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Concho Resources Inc. – Target (NYSE: CXO)

ConocoPhillips – Acquirer (NYSE: COP)

Natural Resources – Oil & Gas

ConocoPhillips Consumes Concho

December 7, 2021

On October 19, 2020, ConocoPhillips Inc. (NYSE:COP) announced their plans to conduct a friendly acquisition of Concho Resources (NYSE: CXO) for USD $9.68 billion. As of January 15, 2021, Concho Resources was officially taken over in an all-stock acquisition for USD $13.72 billion, where each Concho common share was converted to the right to receive 1.46 common shares of ConocoPhillips.

Target Company Strategic Objectives

Concho stakeholders were in overall concurrence that they were supportive of the acquisition, with 97.85% of Concho shareholders voting in favour of the merger proposal. Given Concho was a pure player in Permian exploration, concerns regarding the long-term longevity of demand for fossil fuels, and increasing ESG requirements, management felt this acquisition would reduce the impact of these headwinds by diversifying its portfolio and gaining lower costs to capital.

Acquirer Company Strategic Objectives

ConocoPhillips frequently makes acquisitions and divestitures with the sole objective of becoming the largest independent oil and gas company in the world. The company management saw an opportunity with this deal to improve its financial and operational efficiencies, through incorporating more low cost of supply resources, ultimately improving overall scalability.

Synergies

The two companies estimated that the acquisition would result in major cost synergies after a revised exploration approach, which considered shared assets, geographical presence, as well as general and administrative expenses. From achieving a lower cost of supply, they also expected to enhance their ability to scale and fund strategic projects addressing industry headwinds, such as growing pressures towards diversifying away from fossil fuels.

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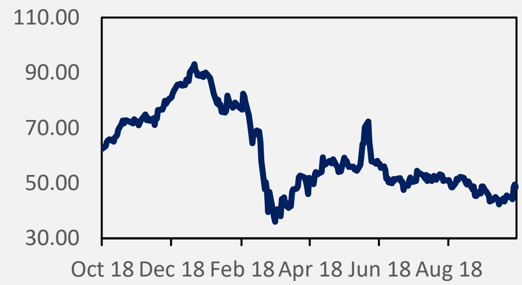
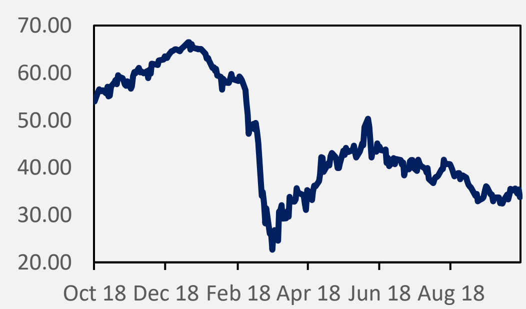
Key Statistics – Concho Resources Inc.	
52 Week H/L (Oct-16-2020)	$93.34/$33.13
Market Capitalization	$9.36B
Average Daily Trading Volume	1.99M
Net Debt	$3.45B
Enterprise Value	$12.9B
Net Debt/EBITDA	1.3x
Diluted Shares Outstanding	198M
Dividend Yield	1.7%

1-Year Price Performance



Key Statistics – ConocoPhillips	
52 Week H/L (Oct-16-2020)	$67.13/$20.84
Market Capitalization	$36.22B
Average Daily Trading Volume	8.07M
Net Debt	$8.06B
Enterprise Value	$42.36B
Net Debt/EBITDA	1.2x
Diluted Shares Outstanding	1.07B
Dividend Yield	1.24%

