The Pursuit of Basin Consolidation and Contiguous Acreage Positions: Weighing the Risks and Benefits

11/15/2016

Reading Time : **2 min**

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Financial sponsors and exploration and production companies pursue acreage consolidation and contiguous acreage positions because such transactions allow them to optimize the utilization of infrastructure and achieve efficiency improvements, including centralized facilities, streamlined operations and reduced land work. Owning core acreage in a single location, as opposed to holding small pieces in multiple areas, allows producers with generally higher operating costs to harness greater efficiency benefits by implementing technological advancements in drilling, completions and productions. In addition, those investing in areas where they already hold assets have the advantage of being familiar with the geologic play at hand, allowing them to deploy their resources and generate attractive returns more quickly than if they had to acquaint themselves with the location.

However, despite the benefits of basin consolidation, investors and operators should be mindful of certain risks associated with the strategy. Among other things, those seeking to do business in the “hot” areas are potentially paying a premium, which may be sizable and become a drag on the eventual return on investment. In addition, assets that are centralized in one location are likely subject to substantially similar risks across the portfolio, and as a result, the occurrence of any one risk would have a much greater impact on that operator than if its assets were diversified across multiple basins and operators. For example, upstream assets that are concentrated in one area may be disproportionately impacted by risks related to midstream providers and employees. If a producer or sponsor seeks efficiency by using the same midstream infrastructure to get its entire product to market, any problem with such infrastructure would likely have a much greater effect on the business than if the assets or transportation and marketing options were diversified. Similarly, before entering a market, producers and sponsors should evaluate the availability of skilled laborers in the area, particularly given that many may have scattered since the decline in oil prices. The lack of nearby skilled labor could significantly lessen the appeal of certain assets, given that access to a sufficient talent pool is fundamental to successful operations.

Furthermore, acquirers that seek to roll up previously competing companies in the same basin should be mindful of how such companies' cultures and management will work together following consummation of the transaction. An otherwise financially savvy investment may never deliver if an acquirer is unable to successfully integrate potentially disparate cultures that do not see eye to eye with respect to the assets or the operation thereof. Given such attendant risks, acquirers and targets should be careful to conduct thorough financial and legal due diligence with respect to both in any proposed transaction.

In sum, while the strategy of pursuing acreage consolidation and contiguous acreage positions is appealing, financial sponsors and exploration and production companies will benefit from carefully weighing the risks and benefits of each proposed acquisition prior to making their investments.

For more information on managing the risk of investing in the oil patch in the current economic climate, see the blog post titled "Mitigating Private Equity Investment Risk in the Oil Patch" dated August 9, 2016, by Shubi Arora and Jhett R. Nelson.

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