Baker McKenzie.

Energy deals to rise in 2018 amid firming oil prices and strong global economic growth

Higher oil prices, plentiful financing and a strengthening global economy have been fueling a resurgence in energy sector transactions, with total M&A values more than doubling in 2017 to US$345 billion, up from US$164 billion in 2016.

In 2018, we forecast M&A deal values to continue rising to a peak of US$353 billion before cooling in line with a slowing of global investment growth as borrowing costs rise in key economies and stretched stock market valuations start to soften.

"There's an expectation now that oil prices won't go below $50 barrel, up from lows of $25 to $30 a barrel in recent years," says James O'Brien, chair of Baker McKenzie's Global Energy, Mining & Infrastructure Industry Group. "It may not be $80 or $100 a barrel like it's been in the past, but it's sufficient enough to drive deals."

In one of the most significant energy deals since oil and natural gas prices crashed in mid-2014, Canada's Enbridge Inc. acquired Spectra Energy Corp. of Houston in an all-stock deal valued at US$28 billion. The merger of the two pipeline companies, which closed in February 2017, creates the largest energy infrastructure company in North America.

A depth of liquidity in the capital markets and synchronous economic growth are also driving higher levels of deal activity. In 2018, we forecast IPOs to double to US$13.9 billion, up from US$7.3 billion in 2017. One of the largest energy IPOs last year was Houston-based Kinder Morgan Canada's listing on the Toronto Stock Exchange, which raised US$1.3 billion that the oil and gas company is using to expand its Trans Mountain pipeline in British Colombia.

"The fact that there is economic growth across all regions and that it's happening all at the same time is unusual," O'Brien says. "In the past we've seen North America's economy growing but Europe's is not. Or Europe is growing and Asia is not. Having all regions growing at the same time is acting as a springboard for transactions."

GLOBAL ENERGY M&A (US$ BILLION)						
2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
326	293	164	345	353	312	256

GLOBAL ENERGY IPOS (US$ BILLION)						
2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
19	4.3	10.5	7.3	13.9	12.3	6.1

Source: Oxford Economics

Energy M&A in 2018: Key drivers

North America will continue to lead M&A activity in the energy sector in 2018, although we forecast transaction values to dip slightly to US$227.7 billion, down from US$242.5 billion in 2017. In Europe, we forecast energy M&A to rise by more than 30% to US$56.6 billion, followed by Asia Pacific with US$50.4 billion, Latin America with US$13.4 billion, and the Middle East and Africa with US$4.5 billion.

North America

In the US, a provision of the tax reform law that enables companies to write off capital investments on new projects the year they are placed into service is expected to stimulate investment in the industry, as is the Trump administration's pro-energy policies.

One example of those policies is a directive issued by the US Department of the Interior in December 2017 stating that the government would no longer prosecute energy operators that accidentally harm birds. Under the Obama administration, owners faced strict liability under the Migratory Bird Treaty Act that carried a penalty of up to six months in jail and a US$15,000 fine for every bird they injured or killed, typically those electrocuted on power lines or struck by wind turbines.

The strict interpretation of the act compelled energy companies to take preventative measures like avoiding putting wind farms in migratory bird flight paths and shutting down turbines during peak migration times, measures the Trump administration cited as a burden on domestic energy production.

Now the government would have to prove an energy company intentionally killed migratory birds to prosecute them under the statute. “The Trump administration is doing all it can to remove obstacles to developing new energy projects,” O’Brien says.

Europe

Across the regions, we anticipate that Europe will see the greatest rise in energy M&A deal values this year, bolstered by an improving labor market, rising intra-EU trade, and growing business investment in the region. We forecast deal values to climb to US$56.6 billion, up from US$42.1 billion in 2017.

“From a macroeconomic perspective, Europe is experiencing widespread and coordinated economic growth,” says David Duncan, a corporate partner at Baker McKenzie based in London. “Combine this with relative oil price stability and you will see greater boardroom confidence to do strategic deals.”

> “Many of the major energy players in Europe are accelerating their efforts to diversify and adjusting their asset portfolios to be better positioned for investor, regulator and consumer-led changes.”
>
> **DAVID DUNCAN**
>
> Corporate Partner

M&A volumes in Europe are also being driven by the energy transition. Big Oil is increasingly diversifying and pushing deeper into new markets and sectors like technology and renewables. In one of the largest energy deals of last year, for example, Russia’s state-owned oil company Rosneft bought the oil refining and port assets from India’s Essar Group for $13 billion to boost its presence in India, the world’s third-largest crude oil importer.

In December, BP announced its US$200 million investment in Lightsource, Europe’s largest solar development company. BP will acquire a 43% stake in the rebranded Lightsource BP business, which will add to BP’s existing alternative energy investments that include wind, biofuels and biopower.

“Many of the major energy players in Europe are accelerating their efforts to diversify and adjusting their asset portfolios to be better positioned for investor, regulator and consumer-led changes,” Duncan says. “Technology is a strong driver as it is expected to play a big role in the future of energy supply and demand. As these companies continue to invest in new technologies and renewable assets, we should see an uptick in M&A activity.”

Asia Pacific

In Asia Pacific, we forecast energy M&A values to rise nearly 25% over the next two years, from US$43.6 billion in 2017 to US$53.2 billion in 2019. Chinese spending, bolstered by appreciation of the yuan and the government's ambitious Belt & Road initiative, is expected to drive M&A activity in the region.