1-Year Price Performance

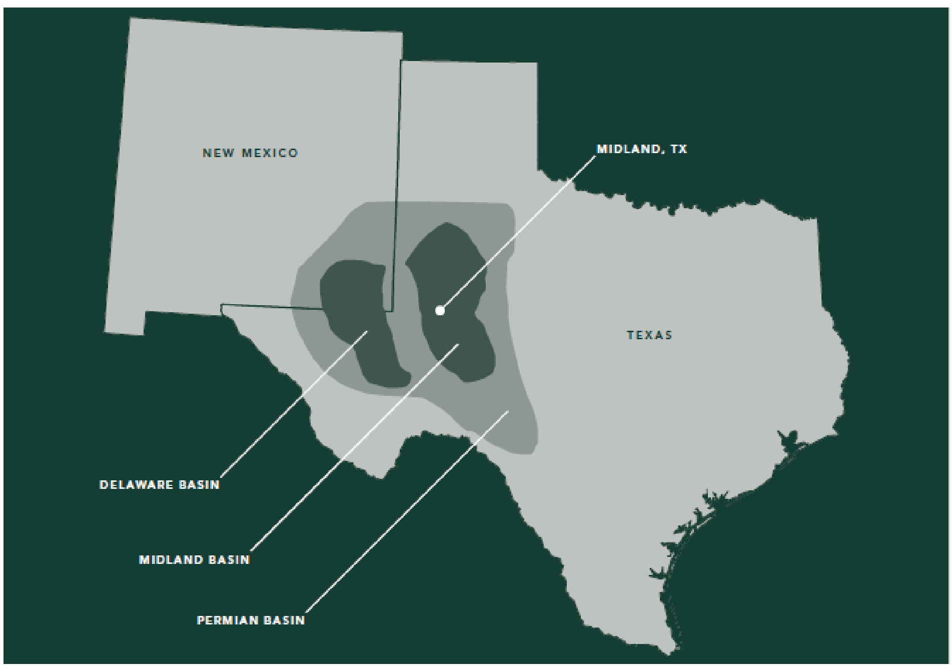


Business Overview – Concho Resources Inc. (Target)

Company Overview

Prior to its acquisition by ConocoPhillips, Concho Resources was an independent an oil and gas company headquartered in Midland, Texas. Their operations were centred around the Permian basin (Exhibit 1), particularly in the Delaware and Midland Basins, a combined total area of approximately 250 miles wide and 300 miles long. In December 2019, Concho had estimated proved reserves of 556 million barrels of oil equivalent in its Delaware Basin, 55% of its total proved reserves, and 446 million barrels of oil equivalent in its Midland Basin, representing 45% of its total proved reserves.

Exhibit 1: Locations of Operations



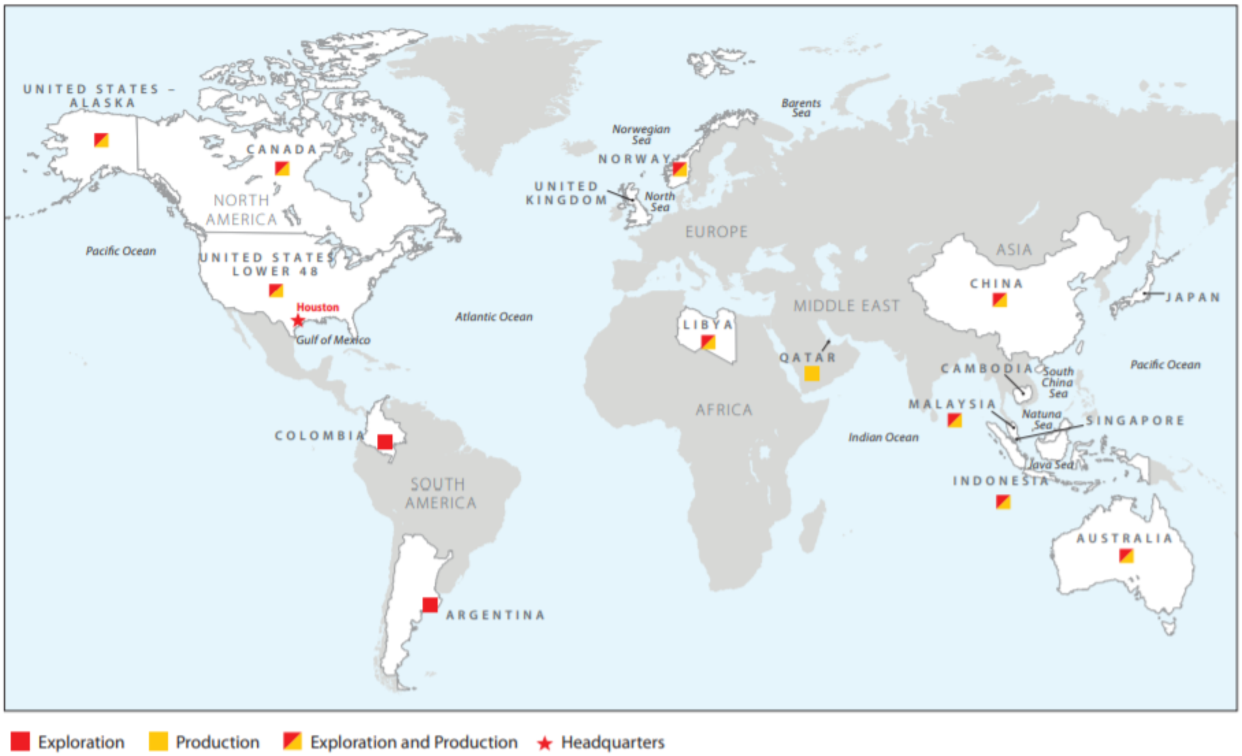
Source: Concho Resources FY19 Annual Report

