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Cross-border M&A: Perspectives on a changing world

Highlights for the Oil & Gas Sector

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M&A activity in the oil and gas sector continues unabated, fuelled by the desire of market participants to secure scarce resources even in jurisdictions where there is significant country risk. Those embarking on opportunities in emerging/high growth markets need to navigate through a variety of legal, regulatory, cultural and business risks and challenges which will likely be different to those with which they are familiar.

In the first quarter of 2012, the Economist Intelligence Unit carried out a global survey on behalf of Clifford Chance to explore current perceptions of the key opportunities and risks in cross-border M&A. It looked at current and future plans for M&A activity, and key barriers that might get in the way of successful cross-border deals. 377 respondents from companies with annual revenues in excess of US$1 billion were surveyed, from across a range of regions and industry sectors, including the Oil and Gas sector.

The desire to pursue assets in emerging/high growth markets was confirmed by our survey with approximately 58% of respondents from the oil and gas industry indicating that this was the focus of their organisations' growth strategies.

What is apparent is that, although the aforementioned risks and concerns are important factors which are taken into account when assessing potential targets, it does not appear that many of these are ultimately deterring potential bidders from seeking to secure highly attractive or strategic assets, particularly where there is the opportunity for the sharing of risk with international or local players.

Existing cash resources, presumably arising from sales of hydrocarbons into a generally buoyant energy market, means the use of existing cash piles remains the predominant source of funding for deals in this sector. However, respondents in our survey indicated that debt financing may be on the increase, particularly in North America.

Top five risks and concerns for M&A activity over the next 2 years

1	**Concerns around effective integration and cultural differences.**
2	**Resource nationalism, manifested in protectionism and foreign ownership restrictions.**
3	**Economic and political volatility in target markets.**
4	**Environmental risks in the context of cross-border transactions.**
5	**Concerns around bribery and corruption, bought into even sharper focus following the introduction of the UK Bribery Act in July 2011.**

Given the scarcity of resources in developed nations (the recent shale gas boom in North America aside), Oil and Gas investors are continuing to seek opportunities through M&A in emerging markets. With such deals can come significant country risk, and it is unsurprising that investors are focusing on resource nationalism as a particular challenge. ”

David Lewis, M&A Partner, London

Concerns around effective integration and cultural differences

- Investors in cross-border deals are often increasingly focused on the necessity to bridge cultural divides between foreign shareholders and management, employees, local partners and/or government.
- This trend is manifesting itself in attention being paid to careful integration planning at the outset of transactions. An important element of this is making sure that the goals of the target company and new shareholders are understood and appropriately aligned. Investors are also devoting more time to familiarising themselves with management as part of the due diligence process.
- Interestingly, our research indicated that the extent to which respondents perceive cultural differences as critical varies from region to region. 67% of respondents from the Asia-Pacific region considered that cultural differences are a deterrent to pursuing cross-border deals. By contrast, only 35% of European respondents did, suggesting that European investors may be more familiar with negotiating the cultural dynamics of post-deal integration.

Resource nationalism: Protectionism and foreign ownership restrictions

- It may not be a surprise to readers that respondents in our survey from the Oil and Gas industry expressed a greater concern regarding protectionism and obstacles to foreign ownership than other industries, reflecting the industry-wide concern as to how to respond to rising resource nationalism in many countries.
- In April 2012, Argentina startled the market by announcing the renationalisation of YPF, the largest oil company in Argentina, ousting the majority owner Spain's Repsol. Following a series of high-profile nationalisations in Venezuela over the past years, this step by Argentina is more evidence that outright state expropriation of foreign-owned assets cannot be deemed a thing of the past in the Oil and Gas sector.
- Leaving aside outright expropriation, foreign investors often encounter legal and regulatory barriers either explicitly or implicitly designed to restrict the nature and scope of overseas investment in prized oil and gas resources of certain nations.
- Various countries (particularly in Africa, such as Angola and Nigeria) have taken steps to either promote local ownership of oil assets or cap foreign ownership. Other countries have in recent years announced changes to the regimes governing national security review of foreign investments in strategic industries, which would be likely to capture many Oil and Gas investments.

- The way that governmental approvals can complicate deals was exemplified in the collapse in 2011 of the proposed sale by BP of certain Argentine oil assets to a joint venture involving Bridas Energy and China's CNOOC, amid mutual recriminations about the failure to secure Argentine antitrust and Chinese governmental approvals, and media speculation about Argentine political opposition to the deal.
- Interestingly, concerns around protectionism and foreign ownership restrictions were even more pronounced among respondents from the Asia-Pacific region, with over half of those respondents placing these issues in the top three risks they identified in cross-border M&A. This may reflect a concern among Asia-Pacific respondents that markets and opportunities in certain regions are still not fully open to them.

