Post #70: Oil & Gas Industry Consolidation—Is Compensation a Driver, an Obstacle, or Irrelevant?

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Many investors, boards, and management teams are looking for consolidation within the oil & gas industry. The rationale for consolidation includes increasing efficiency through scale, improving the quality of assets, and creating a more attractive financial profile for investors.

Some investors have suggested that current change in control (CIC) severance packages are not substantial enough to drive consolidation and have pushed for more generous arrangements to encourage management teams to "accept" consolidation. We have certainly seen consolidation pick up in the last 24 months, particularly in the upstream segment; however, we do not think CIC severance packages are a driving factor.

In general, compensation plans are intended to align executives with shareholders and company performance, and CIC severance protections are intended to keep officer teams neutral to a merger or sale despite the risk of losing their own job through the transaction. CIC severance provisions across the industry have not materially changed over the past few years, and industry provisions are also consistent with those provided among the broader general industry marketplace (outside of oil and gas). So what is driving this burst in consolidation?

Strategic Rationale and Business Imperatives

First, it appears to us that there are several non-compensation reasons for the increase in consolidation:

- The delta between the "bid" and "ask" has narrowed—perhaps due to greater consensus on company valuations in this new environment.
- The past 12-18 months have reinforced the importance of scale in managing risk in an uncertain industry, and limited access to capital has pushed some companies to pursue mergers of equals or no-premium deals in order to continue effective operations and to generate scale.
- Concentrated shareholders at certain oil and gas companies (e.g., following a bankruptcy or capital infusion) are pushing for a quick return on their investment and often have an improved balance sheet to facilitate consolidation.
- Shareholders have begun to reward consolidating companies with improved stock price performance instead of punishing purchasers for overpaying or taking on additional debt.

Potential Compensation Drivers

As noted above, we have not seen a material change in CIC severance protections in the market recently, so we do not think CIC provisions are a driver of this period of consolidation, nor an obstacle given the pace of transactions. However, there are a few recent compensation developments that may have had some impact on the margins, such as:

- Greater focus on absolute TSR in incentive plans—absolute TSR metrics create greater incentive to lock in gains through a deal.

- A general pullback in compensation outcomes, either via lower bonuses for 2020 or recent LTI reductions (both in grant date value and realizable value as market values declined over the past few years)—this creates greater uncertainty in future compensation outcomes and may decrease the risk-adjusted present value of future compensation.
- Special bonuses, retention payments, or more generous treatment of outstanding incentives upon deal closing—there have been a few examples of outstanding awards paying at higher than target or special one-off awards which may help mitigate management concerns of selling at a “low” point in the cycle.

In our view, CIC severance protections do not need significant changes to drive continued consolidation. The pace of transactions suggest that CIC provisions are working as intended by allowing the strategic merits to drive deal-making. In other words, CIC severance packages should be irrelevant to the merits of a deal, and should instead focus on the fair and equitable treatment of impacted employees. In fact, significant increases to the potential CIC package could cause additional issues like excise taxes or negative proxy advisor reactions and could potentially stifle deals if the cost of a management team’s exit is too expensive.

Instead, companies have continued to focus on thoughtful governance and ongoing compensation programs that align pay outcomes with value creation. The real driver of consolidation should be the strategic rationale and the opportunity for improved shareholder value.

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