Business Overview – ConocoPhillips (Acquirer)

Company Overview

Headquartered in Houston, Texas, ConocoPhillips is an independent exploration and production company with global operations in 15 countries. ConocoPhillips engages in the production, transportation, and advertisement of natural gas, crude oil, LNG, NGL and bituminate. The company was incorporated in November 2001, when Conoco Inc. and Phillips Petroleum Company agreed to merge. As of September 30, 2020, they have a presence in six distinct geographical regions: Alaska; Lower 48 (all states in the US excluding Alaska and Hawaii); Canada; Europe, Middle East, and North Africa; Asia Pacific. They have since expanded their global presence following the acquisition of Concho (Exhibit 2).

Exhibit 2: Worldwide Operations and Locations



Source: ConocoPhillips Online Fact Sheet

Industry Analysis

Permian Basin

The Permian Basin, located across West Texas and Southeast New Mexico of the United States, is one of the most highly investigated geological regions on the planet, due to its prominent natural gas, potassium, and petroleum deposit scattered across 75,000 square miles of land. In essence, the Permian Basin is divided into three geographical zones: the Delaware Basin on the west, Central Basin Platform in the centre, and Midland Basin on the east. Most producers, notably Concho Resources, are focused on conducting operations in the Delaware and Midland Basins, which together represent the United States' largest crude oil-producing basin. According to estimates from *Enverus*, since the 1920s when exploration had first begun in the Permian Basin, 30 billion barrels of oil and 75 trillion cubic feet of natural gas have been produced.

Value Chain

Companies in the oil and gas industry are categorized into three main segments: upstream, midstream, and downstream. Depending on where companies fall under these segments, this will indicate what they fall under the value chain. In the upstream, companies focus on the exploration and production of crude oil and natural gas, including oil rig operators, pressure pumpers, and engineering firms. Next, midstream companies support the transportation of the extracted oil and gas from the upstream to the downstream operations, through offering pipeline development, trucking, and oil tanker services. At the end of the value chain, the downstream companies, such as petroleum distributors, natural gas distributors, and retail outlets, focus on preparing and marketing these products for their retail clients.

Energy Transition – Leaner and Greener

During the pandemic, oil and gas companies were already fighting to minimize costs and optimize operations to survive. In tandem with financial considerations, companies in the oil and gas sector need to adapt to offering diversified portfolios of services apart from oil and gas, so they can capture the needs of shifting consumer demand. Many oil and gas giants are attempting to evolve their business models to become integrated energy players, where they need to balance standing their ground in their current markets, while also making efforts to enter new low-carbon energy arenas. According to *Mckinsey* in their report "The Big Choices for Oil and Gas in Navigating the Energy Transition," the giants' initial steps towards becoming integrated energy players should be to quickly adapt their operating models to integrate carbon management capabilities, which entails quantifying how much carbon their products and services produce, developing plans to reduce their emissions, and communicating these processes to stakeholders.

ESG Considerations in M&A Activity

In view of the changes in investor sentiment towards fossil fuels, there has been a significant change in how companies are operating in accordance with ESG requirements in their respective industries. Presently, companies are pressured to meet net-zero targets by their stakeholders, so it is becoming increasingly important that companies consider approaching mergers and acquisitions of companies that meet a standard of ESG criteria. Particularly for companies in the oil and gas industry, it is pivotal that ESG is considered in valuation since the market is already hyper competitive, otherwise a loss in stakeholder support because of a regretful deal could be detrimental to a company's survival.

