THE BIG SQUEEZE IN OIL FIELD SERVICES

THREE STRATEGIES TO SURVIVE THE CURRENT OIL PRICE DOWNTURN

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Since the collapse of global oil prices, oil field activity (both ongoing and planned) has decreased dramatically: Global exploration spending has contracted by almost 25 percent, the equivalent of $120 billion, due to delayed or cancelled projects. Additionally, global rig count – the key indicator of level of future exploration activity – has shrunk by 43 percent over the past 12 months.

Oil field services companies are being squeezed on almost every front, given falling oil prices. Their total revenues are expected to have declined by 20 percent through the end of 2015, based on third-quarter results. If oil prices remain at current levels, we estimate that oil field services firms' revenues could decline by another 28 percent over the next four years, and we expect steep, long-run declines in spend across the industry, with drilling companies being hit almost twice as hard. (See Exhibit 1.)

In response, these firms, which provide national and international oil companies with everything from seismic surveys and drilling technology to production maintenance services, likely will have to lay off a considerable number of people: The top 37 companies alone are expected to reduce their workforce by 170,000 – this in addition to the more than 120,000 who lost their jobs in 2015. To regain profitability, Schlumberger, Halliburton and Baker Hughes (the industry's three largest firms, accounting for about one-fifth of the market) will likely have to eliminate another 10,000 positions on top of the 64,000 they lost in 2015 and have announced for 2016. The 34 firms that represent the middle tier of the industry will need to cut the deepest, with the remaining 160,000 jobs in jeopardy. And the industry's bottom third tier in terms of revenues, which is made up of more than 300 small firms with limited cash reserves, will struggle to survive without further drastic cuts.

While it's true that cost cutting can enable a strategy, it cannot take the place of one. Leading oil field services firms are not just aiming for bottom-line targets. Medium-size players are looking to take steps to emerge on top once the oil and gas industry's economic cycle turns. What follows is a "top three" list of potential approaches that mid-tier oil field services firms should be considering. These strategies are about to reshape, and perhaps significantly strengthen the oil field services industry, and their impact will be felt long after the present big squeeze.

BECOME A NICHE PLAYER

Giant and mid-tier oil field services businesses have already laid off nearly 10 percent of their workforce to shrink their operations to suit current demand, with the assumption that when oil and gas prospects brighten, they can ramp up once more. But it's more likely that these firms will need to cut even more positions should they continue to follow the same strategy. Many will ultimately become much smaller players or else be forced to shut down if oil prices fluctuate between $45 and $70 for an extended period.

Shrinking is a long-term solution only for those firms that are willing to become niche players, since the elements necessary for growth may be out of reach after the cycle turns. Take strong customer relationships and long-term contracts, for example, which many mid-tier firms are relying on to get them through the current hard times. The margins associated with these contracts are likely to shrink and not return to their current levels any time soon. Already, international oil companies and national oil companies are in the process of renegotiating the terms of their contracts with oil field services companies that will remain in place for three to five years.

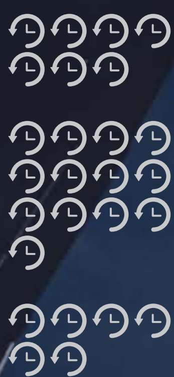
Once the decision has been made to downsize, the people and technology required to gain a competitive edge when the cycle turns may also prove to be unobtainable. Oil field services talent is highly mobile, quick to move between geographies and firms. Competitors that do

EXHIBIT 1: THE BIG SQUEEZE

Oil and gas companies are delaying projects and withdrawing rigs resulting in an expected 48 percent decline in revenues for oil field services companies

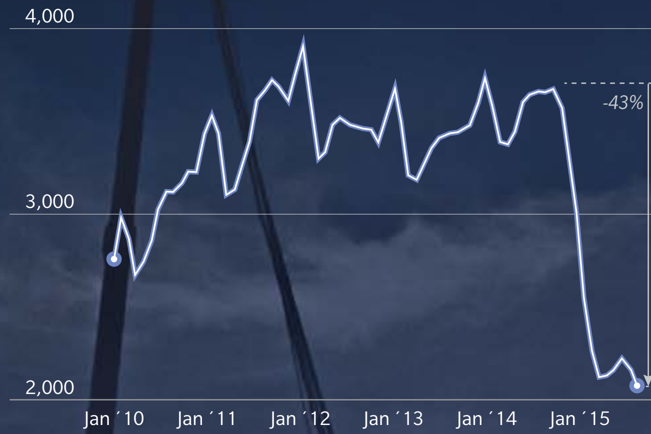
PROJECTS HAVE BEEN DELAYED OR AXED

	NUMBER OF PROJECTS DELAYED	TOTAL SPEND ($BILLIONS)
EMEA		25.7
AMERICAS		50.9
ASIA PACIFIC		41.5



Source: *Financial Times*; Rystad Energy; Morgan Stanley; Oliver Wyman analysis, from December 2014 through December, 2015

