

Water midstream braces for oil price crash impact

Plummeting oil prices will lead to a reduction in 2020 oilfield water management activity and a rationalization of M&A deal multiples

Lower production volumes and a squeeze on service fees could result in a 40% year-on-year reduction in US oilfield water management revenues in 2020, according to new projections from investment bank Raymond James.

The combined effect of the oil price war and the coronavirus pandemic is severely affecting US shale producers, many of which were already burdened by debt and budget constraints. The steep price drop has driven many producers to slash 2020 capex budgets and drilling programs as they look to maintain free cashflow and continue servicing debt.

Under these circumstances, pro-

ducers are pressing services providers – including water midstream companies – to cut their prices by as much as 25%.

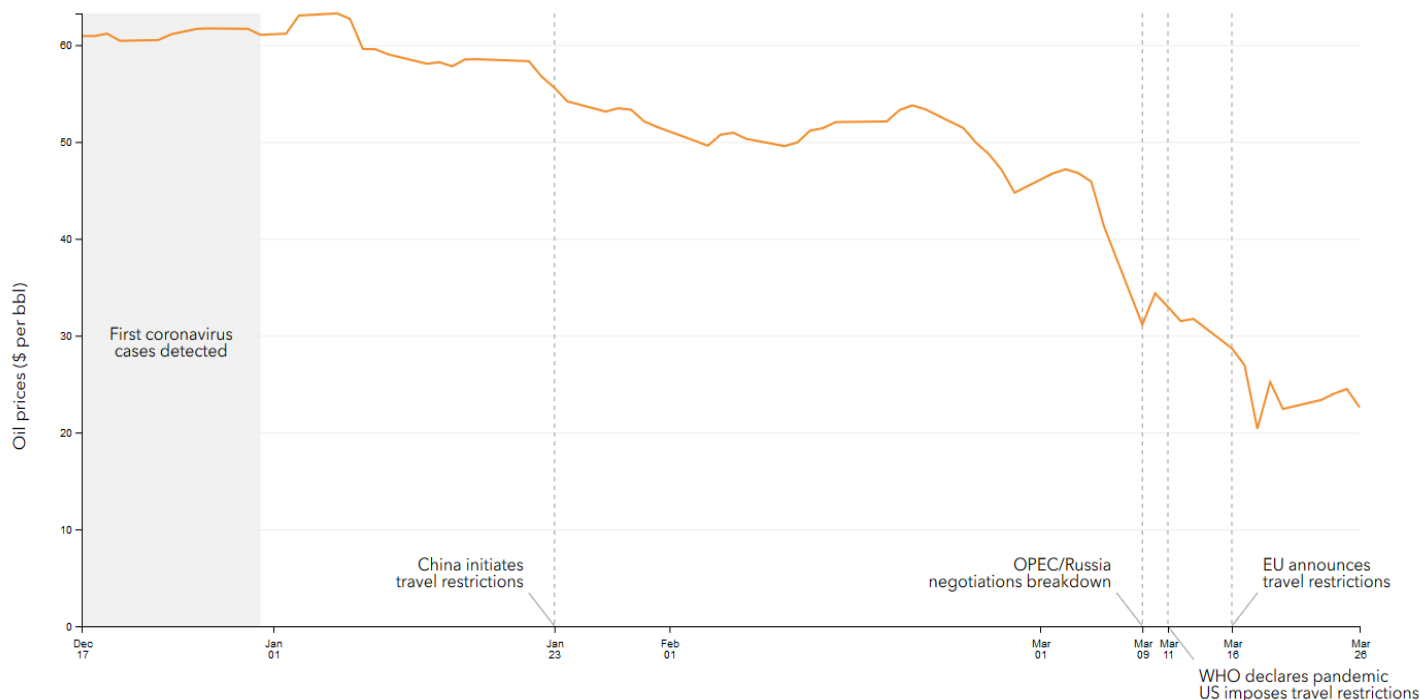
“All the services companies are already operating near breakeven. That’s not how we’re going to revive business in West Texas. We’re going to revive it by working together and finding lower-cost solutions,” Joe Titzer, vice-president of business development at Midland Basin-focused Gravity Oilfield Services, told *Water in Oil*, underscoring the key role of water midstream companies in helping struggling producers.

The extent to which water services providers weather the slump will

ultimately depend on the location and scale of their primary assets, breadth of their service portfolio, resilience of their customer base, and balance sheet strength.

