



# WHATEVER HAPPENED TO BIG OIL?

OIL MAJORS NEED A NEW PLAN TO  
OUTPERFORM OIL PRICES

FRANCOIS AUSTIN  
FERGUS MACLEOD  
ROLAND RECHTSTEINER

Oil prices have quadrupled since 2001. But many of the world's largest international oil companies have not kept pace. Instead, their operating cash flows have only doubled over the same period. And most of their stock market valuations have trailed even further behind, underperforming the broader stock market as a group by about 65 percent. (See Exhibit 1.)

There's an important lesson for oil and gas firms here – but it may not be what you think. Even before the recent downturn in the oil market, most international oil companies were no longer capturing the value of rising commodity prices for shareholders, especially oil prices. That new development alone should set off alarms in the executive suites of international oil majors, since it potentially undermines the reason why most investors want to own stakes in them.

But the bigger lesson is that oil and gas firms urgently need either to break apart or become more vertically integrated. Those are two key ways they can deliver value to their shareholders commensurate with rising commodity prices, and remain the leaders of their industry going forward. Business models that straddle the middle ground don't seem to be working.

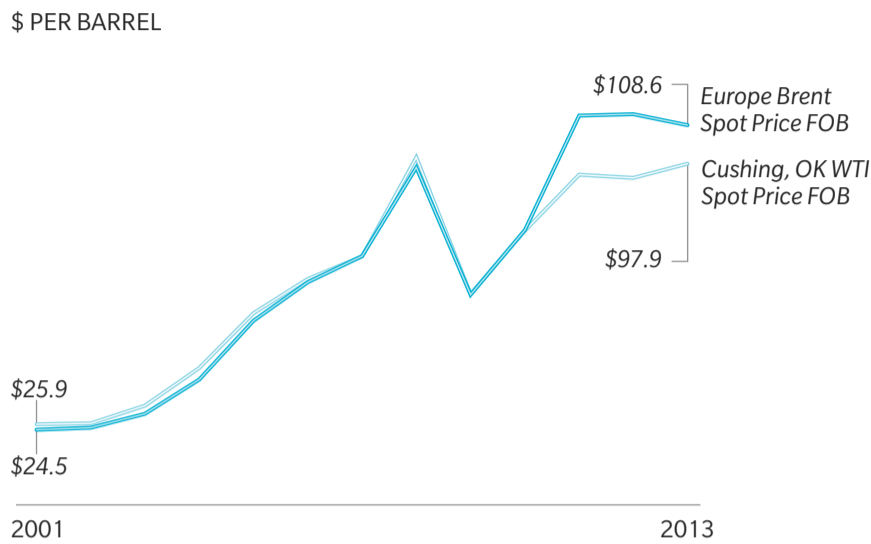
## MIGRATING VALUE

The value created from oil field development is migrating to oil field services companies. At the same time, volume, which has been the favorite measure of growth for international oil companies, is becoming an unreliable indicator of growth in value for shareholders. The traditional correlation between the market valuations of most of the international oil companies and volume is breaking down as more natural gas is traded at a discount to oil prices, fewer petroleum supply agreements are structured around oil prices, and the amount of capital required to renew a unit of production continues to expand.

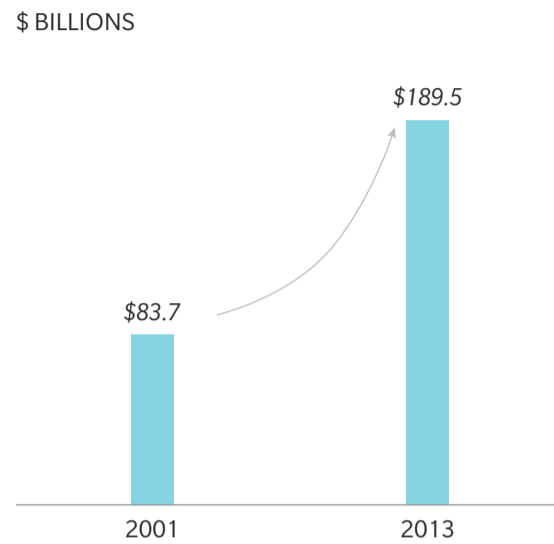
The relationship between depreciation and capital expenditures is also fundamentally changing, making historic earnings almost meaningless. Until 2000, international oil companies expended roughly as much capital as their assets depreciated. But since then, their capital expenditures have increased by five times, while depreciation has risen by only half as much. (See Exhibit 2.)