M&A Rationale

Strategic Objectives

The main objective of ConocoPhillips is to become the largest player in the oil and gas industry globally. Their management stated that their strategy is to undergo frequent transactions to improve operational and financial efficiencies as they expand their global presence into different markets.

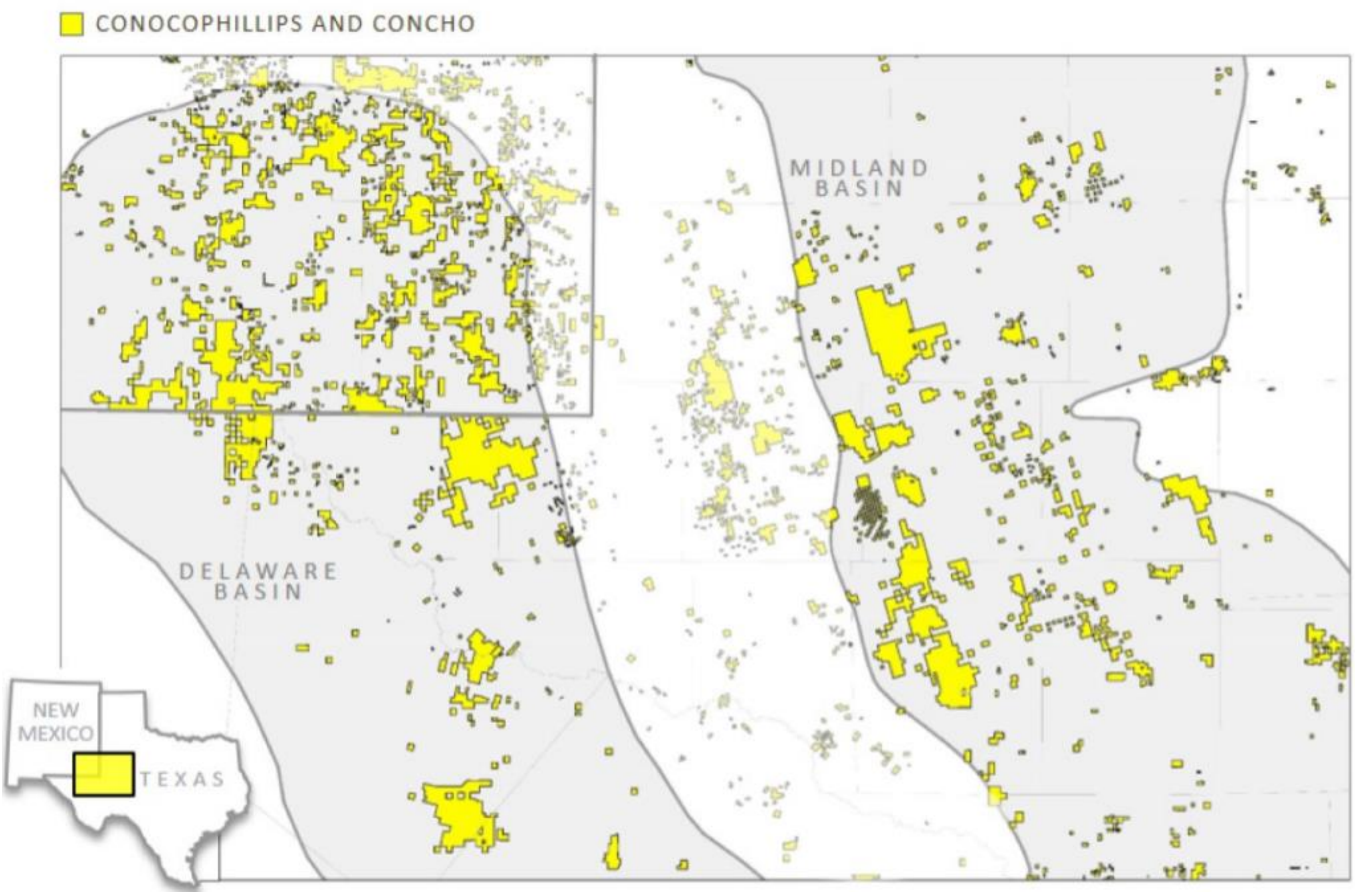
Cost Synergies

The main synergies that ConocoPhillips aimed to gain from their acquisition of Concho Resources were cost synergies, specifically on the production side. It was estimated that ConocoPhillips' acquisition would result in $500 million in realized cost synergies by 2022, where $400 million will come from ConocoPhillips and $100 million will come from Concho. Among the $400 million in savings from ConocoPhillips, $250 million would be a result of a revised exploration strategy, reducing overall general and administrative expenses, geological and geophysical costs, and the exploration capital budget.

