



1750 Emerick Road, Cle Elum, WA 98922 USA • +1 (509) 857 2235 • Fax: +1 (509) 857 2237

THE OIL & GAS SERVICES SECTOR:
GOOD PROSPECTS FOR THE MEDIUM TO LONG TERM

Remarks by

Dr. Kris R. Nielsen
Chairman and President

Presented at the

9th ANNUAL DEUTSCHE BANK GLOBAL OIL & GAS CONFERENCE
24 SEPTEMBER, 2009

EXPERIENCED-HONED OBSERVATIONS REGARDING OIL & GAS SERVICES COMPANIES

With increasing frequency Investors and Analysts ask why they cannot get a long-term commitment from the oil and gas Service Sector firm's management regarding backlog and margin expectations. Among investors and analysts there is a perception that E&C firm management predictions and information is often vague, misleading, uninformative, or unbelievable. E&C firm management is much better than these alleged deficiencies imply. It seems self obvious to say, however, in order to give reliable predictions of backlog, E&C firms are wholly dependent on predictions of the Owners and Operators (IOCs, NOCs, and E&P companies) – the customers of the Services Sector. In turn, the Owners and Operators must “read the tea leaves” of their ultimate customers, the users of these critical resources. When it comes to margins, Services Sector firms have more control, and thus more predictive capability, because it is what they do best – engineer, procure, and construct projects.

From observations and discussions in Board rooms and senior management evaluations regarding CAPEX projects, Owner and Operator decisions are based on a long term view-often a decade or two in length. There are years of pre-Final Investment Decisions (FID) that occur before FID, and the Oil and Gas companies are very close lipped about their potential CAPEX projects. Potential projects decisions take into account items, such as:

- Geopolitics,
- Demographics, and
- supply and demand data.

Thus, Services Sector management can only predict anticipated backlog with any assurance based on relatively near-term assessments of the volume of CAPEX that is moving to FID fruition, usually within a year or two of FID. There may be engineering studies earlier, but backlog is not measured by the volume of engineering, but by the construction value of real projects that have received their FID. In addition, they can predict future margins from this real potential backlog. In fact, margin prediction from current and near-term backlog is more properly linked to a particular Services Sector firms' capacity and ability to predict project risks and manage them. During the 2007 Deutsche Bank conference, I discussed various items in the near-term that management had to assess under the then anticipated and current conditions, such as, resource constraints that affected project costs and execution time:

- labor supplies and costs,
- material and equipment availability, and
- project management, engineering, and specialty contractor availability.

Pegasus Global Holdings, Inc.

Last year, I discussed project risks which would affect margins under the then evolving and largely unforeseeable global economic recession. Risks included items like broadly-based capabilities and cash management. As I explained, the differentiation Oil & Gas Services Sector E&C firms regarding margins is their success in anticipating the risks and crafting solutions to those risks which then determine the costs versus their anticipation.

This near focus of Services Sector firms and long-term focus of Owners and Operators is the cause of the dilemma that causes comments like those above by investors and analysts. The E&C firms cannot in all truth tell investors the magnitude of CAPEX and the Oil & Gas companies are not going to disclose the magnitude of their CAPEX. Thus, E&C firm senior managers are telling you the truth within these limitations; they just do not know more reliably than about two years out regarding their backlog, and it gets even more difficult in transitions in the global economy like we are experiencing now.

THE SERVICES SECTOR PROCESSES OF PREDICTING BACKLOG VOLUME AND MARGINS

Typically Services Sector firms rely on processes to project backlog that employ approximately five years of immediately prior sales history as a base from which to project. The theory is that using this approach closely approximates backlog from the inevitable that occur in every 5 to 7 year- cycles, and the typical duration of projects is 3½ to 5 years of engineering and construction. Thus, averaging the actual backlog over this period typically provides recognition that in an up cycle there is a lag that allows for the increases in project value recognition because the engineering phase typically is 15% or less of the project and in down cycles accounts for the legacy lag of current projects, such as, has occurred in the last 12 months. Once the Service Sector firms have determined the volume anticipated by the Owners and Operators, E&C firms apply sales success rates known as actual “hit” rates. The averages are typically adjusted by factors that may include:

- Project type focus – desired or actual
- Regional focuses
- Capability focuses – planned , actual, perceived or desired
- New capabilities that are internally grown or result from acquisitions
- Government influences that result from state goals (dependent on how close state policy influences corporate decisions)
- Type of contract desired (for instance, in geographic areas in which NOCs have a great