"If oil prices continue to rise, it's likely to kick-start development of the projects that have been put on hold because of low oil prices," says Martin David, co-chair of Baker McKenzie's Global Power Industry Group. "We will also likely see a rise in M&A activity in the upstream and mid-stream sectors."

Latin America

In Latin America, we forecast energy deals to rise slightly to US$13.4 billion in 2018 and continue to a peak of US$17.3 in 2019. Economic recovery in Brazil, along with increased productivity and currency stability within the region should accelerate deal activity beyond 2018.

"Latin America's abundant natural resources and government commitments to improving the power infrastructure and increasing supply from conventional and renewables sources should create business opportunities across the region," says Anna Mello, an M&A partner at Trench Rossi Watanabe Advogados, a Brazilian firm in cooperation with Baker McKenzie.

To reduce domestic public debt and attract foreign capital, the Brazilian government has announced the privatization of 57 state-owned assets, including airports, port terminals, highways and the national electric power company.

Meanwhile Vale, the world's top iron ore producer, announced last year that it would absorb the stocks of Valepar, its controlling shareholder consisting of Brazilian state pension funds, national development bank BNDES, private bank Bradesco and Japan's Mitsui, to reduce government involvement in its operations by 2020.

Middle East and Africa

In the Middle East, oil remains key to the macro outlook as OPEC continues its production caps through 2018. We forecast a modest rise in energy M&A to US$4.5 billion this year and a further increase to US$5.2 billion in 2019.

"OPEC members have been surprisingly good at complying with the production quotas, which is helping to constrain supply and support oil price stability," Corporate Partner David Duncan says. "However, production limits can slow transactions activity because companies will not buy assets they cannot then exploit."

ENERGY M&A BY REGION (US$ BILLION)				
	2017	**2018**	**2019**	**2020**
North America	242.5	227.7	186.1	152.9
Europe	42.1	56.6	49.8	39.3
Asia Pacific	43.6	50.4	53.2	44.3
Latin America	12.8	13.4	17.3	16.1
Africa & Middle East	4.4	4.5	5.2	3.3

Source: Oxford Economics

Energy IPOs in 2018: Key Drivers

Energy IPOs dropped to US$7.3 billion in 2017 but are expected to double to US$13.9 in 2018, driven by a rebound in oil and gas listings. As oil prices dropped, companies halted proposed stock market launches.

"The 2014 drop in oil prices had a big impact on the energy sector across EMEA," Corporate Partner David Duncan says. "The prolonged downturn has acted like something of a dam, holding back capital. Now we have three to four years worth of deals waiting to come to market."

> "Economic recovery hopes in Brazil and Argentina triggered a surge in initial public offerings."
>
> **ANNA MELLO**
>
> M&A Partner

With oil prices firming, IPOs are expect to swing back this year across a number of geographies, including North America as industry players seek to raise capital to acquire new talent and technology.

"Energy companies emerged from the downturn with better core assets and a lower cost basis, making them leaner and more efficient," says Denmon Sigler, a partner in Baker McKenzie's Energy, Mining & Infrastructure Industry Group based in Houston. "Combined with stronger oil prices, these lean, asset-rich companies are attractive to investors."

Stock markets have been increasingly active in Asia Pacific, where domestic IPO proceeds across industries rose from US$47 billion in 2016 to an estimated US$55 billion in 2017.

"Oil and gas are likely to be the triggers that drive the energy market in Asia Pacific," Global Power Co-Chair Martin David says. "Liquid natural gas continues to be active as countries constrained by environmental concerns about fossil fuels like coal seek to import gas for power generation."

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>
> **DENMON SIGLER**
>
> Energy Partner

Amid signs of economic recovery in Latin America, IPO markets in Brazil and Mexico rebounded in 2017 with domestic IPO proceeds in both countries rising ten-fold or more in 2017 – the highest in years.

"Economic recovery hopes in Brazil and Argentina triggered a surge in initial public offerings," M&A Partner Anna Mello says. "More than 25 Latin American companies are expected to go public this year."

But the biggest news of the year could come out of the Middle East, where Saudi Aramco, the world's largest crude oil exporter, has announced plans for a public listing that could become the largest IPO ever. The Saudi government aims to raise US$100 billion by selling a 5% stake in Aramco, which would value the company at US$2 trillion.

It's unclear exactly how much the potential sale would raise, however, given that independent analysts have produced much lower company valuations of US$250 billion to US$500 billion, which would generate proceeds of US$12.5 billion to US$25 billion.

If Aramco manages to achieve a valuation that matches Crown Price Mohammed bin Salman's expectations, the listing would far exceed the IPO record of US$25 billion set by China's Alibaba in 2014. Because of the discrepancies about how much an Aramco listing would raise, we did not include it in our global IPO forecast. If it goes forward as planned, the listing would raise the 2018 total to record levels.

Beyond 2018

Following a peak in deal activity in 2018, we anticipate that energy M&A and IPO transactions will decline in 2019 as part of cooling of activity worldwide. After reaching a five-year high this year, we forecast energy M&A to drop to US$312 billion in 2019 and to US$256 billion in 2020. For IPOs, we forecast a dip to US$12.3 billion in 2019 and another drop to US$6.1 billion in 2020.

Looking forward, the energy sector is expected to undergo greater diversification as companies prepare for advances in technology and renewables. New technology, especially innovations like self driving and electric cars, could create major disruptions in the market.

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