Navigating the M&A Landscape in the Permian Basin

May 1, 2024

In the Energy Sector, particularly in the Permian Basin, Mergers and Acquisitions activity appears cautious but optimistic and signs are pointing to increased activity for calendar year 2024. Despite various industry and overall economic challenges, including high interest rates, global conflicts, political pressure and reduced demand, the Energy Sector in 2023 had one of its best years, from an activity standpoint, since 2016. According to PitchBook, the second half of 2023 saw activity increase significantly compared to the first half, and forecasters are predicting that increased level of activity will continue into 2024. The fourth quarter of 2023 saw a significant uptick in deal activity and value, representing more than half of the total deal value for the entire year. In total, the fourth quarter saw $194.2 billion in deal value, surpassing the previous three quarters total aggregate deal value of $186.6 billion. Total annual deal count closed at 1,349, the largest number since 2016. The Permian Basin remains a hotbed of activity as it continues to thrive with new opportunities for investors, ranging from the large majors to small private equity backed deals.

Several metrics are helping buoy the levels of activity in the Permian Basin, including strong operations, increased production and expected production levels, healthy margins, favorable political climate and majors and private equity that are flush with cash to spend on mergers and acquisitions (M&A). While many metrics were high, the sector saw a sizable decrease in the average Enterprise Value/EBITDA multiples during 2023, reaching the lowest level in the past 10 years, apart from the anemic activity experienced during the heavily-impacted COVID year of 2020. Average multiples finished 2023 at 5.9x, down a full turn from 6.9x experienced in 2022. This decline likely indicates that a bridge has been made in the valuation gap between what buyers and sellers experienced in prior periods. This bridge will likely help to accelerate deal activity in 2024, as long as interest rates and regulatory headwinds don't interfere. Although deal acceleration is likely, with strong cashflows and healthy balance sheets, mid-market operators may become less interested in selling and attempt to "ride the wave" as long as they can.

Owners that are considering an M&A exit in both the near and long term should consider how to position their companies for the best possible outcome. The longer the owner's exit runway, the better they can prepare for their best desired result. As such, if an owner's exit runway is greater than two years, they should consider the strength of their financial reporting and button up their accounting department to ensure segregation of duties and proper financial reporting. A seller should also consider getting their financial statements audited to ensure proper reporting in accordance with Generally Accepted Accounting Principles (GAAP). Additionally, a seller should identify and attempt to remedy any significant risk areas a potential buyer may use to try and devalue the company. These items may include customer and/or vendor concentration, commodity and margin risk, customer contract risk and bloated balance sheets. Partnering with a well-versed "Transaction Quarterback" can help an owner identify these risk areas and provide meaningful guidance to ensure unique solutions are implemented.

If timing of a proposed transaction is shorter than a couple of years, an owner may consider obtaining a Quality of Earnings (QOE) analysis to help identify non-recurring or out of period accounting transactions that impact the repeatability of the company's earnings. A QOE analysis will prepare the organization for the buy-side due diligence process and will help tell the story of what is driving the economics of the business. For example, the analysis can show the mitigating factors for potential and identified risks and identify the opportunities for a buyer in the post-transaction future. A QOE report will help identify appropriate levels of net working capital, which is customarily part of the overall economics of a transaction. Many parties in a transaction do not focus on net working capital trends as they relate to a transaction until final negotiations, which could lead to a seller leaving valuable excess working capital with the company unnecessarily or crater the transaction completely.

Despite many economic and industry sector headwinds, M&A activity is forecasted to remain robust for at least the next couple of years as financial and strategic buyers remain flush with cash, or "dry powder", waiting on the sidelines to be invested. Over the next several years, the United States economy is anticipated to see the largest shift in wealth as the baby boomer generation retires and passes their legacy to new buyers/owners and the younger generations. To ensure the best possible outcome, however a seller defines it, work needs to be done beforehand to position the company properly and ensure a successful transaction.

Whitley Penn's Deal Advisory teams are equipped to guide you through the intricacies of undergoing a transaction. Whether it be a merger, acquisition, joint ventures, equity investment, or divestiture, our team is ready to scale with you and guide you along the way. Reach out to a consultant by visiting **www.whitleypenn.com**.

Contact

Daniel Boarder
Deal Advisory Partner
Daniel.Boarder@whitleypenn.com