns are expected to be the priority. Share buybacks tripled from 2021 to 2022, reaching a high of $21 billion for 25 leading independents and representing approximately 5 percent of total outstanding shares.[6] Likewise, dividends doubled over this period to reach an

all-time high of $23 billion, and are expected to climb to between $30 billion and $40 billion over the next year. However, direct returns will likely also have a natural ceiling in the range of 25 to 30 percent of total sector operating cash flow.[7]

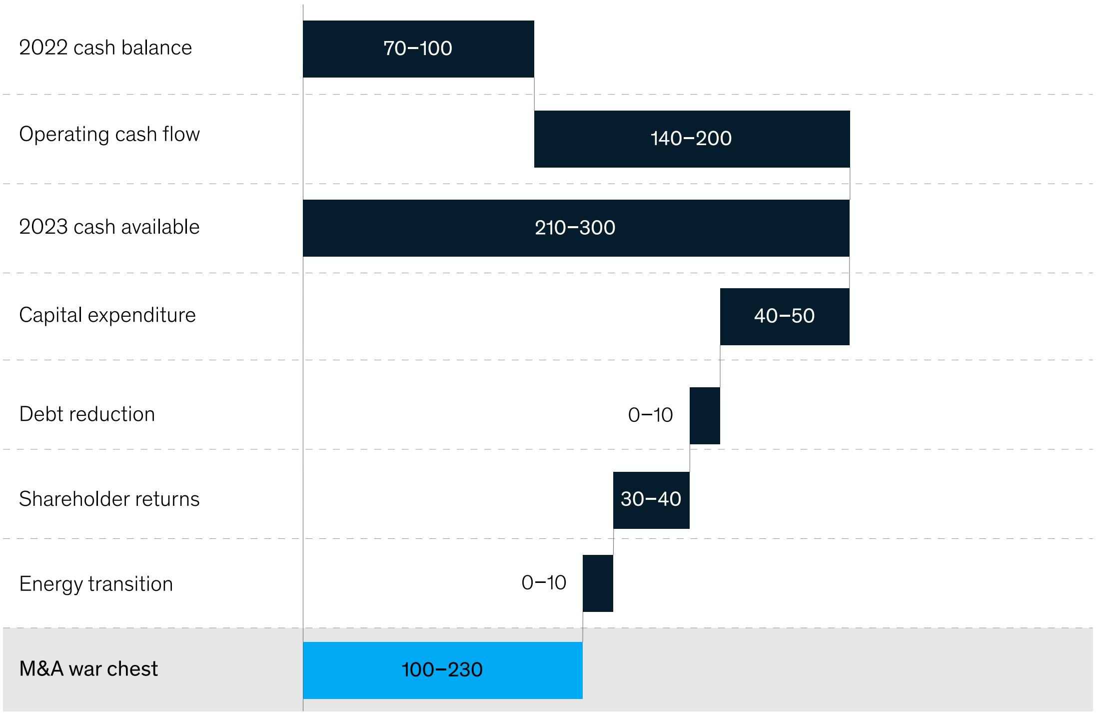
- **Energy transition.** Many operators are investing to reduce their Scope 1 & 2 emissions or make early moves to participate in energy-transition value chains. However, we expect a ceiling of 5 percent of operating cash flow to be allocated to these efforts.[8]

Even after these uses of cash have been exhausted, the industry is likely to remain cash-flow positive in 2023 and beyond, with a “war chest” of hundreds of billions of dollars in 2023 alone for the 25 North American E&Ps analyzed, including estimated current cash balances. The primary tool left in the corporate finance toolkit is deployment of cash through M&A.

Exhibit 2

Another wave of upstream M&A is likely, with M&A as the primary remaining use of cash given current strategies.

Estimated breakdown of uses of cash for 25 large independents in 2023,[1] $ billion



[1]Based on cashflow modeling of 25 large independents; assumes constant production and product mix, operating expenditures, price per barrel, and general and administrative expenses.

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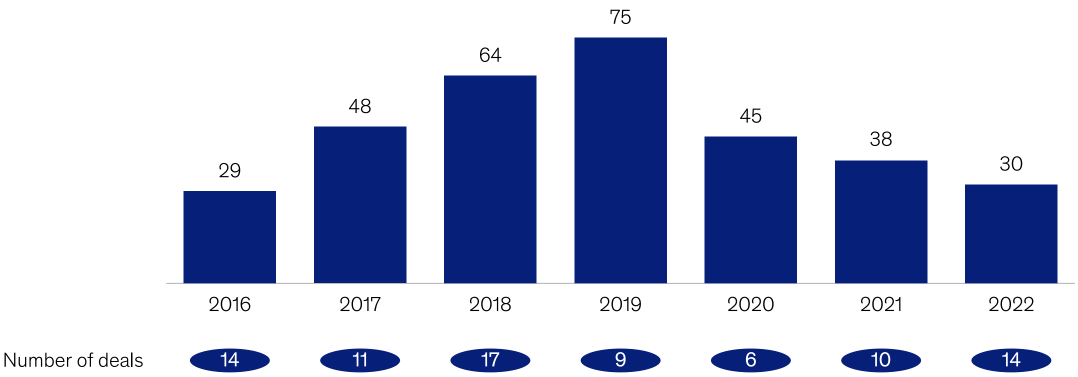
Who's coming to dinner?

The oil and gas industry is, in many ways, the epitome of competition and free-market capitalism. A common refrain from industry veterans discussing M&A is, "You are either at the table, or you're on it." This is a harsh reality, but companies with strong M&A capabilities and bold strategies often exit the cycle fully fed and healthy. Dealmaking in the North American upstream sector in 2022 generated relatively low upstream transaction value compared to previous years, due to a range of factors in the upstream sector, such as high oil prices and macroeconomic factors impacting all sectors, including geopolitical instability, inflation, and the possibility of recession (Exhibit 3). However, our analysis of the fundamentals indicates that a new M&A wave is coming.

Exhibit 3

Dealmaking in 2022 generated relatively low upstream transaction value compared to previous years.

Upstream transaction value generated in North America by deals of more than $1 billion, $ billion



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Industry trends suggest that multiple M&A strategies are driving this next wave of consolidation activity. Basin consolidators (such as Colgate and Centennial) will likely look to add scale and leverage operational advantages to achieve outsized returns. Integrators (like EQT with the acquisition of Tug Hill) may seek to add assets in adjacent portions of the value chain to expand margins and increase resiliency. The bold (for instance, BP and the acquisition of Archaea) will probably use a portion of their cash stockpiles to seed businesses to reshape their portfolios and position for the energy transition. Overall, consolidators (eaters at the table) will likely be those that have pulled the operational levers to have better cash flows than their geographically proximate competitors.

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capabilities—to accelerate their future growth and performance.”

The oil and gas industry is entering a period of unprecedented uncertainty characterized by the energy transition, evolving investor sentiment, and mounting concerns around energy security. While our industry should be proud of recent performance, now is not the time to bask in the glow of success. As in the past, successful industry players will work tirelessly to define and deliver a strategy rooted in sound M&A investments—honing their evaluation skills and integration capabilities—to accelerate their future growth and performance.

The next article in this series will discuss what it takes to succeed. Until then, we leave you with one thought: “Who’s hungry?”

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Robert Belanger and **Jeremy Brown** are consultants in McKinsey’s Houston office, where **Tom Grace** is a partner.

The authors wish to thank Joaquin Cancino and Luca Sivers for their contributions to this article.