Scaling Potential

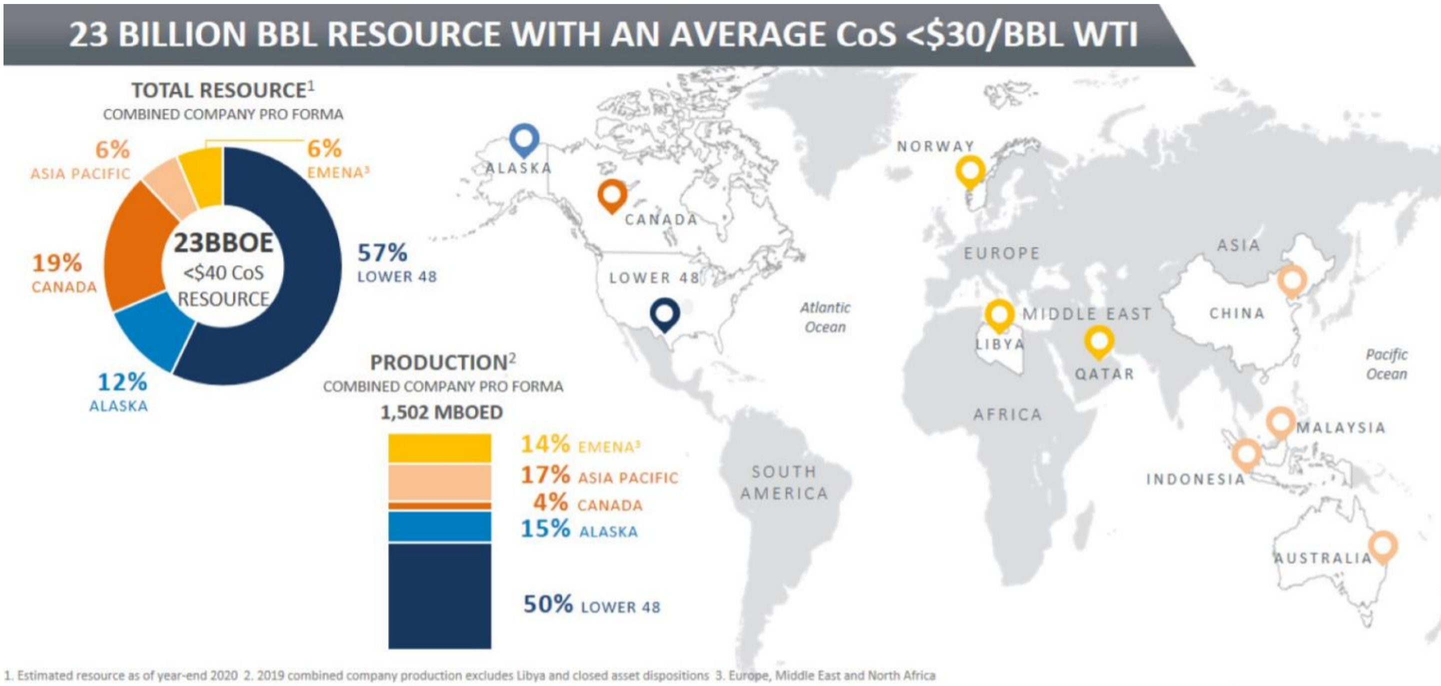
Additionally, ConocoPhillips had great scaling potential because of Concho's prominence in the Permian Basin. Prior to the deal, Concho had access to a large plot of the Permian Basin, so combining those with ConocoPhillips' existing wells (Exhibit 3) was anticipated to create economies of scale. Concho could share existing technologies, transportation, and expertise in the Permian with ConocoPhillips to extract the companies' combined resource base of 23 billion barrels of oil equivalent (Exhibit 4) more efficiently, leading to increased free cash flow generation. They hoped to employ this free cash flow to fund future initiatives to further adapt to headwinds causing the decline in fossil fuels and defend against commodity price volatility.