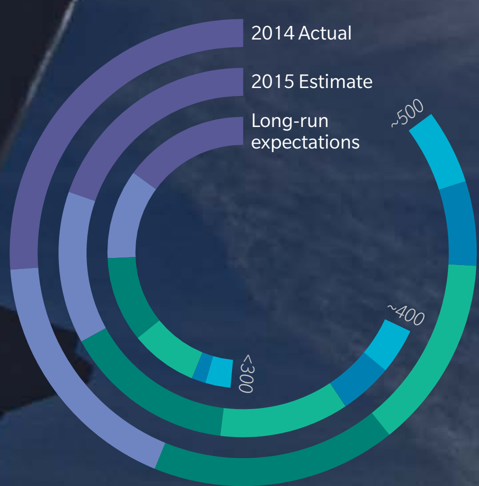
THE ACTIVE RIG COUNT HAS DROPPED



Source: Baker Hughes Worldwide Rig Count; Oliver Wyman analysis

REVENUES HAVE DECLINED

$BILLION *REVENUES OF TOP 350 OIL FIELD SERVICES FIRMS

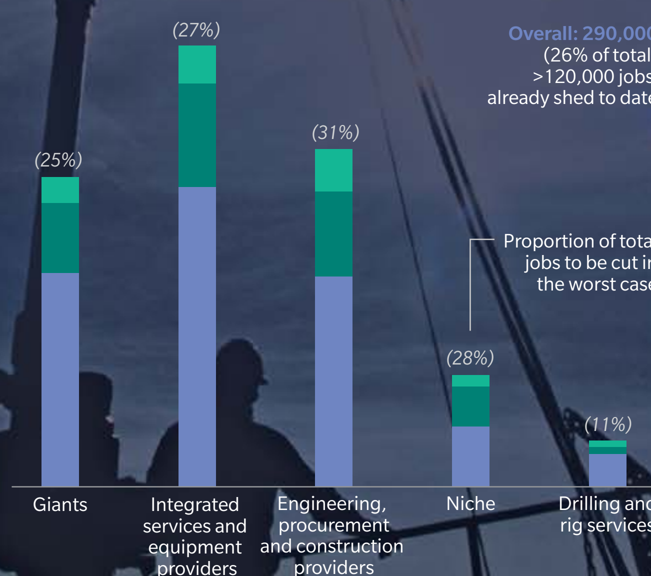


Small players
Integrated service and equipment providers
Drilling and rig service providers
Major players
Engineering, procurement and construction providers
Niche players

*Assumes oil prices remain at 2015 levels
Source: Capital IQ (2015 estimate based on 2015 data through December); Oliver Wyman analysis

NEARLY 170,000 MORE JOBS CUT

EXPECTED JOB LOSS IN GIANT AND MID-TIER OIL FIELD SERVICES FIRMS*
2000 FTE, 2016 - LONG-RUN EXPECTATIONS



Jobs remaining
Low case
Additional in high case

* Top 34 mid-tier oil field service firms by revenues and three giants
Source: Capital IQ and company announcements; Oliver Wyman analysis

not downsize in the interim will likely have hired away key talent and implemented today's cutting-edge technologies – or may be moving toward adopting even more advanced tools and knowhow.

CONSOLIDATE

Another option is to consolidate, as demonstrated by Halliburton's pending acquisition of Baker Hughes and Schlumberger's recent purchase of Cameron International (the oil field services industry's eighth-largest player). If this $50 billion total of mergers is completed, there will be only two major oil field service companies with a global footprint. These giants will raise the bar for the entire oil field services industry in terms of size and scale of operations.

An oil field services firm could improve its bargaining power by following a similar strategy of bulking up by acquiring smaller companies. There is room for a third oil field services giant to satisfy those customers concerned that the industry is becoming too concentrated. Moreover, the underlying structure of the market that oil field services firms serve remains the same.

But to compete with the other top two players, such an entrant would have to be able to support new projects and production everywhere, from Australia to Iraq to the United States. It also would have to deliver innovative approaches and technologies to supplying services ranging across sub-surface management, engineering design, construction and production services.

Creating a third oil field services company with revenues between $25 billion and $30 billion would require $12 billion to $30 billion in investment. That might sound like a tall order but is not impossible to imagine. A large conglomerate such as General Electric could develop a larger, more competitive oil field services presence by acquiring businesses. Or an ambitious oil field services business with a strong brand and footprint could partner with a private equity firm.

CHANGE THE RULES

Major oil field services firms must walk a difficult line between serving international oil companies and competing with them, especially for contracts that do not demand high levels of risk capital. This tension will grow as 'difficult oil' remains unprofitable and onshore or shallow water resources are exploited. These resources are now well understood and in the more politically stable countries require little in the way of risk capital. That means there is less need for international oil companies to be involved.

Larger oil field services firms are unlikely to challenge the status quo. But mid-tier firms with less to lose and under greater pressure to survive may attempt to change the rules by providing expertise and technology competitively and directly to national oil companies or other potentially unsophisticated mineral owners, especially to OPEC countries interested in achieving greater returns from their resources. Petrofac, for instance, already has a number of operations where it provides such services (and has an equity stake).