Economic and political volatility in target markets

- Respondents varied from region to region as to the precise political and economic factors that they perceived as key risks. The Oil & Gas industry can find itself particularly exposed to the fall-out from political disputes, as has been demonstrated by the recent announcement by Argentina that it will not allow to dock in its ports ships involved in the exploitation of oil resources around the Falkland Islands.
- Oil & Gas projects can also be subject to sudden changes in tax regimes designed to increase the host State's take – such as the UK's windfall tax on North Sea projects in 2011.
- In the shadow of the Eurozone crisis, respondents to our survey based in Europe suggested a particular sensitivity towards fluctuations in macro-economic conditions: 25% of European respondents identified volatility in pricing or valuation as the main reason for deal failures they had experienced in the previous two years, while not a single respondent from the Asia-Pacific region identified the same cause for deal failure.

Environmental risks in the context of cross-border transactions

- With the legal and economic consequences of BP's 2010 Gulf of Mexico spill still being played out, and Spring 2012 seeing another high profile gas leak in the North Sea at Total's Elgin platform, an unsurprising inclusion among risk factors identified by respondents was the perception of environmental laws as presenting a challenge to cross-border M&A.
- The environmental legal framework is not just important to assessing the impact of disasters and spills. In particular, the expansion of global shale gas production has provoked considerable media speculation as to the environmental impact of innovative areas of production, and the industry will be watching closely for how legislators (outside North America) react.
- Many market participants also suspect that environmental investigations have been used in some countries as a way of pursuing political goals, applying pressure on foreign investors to agree to make concessions to the host State. This risk has encouraged investors to maintain rigorous compliance with all applicable environmental legislation.
- It was notable that 40% of Oil & Gas respondents from the Asia-Pacific region placed environmental laws as among their top three risk factors when conducting cross-border M&A against 23% of respondents globally in the sector, suggesting a comparative lack of comfort in addressing such issues as part of transactions.
- These results suggest that market participants will be looking closely at environmental due diligence as part of their deal strategies, as well as taking advice from specialist environmental consultancies.

of respondents from the Oil and Gas industry placed protectionism and restrictions on foreign ownership in their top three legal risks in cross-border M&A. This compared with 28% in all other industries and 15% in the mining sector.