### EXHIBIT 1: THE OIL MAJORS' DILEMMA

OIL PRICES HAVE QUADRUPLED ...

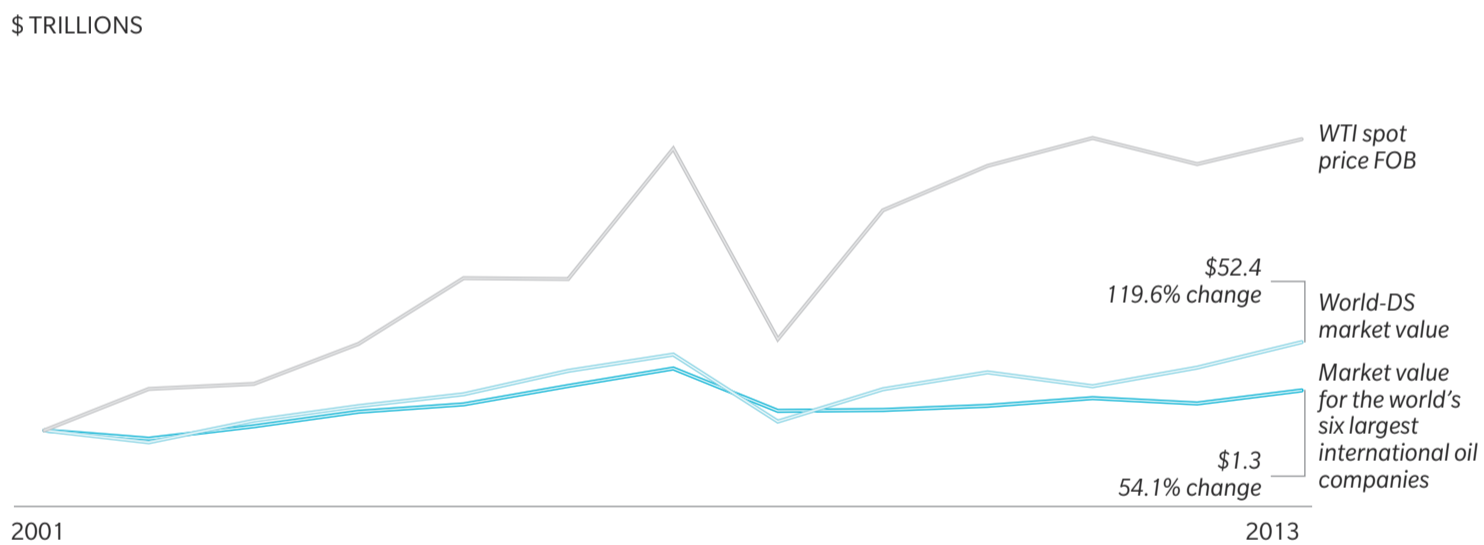


... BUT OIL MAJORS' OPERATING CASH FLOWS HAVE BARELY DOUBLED ...