Pegasus Global Holdings, Inc.

deal of influence on contract terms which favor Lump Sum forms of contracting, a desire win only cost reimbursable contract terms may be a limitation on sales and backlog)

- Engineering expertise – technologically advanced projects typically require advanced engineering talent
- Extent of competition from new or other regional firms
- Market segmentation or size anticipation (interpolation of what the Owners and Operators are projecting)
- Marketing strengths – usually perceived

My advice to Investors and Analysts is to make no mistakes about this seemingly good process. The base input is from the Oil & Gas Owners and Operators, and is only as reliable as the predictions that they make which is normally sound. But the primary characteristic of Services Sector backlog projections is “optimism.” Optimism that they will at least meet the historical “hit” rate, optimism that all of the adjustments are accurate, optimism that the Owners and Operators are accurate and that economic conditions will not sabotage their empirical models!

Historical trends also provide the base of actual margin performance for the Services Sector. Arguably this is too short a period, but there are well honed processes and procedures in place to budget new jobs and to predict from adjusted averages on previous historical experience and what the firm can anticipate from remaining legacy work to be performed over in the next two to three years.

Service Sector firms do long range strategic projections to enable advancement and growth in many of the areas that I mentioned before. I advise the financial community that to expect hard projections from such strategic decision making is not in the best interest of the sector or investors. What should be taken away by Investors and Analysts are perceptions that the Service Sector has identified medium to long term risks and has a sound plan in place to address or build capacity to allow growth in margins.

NEAR TERM OUTLOOK FOR THE OIL & GAS SERVICE SECTOR FIRMS

Consistent with Deutsche Bank’s economists, there are hopeful signs that the separately caused recessions in North America and Europe are nearing an end. I do not expect a quick return to boom times in the Oil & Gas industry. As I argued with some of you in April and since, there has been a fundamental change in the demand for oil and gas in the developed world. For instance, I pointed that there was more near term prospects for E&C firm backlog growth in the broader “Energy” and infrastructure markets. In addition, I indicated that Owner and Operator board

discussions were centering on the apparent shifts that had occurred rapidly in 2008 as a result of the demographics within North America. Both the North American and European economies have focused Oil and Gas companies that serve these two developed economic regions towards long term alternatives. Thus, Owners and Operators have changed their focus on projects that are more engineering intensive – marathon projects – versus projects that will benefit from high prices of the last few years – sprint projects. This change in thinking has altered forever the demand side of the demand-supply equation for the developed world. Owners and Operators in these two regions are now more concerned about demand not supply as we said and OPEC confirmed the following month. Asia, the area where the third of the global recessions is occurring, will represent the best hope of demand growth, but such growth will be dependent on economic recovery in North America and Europe and sustained development of domestic demand. Given these factors and more, the Services Sector firms will not see appreciable backlog growth through 2010. On the other hand, the Services Sector firms should not see margin deterioration in 2010, despite severe price competition from other regions, notably Asian E&C firms. One additional near term note, as I said last year, when cash flow started to dry up, there could be a lot of merger & acquisition activity. The fourth quarter of 2009 and all of 2010 will put considerable pressure on over leveraged firms. M&A activity will be one of the prime means of growing backlogs, but may mean sacrificing margin growth for several years.

PROSPECTS FOR THE SERVICES SECTOR IN THE MEDIUM TO LONG TERMS

Simply stated, in the medium and long term (more than 3 years out) the Service Sector firms stand to do very well generally. Let me paint a macro picture first for you. Engineering and constructing infrastructure is one of the world's largest endeavors and one of the activities that is similar the world over. In my opinion, building is one of the three most creative things that humans do (art and music are the other two). First we must define "infrastructure." It is broadly defined as encompassing all the stuff we use day-to-day but never think about: water from the tap; the road to work; the bridge we cross on the way to work; what happens when we flush the toilet; the energy that is accessed when we switch on a light; the runways our planes land on. It also includes very big things that make the global economy go round: airports, seaports, energy facilities, schools, hospitals and rail links. And, importantly, oil & gas facilities that enable us to receive and use these facilities.