With the backing of a private equity firm or pressure from an expanding rival, mid-tier oil field services companies will most likely pursue three types of opportunities: those that involve oil fields requiring little new or unproven technology, such as mature fields that only need closer management or new fields in a benign environment; contracts or partnerships that involve mineral rights (or products) owned by organizations such as national oil companies that are poorly equipped to exploit them; and projects that don't require a great deal of capital, specifically risk capital.

Many opportunities exist for oil field services companies to not just survive the present downturn, but to change the rules, by creating synthetic international oil companies through partnerships with national oil companies or investors. Such partnerships are especially likely to succeed in major oil producing regions such as the North Sea, Southeast Asia and the Arabian Peninsula, where there are low maintenance oil fields, underdeveloped mineral rights and less capital-intensive projects. (See Exhibit 2.)

Most leaders know that when their backs are up against the wall, it is a sign that their industry is at an inflection point that can lead to potentially greater opportunities. Although it may not feel like it, oil field services companies do indeed have a choice. To survive current low oil prices, they can aggressively downsize. But an alternative course may be much better over the long run: They can make a bold move to rewrite the rules.

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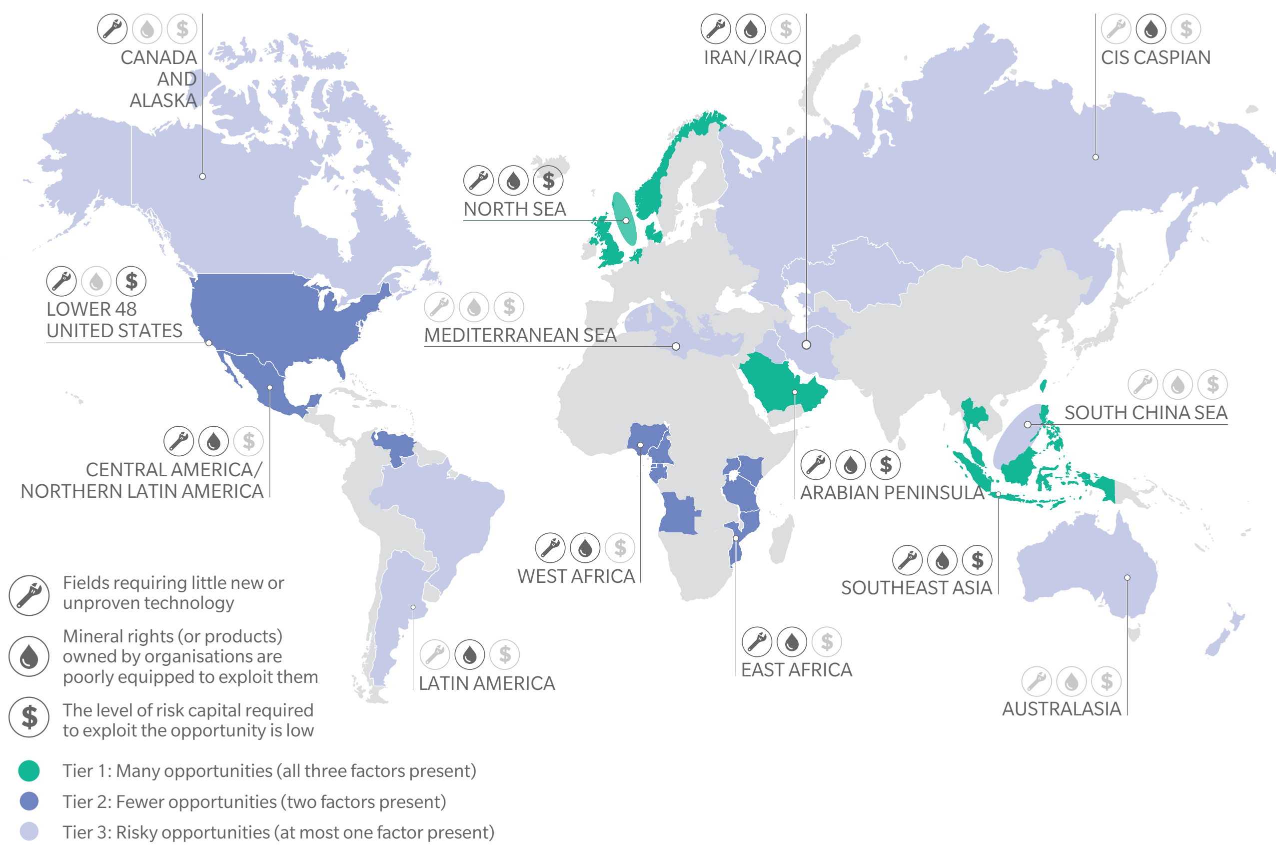
EXHIBIT 2: NEW OIL FIELD SERVICES INDUSTRY OPPORTUNITIES

Mid-tier oil field services firms may attempt to compete with international oil companies in regions where there are low maintenance oil fields, underdeveloped mineral rights and less capital-intensive projects



Source: Oliver Wyman analysis