Source: Thomson Reuters: Datastream, Oliver Wyman analysis. Calculations reflect the world's six largest international oil companies

... AND THEIR STOCK MARKET VALUATIONS HAVE LAGGED THE BROADER STOCK MARKET



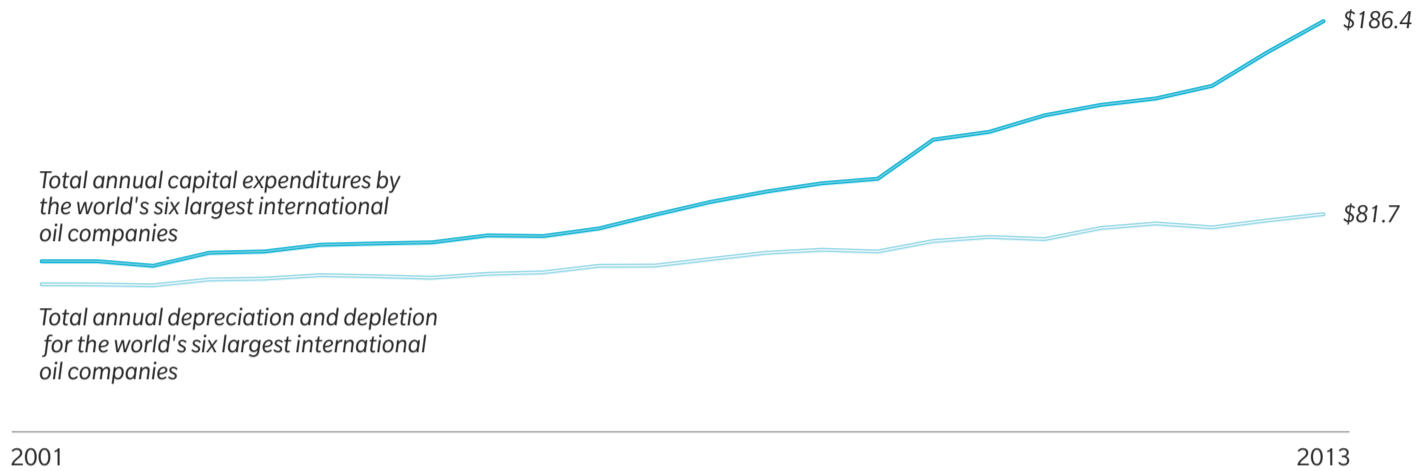
Source: Thomson Reuters: Datastream, Oliver Wyman analysis

Sooner or later, all that extra capital will have to be depreciated, a factor that is creating a potential new moral hazard for an industry that has been issuing distributions to shareholders based on historic earnings. Many oil majors have paid dividends to shareholders that have met or exceeded their combined cash flow remaining after capital spending – or free cash flow.

## EXHIBIT 2: THE OIL MAJORS' DILEMMA

THE RELATIONSHIP BETWEEN CAPITAL EXPENDITURES AND DEPRECIATION FOR MOST INTERNATIONAL OIL COMPANIES HAS FUNDAMENTALLY CHANGED ...