Exhibit 3: The Combined Operating Areas of ConocoPhillips and Concho



Source: ConocoPhillips & Concho Resources Transaction Announcement

Exhibit 4: Map of ConocoPhillips and Concho Resources' Combined Presence



Source: ConocoPhillips & Concho Resources Transaction Announcement

Lower Cost of Capital

Through the merger, the companies were projected that the acquisition would materially decrease their combined cost of capital. It was expected that due to their diversified portfolio of operations and broad geographical scope, they would be less vulnerable to price inflections of any single resource alone, such as oil, gas, or LNG. Taking in consideration their low cost of supply from cost synergies and diversified operations, the combined company was anticipated to gain higher credit ratings and thus superior access to capital markets, developing a more robust ability to fund future projects.

Common Visions for ESG Management

ConocoPhillips stated their target is to reduce operation emissions by 35% to 40% by 2030 and reach net-zero by 2050. As stated in several instances in their *schedule 14A* release, a joint merger proxy statement from ConocoPhillips and Concho, one of the shared reasons for the acquisition was their shared values of ESG. According to ConocoPhillips' Board of Directors, the companies " have similar cultures and values of safety, execution, people and a strong commitment to environmental, social and governance excellence, which serve as a platform to lead the independent sector into an energy transition and low-carbon future." In addition, Concho's Board of Director's highlighted how, " ConocoPhillips was expected to announce that it would be the first U.S.-based oil and gas company to adopt a Paris-aligned climate risk strategy to meet an operational net-zero emissions ambition by 2050." Undoubtedly, without these ESG-oriented reasons from both companies, there could have been skepticism from their respective stakeholders about the cohesiveness of the companies, potentially resulting in stakeholders voting against the acquisition.

Valuation

Precedent Transactions Analysis

In our precedent transactions model, we compared 10 other acquisition deals within the oil and gas space. These transactions were chosen based on their recency being within around two years of the Concho acquisition, the targets' operations primarily in the United States, and the targets' relatively similar enterprise values. The multiples we compared the transactions with were enterprise value to the last twelve months of revenue until the acquisition announcement date (EV/LTM Revenue) and enterprise value to the last twelve months of EBITDA until the acquisition announcement date (EV/LTM EBITDA). Relative to the other transactions, Concho's EV/Revenue multiple was calculated to be 4.0x, which fell exactly around the mean and above the median. Additionally, Concho's EV/EBITDA multiple was determined to be 4.8x, falling under the median of 5.4x and mean of 6.7x. Observing Concho's premiums in comparison to the other transactions, ConocoPhillips offered a low initial price, with a premium of 1.44% 1-day before, 10.24% 1-week before, and 2.52% 1-month before the announcement date.

Risks

Fruitless Integration of Concho Resources

There are countless risks associated with acquiring businesses, therefore it is challenging to achieve each of the potential upsides regarding a deal. Under a relationship frame of view, it is possible that there will be challenges integrating relationships among employees and industry connections, despite both companies sharing "similar cultures and values," as argued by ConocoPhillips management in their list of reasons for the acquisition. Furthermore, from a financial standpoint, there was a risk of ConocoPhillips being unable to realize the entirety of their projected costing savings and revenue magnifications, and instead realizing unforeseen liabilities and expenses. Lastly, from an operational outlook, there could be potential difficulties gaining momentum if the businesses operate with varying procedures, policies, controls, and standards, as these could disrupt supply chain synergies.

High Combined Debt Obligations Impede Financial Flexibility

In ConocoPhillips Q3 2021 earnings, they reported USD $15.39 billion of outstanding indebtedness, streaming from its unsubordinated notes and commercial paper program in its current credit facility. Meanwhile, Concho reported $3.9 billion of outstanding indebtedness in Q3 2021, consisting of mainly Senior Notes due from the years 2027 to 2047, depending on the note. While ConocoPhillips intends to clear Concho's credit facility with this acquisition, by exchanging new ConocoPhillips notes in exchange for existing Concho notes or issuing cash, this deal still leads ConocoPhillips to take on $19.95 billion in debt, more than what they have historically taken on. Consequently, this significant possession of debt leaves ConocoPhillips more vulnerable to defaulting on their debt obligations and economic downturns, in addition to reducing their ability to engage in strategic transactions soon.