As I said earlier, over the last six years globally the focus has been on the shortage of engineers and skilled workers, because never before had we been faced with a situation in which every geographic area of the world was experiencing high demand from every sector of the engineering and construction industry. In the last year, the situation has been reversed. Currently, construction

Pegasus Global Holdings, Inc.

of infrastructure globally will rise to US\$35 Trillion over the next two decades. Infrastructure spending **each** of the next 20 years, for instance, is forecast to be:

- North America - US\$180 Billion
- Europe - US\$205 Billion
- Asia - US\$400 Billion

And these amounts only include what is typically referred to as public infrastructure.

I am not talking about the current “stimulus packages” which are near term by their very nature. The renewed focus on infrastructure is because globally there has been recognition that Infrastructure, as the American Society of Civil Engineers says, provides the “quality of life.” Infrastructure is the backbone which allows an economy to become more efficient and grow. As a result, Infrastructure allows people all over the globe to improve their condition and status. Thus, the decision by governments is viewed as a tried and true response to improvement of the current economic conditions.

Therefore, from the perspective experiencing four decades of ebb and flow of Oil & Gas cycles, over the medium and long term, Services Sector firms stand to reap the rewards from this engineering and construction spending, but provided that they strategically positioned to recognize risk issues, such as:

- **Sustainability** – more and more stakeholders ranging from countries to individuals are looking to execute projects which use sustainable technology. This is particularly true for energy projects (Oil & Gas and Power) and building/facilities projects. For example, the physical infrastructure portion of the United States stimulus package includes several earmarked projects which are intended to modify or build public buildings which are “green” (environmentally neutral impact). Likewise, both China and the United States are investing heavily in sustainable Oil & Gas and Power projects. The concept of sustainability is not limited to the constructed infrastructure system itself but extends to the materials and processes by which the infrastructure system was built. For example, the use of recycled materials in construction, the use of energy efficient equipment during construction and the use of sustainable resources to power that equipment are increasingly important. Over the next 20 years, the demand for sustainability in infrastructure will continue to grow as the world competes for the resources necessary to execute those infrastructure projects – which is beyond the scope of my current remarks.
- **Productivity** – the competition for the human resources to execute infrastructure projects will put pressure on all those resources which are necessary to complete those projects. To successfully meet the demand projects will have to be planned, designed, and executed effectively and efficiently. Given the levels of investment being made in

Pegasus Global Holdings, Inc.

infrastructure by nations there will be little tolerance for projects which fail to meet cost and schedule objectives, yet the reality is that the engineering, manufacturing and construction labor needed to execute those projects has been shrinking. Failure to maximize the productivity of the human resources available will quickly endanger the successful completion of any infrastructure project.

- **Operational life** – Stakeholders, such as, Oil & Gas Owners and Operators are looking for infrastructure systems which can last and operate longer before having to be replaced. This result will be driven in the medium term by the need to replace almost every major infrastructure system simultaneously. Some of that simultaneous replacement is due to governments waiting until the system fails before acting and some actually is a result of the current system of having performed its function so well as to lull societies into thinking those systems were immortal. As the crisis of the aging infrastructure has grown in the developed world over the past 20 years (especially in North America), there has been an increasing focus on ways to make the replacement systems last longer. Therefore, provided that the Oil & Gas Services Sector firms retain a semblance of institutional memory, the current emphasis on engineering of Oil & Gas projects, will be a long term commitment by Oil & Gas Owners and Operators.
- **Natural resources** – construction projects are dependent upon natural resources, whether those resources are used in a raw state (water) or manufactured state (iron ore to steel). For example, steel prices which had fallen significantly during the current economic crisis are expected to rise significantly as the infrastructure spending increases to the projected levels. Competition for natural and manufactured resources, will be a two edged sword; demand will increase jobs and improve the economies while at the same time driving up the cost of the physical infrastructure projects. Cost control and containment will be an important risk to be mitigated during project execution, so once again, project execution will become an important and differentiating characteristic between Oil & Gas Service Sector firms.
- **Social pressure** – it is hard to underestimate the social forces that are beginning to influence the world; access to immediate information has forced transparency and accountability into almost every aspect of public and corporate life, and thus large expenditures for projects, like Oil & Gas projects.

Thus, Service Sector firms that ultimately recognize this medium and long term importance to their strategic thinking will benefit despite their near-term financial forecasting constraints. Service Sector senior management may not be able to quantify the boom and changing attitudes, but their prospects will certainly turn brighter for Investors and Analysts by 2012.