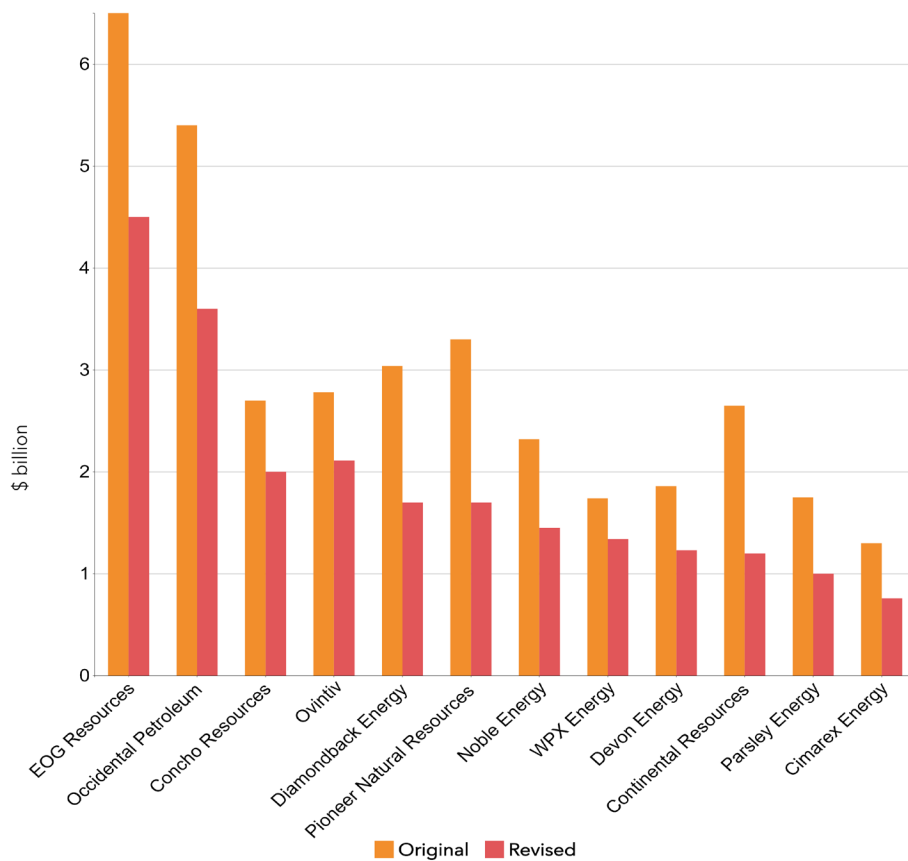
As producers prioritize acreage with better breakeven drilling costs, analysts expect that most water companies active in the Permian Basin – particularly those with larger-scale pipe-connected saltwater disposal networks and contracts tied to minimum volume commitments or acreage dedications – will fare better than their counterparts in other US plays.

Analysts predict that the impact on Oklahoma’s SCOOP/STACK play will be harsh, due to the large number of



WEST TEXAS INTERMEDIATE BARREL PRICES

Source: Nasdaq



EXPLORATION & PRODUCTION CAPEX BUDGETS FOR SELECT COMPANIES, 2020

Source: Evercore

small, private producers operating there. Majors with acreage in Oklahoma are expected to put those leases on the backburner while they focus on more profitable areas. However, not all water players in that space are expected to be affected in the same way.

For example, Lagoon Water Solutions, the largest water services provider in the SCOOP/STACK, is advantaged by its asset network and the fact that one of its key clients is Continental Resources, a larger public producer that did well maintaining free cashflow in 2019. Though Continental has reduced its 2020 capex budget by 55%, the company still expects to grow annual production, which bodes well for Lagoon.

“We’ve been focusing on growing volumes across the core of our system. We are executing on two very strategic projects right now that we anticipate having completed in the next 90 days or so,” Caitlyn Jackson, Lagoon’s CCO, told *Water in Oil*. “Those are projects that will continue to move us forward

on our strategy of laying a large system of interconnected infrastructure.”

Wood Mackenzie senior consultant Evan Tikka told *Water in Oil* that across the US, the drastic reduction in new completions activity would hit the freshwater sourcing and produced water trucking segments hardest, and cause decisions on new water recycling projects to be delayed by three to six months.

Some are now wondering whether low prices will derail the sector’s move towards large-scale recycling at centralized facilities, as those setups entail high development costs that may only be justified if producers continue to plan for robust drilling programs. However, recycling at scale remains essential for reducing costs in this price environment, Titzer said.

James West – a senior managing director and fundamental research analyst at investment bank Evercore – observed that some long-term water services contracts will inevitably be broken. He nevertheless expects the

Permian Basin water infrastructure build-out to continue – albeit with less urgency – because producers will still require water management solutions.

“[The Permian] is still a relatively bright spot in what’s going to be a bit of a chaotic market environment,” he told *Water in Oil*.

The downturn may even hold a silver lining for water midstream players seeking inorganic growth opportunities. Matthias Bloennigen, Wood Mackenzie’s director of upstream consulting, argued that many producers who had been hesitant to sell non-core or low-utilization assets to water service providers prior to the price crash may be more willing to do so under distressed market conditions.

Kirk Presley, an energy equity research associate at Raymond James, agreed that such transactions could pick up in the next six months. “I think the water midstream bullish case is that there are going to be even more E&P dropdowns as those companies are even more starved for cash, and they’re going to be at lower or fairer valuations than they would have been last year,” he explained to *Water in Oil*.

Water asset sales over the past year have involved EBITDA multiples as high as 11x in some cases, based largely on the expectation of future growth in produced water volumes, tied to plans for new drilling. Valuations for upcoming transactions are expected to be considerably lower, reflecting producers’ reduced capex budgets and a sharp reduction in drilling activity.

The new market reality could also accelerate consolidation among water service providers – as larger players able to weather the downturn pick up the assets of distressed competitors – although it remains to be seen how inclined their private equity backers will be to pursue these deals while oil prices remain below \$30/bbl.

“Water probably stands out as one area that is still relatively robust and safe, but overall, I think the appetite for additional capital in oil & gas is going to be really, really low,” Evercore’s West concluded.