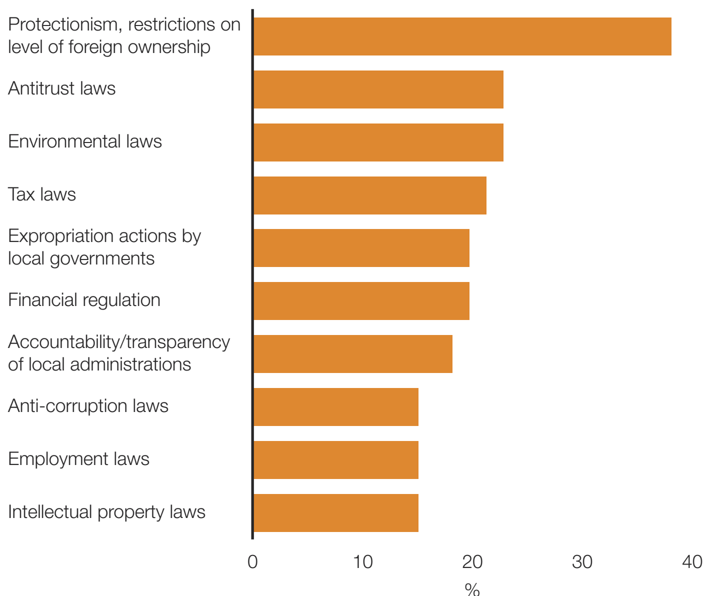
Bribery and anti-corruption

- 15% of Oil & Gas respondents to our survey placed anti-corruption laws within the top three legal or regulatory risks facing their organizations, rising to 20% in the case of respondents from the Asia-Pacific region. When specifically considering which political factors give them greatest concern in the context of their organization's cross-border M&A activity over the next two years, 30% of respondents identified bribery and corruption within their top three concerns, rising to 40% in the case of Asia-Pacific respondents and 33% for North America.
- It is not surprising that an increased focus on anti-corruption measures has impacted on the risk assessment of M&A transactions in the Oil and Gas sector as well as deal terms. Potential acquirers are paying closer attention than ever to bribery issues in their diligence, are seeking additional robust warranties and indemnities in relation to historical compliance as well as focusing more acutely on putting in place anti-corruption practices following completion.
- Bribery and anti-corruption issues are a significant concern in the context of cross-border M&A, particularly in developing countries. Anti-corruption legislation is increasingly reaching across jurisdictions, and is becoming more aggressively enforced. Failure to comply with such legislation can have serious consequences, including criminal sanctions of imprisonment or fines, civil law claims, blacklisting in public and severe reputational risks.
- Extraterritorial exposure was previously most of concern in the context of the US Foreign Corrupt Practices Act ("FCPA") (record US$1.8 billion in fines paid under the FCPA in 2010); however, the UK Bribery Act came into force in 2011 and is widely seen as one of the most stringent and widely applicable anti-corruption regimes in the world. For example, a new corporate offence of "failing to prevent bribery" was introduced under the UK Bribery Act.
- The recent events concerning Cobalt International Energy highlight the risk of (even alleged) non-compliance with anti-corruption legislation. In February 2012, Cobalt International announced that the US Securities and Exchange Commission and Department of Justice had commenced investigations into its Angolan operations, and specifically into alleged ties between Cobalt's local partner and Angolan government officials. Although Cobalt has stated that it has complied fully with Angolan and US laws including the FCPA, approximately £900 million was wiped off its market value shortly after these allegations became public.

Risk mitigation

- In times of economic and political uncertainty, acquirers are increasingly partnering with co-investors in order to share the burden of legal and economic risk. Respondents in the Oil & Gas sector are placing more importance on joint ventures than in previous years. 49% of respondents placed joint ventures in their top three deal structures they would be most likely to pursue now in cross-border transactions, compared with 39% two years ago.
- A rise in the use of joint ventures was reported by respondents to correspond with a drop-off in "traditional" M&A, and also in partnering with financial institutions, compared with two years ago.
- With an emphasis on joint ventures comes a focus on negotiating the terms of an ongoing relationship with the appropriate partner, be that a local player or a multinational.
- Potential acquirers are also often looking to mitigate political risk by engaging with key stakeholders (including regulators and politicians) prior to announcing any deal.
- Investors are also looking beyond the terms of their immediate deal in order to seek protection. Foreign acquirers may choose to structure their investment through companies incorporated in a jurisdiction that benefits from a bilateral investment treaty with the host State. Such treaties provide for the mutual promotion and protection of investors made by two States, and where appropriately drafted will allow an investor to bring international arbitration against the host State (without having to bring proceedings in local courts). Investors will also sometimes choose to obtain political risk insurance to provide third party cover for their investments.
- Respondents also demonstrated that a desire to focus on core businesses is driving Oil and Gas M&A. 46% of respondents in the Oil and Gas sector chose "strengthening our core business" as among their top two drivers for M&A, against 35% across all industries. Only 12% of Oil and Gas respondents identified "diversifying business area" as a key driver of their M&A activity.

When considering cross-border M&A opportunities over the next two years, which three of the following do you see as the biggest legal or regulatory risks for your organisation?



The cross-border M&A activity in the Oil & Gas domain is probably as exciting as it has ever been. Not only do we have the traditional strategic plays continuing to be made by the majors (as evidenced by the ongoing Shell-Cove Energy deal) but we have also the increasingly hungry energy appetites of the Chinese and Indian economies having to be fed by their respective national oil companies as they embark ever more diligently on the acquisition trail of oil and gas reserves such as Emerald Energy Plc's acquisition of Tepma BV. ”

Bleddyn Philips, Global Head of Oil & Gas, Clifford Chance

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Our global presence

Advising Shtokman Development AG, a joint venture of Gazprom, Total and StatoilHydro, and the project company for the development of the Shtokman Field in the Barents Sea. At an estimated cost of US$25 billion, this will be the single largest investment in Russia comprising offshore facilities, significant midstream infrastructure including a potential spur to Nord Stream and an LNG plant

Russia

Advised Royal Dutch Shell on its offer of £992.4 million (US$1.57 billion) for Africa-focused Cove Energy

Africa

Advised Emerald Energy Plc (a subsidiary of China's Sinochem International Corp.) on its acquisition of the Colombian oil and gas production and pipeline unit Tepma BV from a subsidiary of Total S.A.

Latin America

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