Appendix 1: Precedent Transactions Analysis

Precedent Transactions Analysis

(Figures in mm USD)

	Acquirer		Target					EV/Revenue Multiple		EV/EBITDA Multiple			Premium Paid to Undisturbed Share Price		
Announcement Date	**Company Name**	**Ticker**	**Company Name**	**Ticker**	**Percentage Acquired**	**Equity Value**	**Enterprise Value**	**LTM Revenue**	**EV/ LTM Revenue**	**LTM EBITDA**	**EV/ LTM EBITDA**	**Offer Price**	**1-Day Prior**	**1-Week Prior**	**1-Month Prior**
May 24, 2021	Cabot Oil & Gas Corporation	(NYSE: CTRA)	Climarex Energy Co.	(NYSE: XEC)	51%	7,133.2	8,777.1	1750.75	5.0 x	644.73	13.6 x	71.5	0.44%	-3.70%	14.18%
September 28, 2020	Devon Energy Corporation	(NYSE: DVN)	Noble Energy, Inc.	(NYSE: NBL)	97%	4,631.5	12,797.5	3887	3.3 x	2356	5.4 x	10.38	7.45%	19.72%	3.80%
August 12, 2020	Southwestern Energy Company	(NYSE: SWN)	Jagged Peak Energy Inc.	(NYSE: JAG)	77%	1,455.4	2,968.5	564.95	5.3 x	620.17	4.8 x	7.59	11.29%	11.13%	1.47%
July 20, 2020	Chevron Corporation	(NYSE: CVX)	Newfield Exploration Company	(NYSE: NFX)	100%	4,001.3	6,173.3	2479	2.5 x	1165	5.3 x	27.41	35.69%	32.67%	-4.03%
October 14, 2019	Parsley Energy, Inc.	(NYSE: PE)	WPX Energy, Inc.	(NYSE: WPX)	57%	3,375.8	6,579.8	4784	1.4 x	1940	3.4 x	4.56	2.70%	1.11%	-22.32%
August 26, 2019	PDC Energy, Inc.	(NASDAQ: PDCE)	SRC Energy Inc.	(NYSE: ARCA)	100%	1,580.6	2,267.2	703.38	3.2 x	717.07	3.2 x	3.99	-3.86%	-14.01%	6.40%
July 15, 2019	Callon Petroleum Company	(NYSE: CPE)	Carrizo Oil & gas, Inc.	(NASDAQ: CRZO)	100%	1,458.6	3,276.3	977.72	3.4 x	862.54	3.8 x	7.81	-25.62%	-18.90%	-14.36%
April 24, 2019	Occidental Petroleum Corporation	(NYSE: OXY)	Energen Corporation	(NYSE: EGN)	100%	6,956.3	8,165.2	1256.51	6.5 x	775.13	10.5 x	84.95	19.04%	15.05%	14.09%
November 1, 2018	Ovintiv USA Inc.	(NYSE: OVV)	Montage Resources Corporation	(NYSE: MR)	100%	1,646.1	2,334.7	561.51	4.2 x	258.76	9.0 x	5.67	-5.03%	10.74%	58.38%
August 14, 2018	Diamondback Energy, Inc.	(NASDAQGS: FANG)	Andarko Petroleum Corporation	(NYSE: APC)	71%	46,637.7	65,907.7	13006	5.1 x	8202	8.0 x	76	18.77%	18.69%	74.31%
October 19, 2020	**ConocoPhillips**	**(NYSE: COP)**	**Concho Resources**	**(NYSE: COX)**	**79%**	**9452.7**	**12906.7**	**3260**	**4.0 x**	**2717**	**4.8 x**	**49.3**	**1.44%**	**10.24%**	**2.52%**
Median									**3.8 x**		**5.4 x**	**9.10**	**5.08%**	**10.93%**	**5.10%**
Mean									**4.0 x**		**6.7 x**	**29.99**	**6.09%**	**7.25%**	**13.19%**
High									**6.5 x**		**13.6 x**	**84.95**	**35.69%**	**32.67%**	**74.31%**
Low									**1.4 x**		**3.2 x**	**3.99**	**-25.62%**	**-18.90%**	**-22.32%**

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