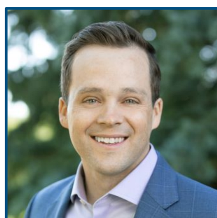
Pearl Meyer

ADVISOR BLOG

Market Consolidation in Oil and Gas: Can Transaction Awards Break the Stalemate?

AUTHOR



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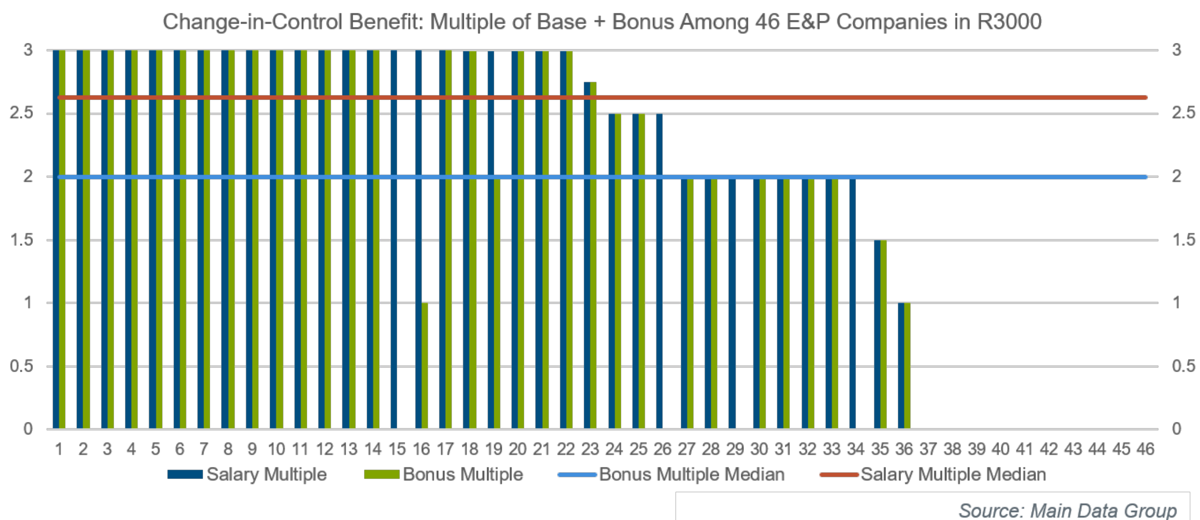
The rationale for consolidation in the US energy industry as a means to preserve future stability and financial success is well-documented. However, despite a few landmark deals in the last year among big name players, as well as some recent attention-grabbing headlines involving two US behemoths, M&A activity in the industry continues to stagnate. Industry observers have their views on why, frequently pointing to executive compensation as a common obstacle. As fiduciaries, board members are charged with looking after the interests of the shareholders that elect them to oversee the management of their investment. Are there compensation levers that boards can pull to help break the logjam?

"Skewed incentives and low insider ownership." This quote from a recent high-profile energy investment firm's published opinion summarizes much of the reality around executive pay designs in the industry. Cookie-cutter compensation programs are not sufficiently incentivizing management teams to create value, whether that be through returning cash to shareholders or merging into another entity to achieve a step-up in equity currency and scale. If a company is unable to generate returns to shareholders because of the economics of its operating model, a change-of-control transaction may be the right choice to preserve value for shareholders into the future. However, management teams may be discouraged to explore such transactions when the calculus of the personal benefits derived from executing such a deal continues to deteriorate alongside a drop in company valuation. To overcome this obstacle, boards could consider a couple of options: increasing change-in-control multiples for executives and/or transaction-related awards.

The idea of increasing change-in-control multiples has been in circulation amongst US energy independents for a few years, along with the idea that the energy industry has become too fragmented and may need a "jumpstart" to encourage consolidation and preserve future value. The industry has delivered consistent underperformance relative to the broader market, yet change in control multiples haven't moved. The reasons vary: pressure from proxy advisory firms that have policies labeling cash severance above 3x as "excessive" (you can see the impact of this policy in the chart below), a broader sentiment

that oil and gas executives are paid too much, and newly appointed executives who have in recent years entered into employment terms with cash multiples at 2x or lower and moved the needle in the other direction. Given the particular influence of the proxy advisory firms on say-on-pay and compensation committee member reelection votes, and the negative sentiment on pay practices from the broader public market on pay design evolution, we see transaction-related awards as a potential solution.



Transaction-related awards are not a novel concept, and have even been put to work in recent industry consolidation transactions. Beyond the added incentive they provide executives of a target company to green-light a transaction, such awards aid the stability of the target company up to and through the change-in-control event. Equally important is the reality that transaction-related incentives are generally implemented for the non-executive employee population as well. While executive transaction awards can make headlines, having been the subject of public scrutiny in the past, those awards are often part of a larger retention program pool for non-executive employees to incentivize behaviors through the transaction and beyond. M&A is extremely complex, and management teams on either side of the deal need the broader workforces to stay engaged to facilitate a smooth process.

Such compensation arrangements are designed to improve shareholder value in the future. Naturally, the structures and values of transaction-related awards are going to differ based on the circumstances of the transaction and the goals and behaviors being incentivized. If your company is evaluating M&A opportunities and weighing the economics, an exploration of the transaction-related award concept is in order. Some perspectives we recommend you consider when determining the appropriateness and design of awards:

- Are awards needed to ensure the company delivers on expectations of the deal (i.e., delivers the business in a form and value expected by transacting parties)?

- Are awards needed to retain and motivate the right people to enact and oversee the transaction? Design criteria might differ if there are human capital assets needed for the short term versus the long term.
- Determine payout conditions, including time of service, performance criteria, etc.

While additional compensation opportunities seem inherently at odds with the current dialogue on executive pay in the energy industry and a company that may need to enter a transaction to preserve value, the underlying rationale has merit. Enough incremental benefit to executive teams to engage in M&A activity could have wider benefit and accelerate the needed consolidation phase in the industry.

About the Author

Ian Keas recently joined Pearl Meyer, bringing with him 10 years of experience advising clients on executive, key employee and board of director compensation program matters. His experience is predominantly in the energy industry, focusing on E&P and oilfield services entities, but also includes banking and nonprofit entities. With clients spanning public, private, and nonprofit sectors, including companies experiencing significant transaction-related events like IPOs and restructurings, Ian is focused on providing the necessary resources that will enable clients to maximize long-term enterprise value by executing on their business plans.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in Atlanta, Baltimore, Boston, Charlotte, Chicago, Houston, London, Los Angeles, New York, Raleigh, and San Jose.

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