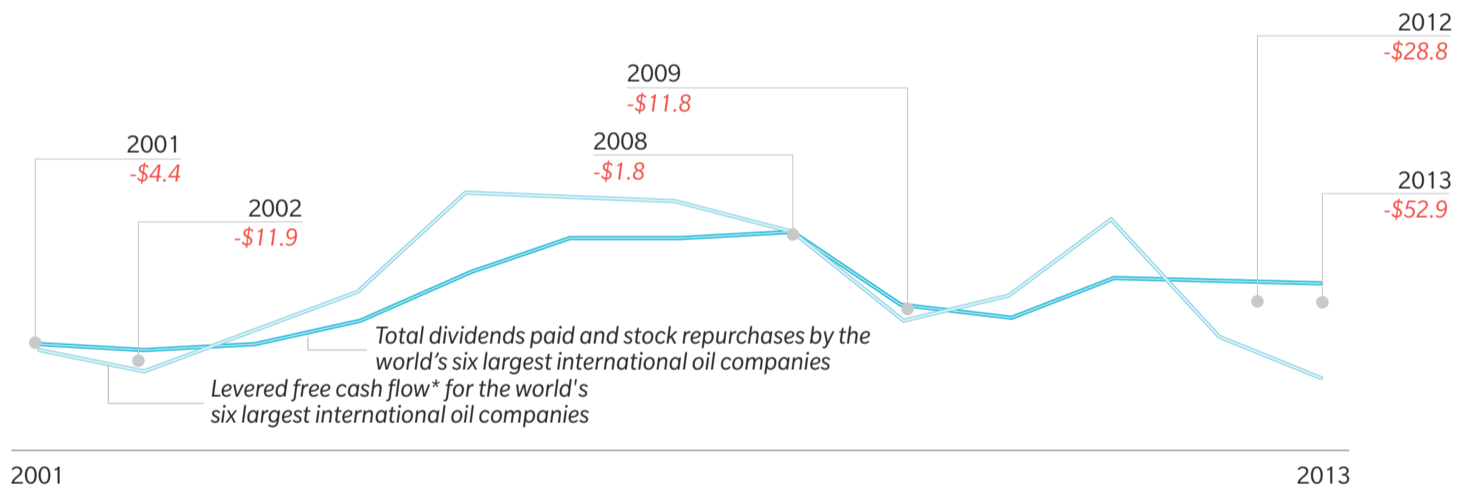
\$ BILLIONS



Source: Thomson Reuters: Datastream, Oliver Wyman analysis

...AND MANY ARE PAYING DIVIDENDS TO SHAREHOLDERS THAT MEET OR EXCEED THEIR FREE CASH FLOW

\$ BILLIONS



Sources: Thomson Reuters: Datastream, Oliver Wyman analysis

\* Levered free cash flow is defined as the amount of cash left over for stockholders and for investments after all obligations are covered

So what steps should the supermajors take?

## INTEGRATE...

First, they should divert cash flow from capital spending and direct it back to shareholders. Due to the false signal of rising oil prices over the years, capital spending has spun out of control. More capital is being committed to high-stakes projects. But the hurdle rates to achieve returns on these megaprojects are higher than is generally recognized when adjusted for their greater inherent risks (including cost overruns

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and delivery delays), especially in today's increasingly fractured geopolitical environment. These projects may also suffer from a higher failure rate than in the past, in part because the chronic hollowing out of experienced workers and managers has made it more difficult for oil and gas firms to oversee contractors.

Supermajors should also seriously consider investing in a wide array of assets from which they can create value, ranging from oil exploration projects to oil field services. Doing so will require oil majors to forge new paths to make intra-business investment decisions, now that oil exploration projects may no longer deliver the highest returns. In the past, an oil exploration investment would not be compared to other types of investments. But in the future, they may need to be.

## ...OR DISINTEGRATE

Finally, international oil companies could divide up their business portfolios and put some of their assets up for sale. As more oil and gas firms attempt to expand their reach into more types of businesses, they are driving up the valuations of everything from gasoline stations to oil field service equipment. It may make sense for some supermajors to unlock value by selling some assets that do not work together or that could realize greater value by being combined with others to achieve economies of scale.

There is a historical precedent for following such a strategy. Seventeen years after the Standard Oil Company was dissolved in 1911, the total market value of the 30 surviving companies of the 33 that were divested had market valuations that were more than five times higher than the original company.

As the business landscape for oil and gas firms radically shifts, supermajors face difficult choices. But they are not impossible, and many companies are already taking action. The industry is in the throes of extreme change – and that calls for extreme measures. The sooner the Big Six can make the profound strategic and operational changes that will enable them to create greater value in a higher-stakes world, the better.

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**Francois Austin** is a London-based partner and global head of Oliver Wyman's Energy practice.

**Fergus MacLeod** is the former head of strategy and planning at BP and a senior advisor to Oliver Wyman.

**Roland Rechtsteiner** is a Zurich-based partner and global head of the Oil and Gas practice in Oliver Wyman's Energy practice.

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