GE-Baker Hughes: A New Oil Services Behemoth?

General Electric Co. (NYSE: GE) — market cap as of 04/11/2016: $251.59bn
Baker Hughes Inc. (NYSE: BHI) — market cap as of 04/11/2016: $24.57bn

Introduction

In a statement on Monday - October 31, 2016 - General Electric (GE) announced its intention to combine its gas and oil division with Baker Hughes, the oilfield services group. The new merged company, which will go by the name "Baker Hughes, a GE company", is expected to rank as the second oilfield services group behind Schlumberger.

According to the terms of the deal, GE will combine its oil and gas business with Baker Hughes, as well as pay $7.4bn cash in dividends to Baker Hughes's shareholders. As a result of the transaction, GE will hold a 62.5% stake in the partnership, whereas the rest will be held by Baker Hughes via a newly created NYSE listed corporation.

The combined company will generate annual revenues of around $32bn and operate in more than 120 countries. It will control 30% of the market, 14% coming from GE and the remaining from Baker Hughes. This might trigger antitrust scrutiny and force the companies to take additional measures to prevent regulatory issues. The deal is expected to close in the middle of 2017.

About General Electric Company

GE - founded by Thomas A. Edison in 1878 and headquartered in Boston, MA - is an American multinational conglomerate corporation that develops and manufactures products for the generation, transmission, distribution, control and utilization of electricity. The operating sectors of the company are: Power & Water, Oil & Gas, Energy Management, Aviation, Healthcare, Transportation, Appliances & Lighting and GE Capital.

The company reported revenues of $115.9bn in 2015 (around 22 per cent lower than the previous year) while net income recorded was $1.5bn in 2015 compared to $15.2bn in 2014.

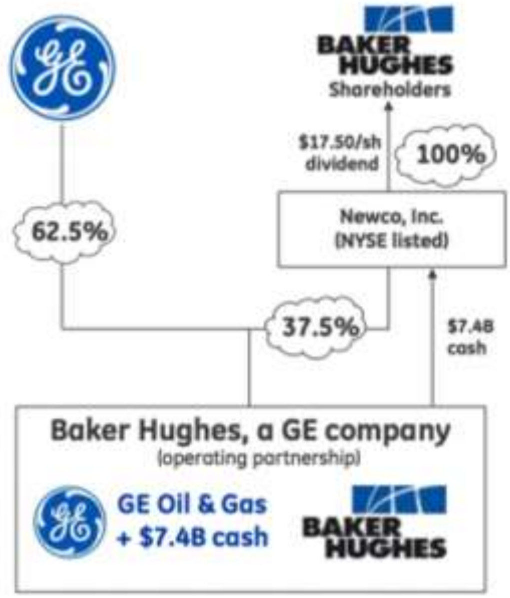
In recent years, General Electric has been very active in the markets, especially in M&A transactions. In the energy sector, the latest of GE's acquisitions was a $10bn takeout of power generation leader Alstom in 2015. GE also fueled its oil and gas business via acquisitions of companies such as Hydril, Vetco Gray, Wellstream and Lufkin Industries.

About Baker Hughes Incorporated

Baker Hughes was created in 1972 as a result of the merger between Baker International and Hughes Tool Company—both founded over 100 years ago. Its headquarter is located in Houston, Texas.
The company is a supplier of oilfield services, products, technology and systems in the oil and natural gas industry around the world. Its focus is divided based on 4 geographical areas: North America, Latin America, Europe/Africa/Russia Caspian and Middle East/Asia Pacific.

The company reported sales for 2015 of nearly $15.7bn. However, this figure declined considerably from 2014 when the company's sales amounted to approximately $24.5bn. Net income for 2015 was negative with a reported $1.9bn loss, whereas in 2014 the figure stood at $1.7bn.

Deal structure



The deal is to be structured through a partnership which will be composed of Baker Hughes and GE's oil and gas business. On top of that, GE will make a $7.4bn payment, by means of a one-time cash dividend of $17.50 for each Baker Hughes share.
Under the final arrangement, GE will hold a 62.5% stake in the merged business, whereas Baker Hughes' shareholders will have an interest of 37.5% through a newly NYSE listed corporation. Given Baker Hughes' market capitalization, the deal implies a valuation of c. $25bn for GE's oil and gas business.

The new company will be headed by Lorenzo Simonelli - president and CEO of GE Oil & Gas. Jeff Immelt - Chairman and CEO of GE - will serve as Chairman of the Board of Directors. On the part of Baker Hughes, Martin Craighead - Baker Hughes Chairman and CEO - will take a position on the board, becoming a Vice Chairman.

<u>Why to engage in such a complex transaction?</u>

According to GE's CEO such a structure enables to capture all benefits arising from the synergies, but also gives an upside to both GE's and Baker Hughes' shareholders and allows GE to maintain flexibility in capital allocation. According to Baker Hughes' CEO, the structure is also beneficial to Baker Hughes' shareholders as it removes the timing risk and focuses on long-term value creation.

With a newly listed firm, GE could use Baker Hughes' platform to pursue acquisitions strategy in a cleaner fashion than having to consolidate them at the corporate level. The structure also provides an easier way out for GE, were it to get rid of oil and gas business. In this case, it could simply sell down its stake. Furthermore, having a handy tracking stock will make it easier for investors to value GE's oil and gas business, or hedge against it.

Deal rationale

Not surprisingly, forecasted financial benefits are a strong driving factor for this deal.
Synergies are expected to generate cost savings of $14bn, with an improvement in the operating margin of "New" Baker Hughes as well as in the cash flow profile of General Electric.

This transaction comes as other oilfield contractors are establishing partnerships to cut costs and expand their distribution channels. The "New Baker Hughes" will have annual revenues of c. $32bn, second only to Schlumberger in the oilfield services industry.

Integration is another key factor. Bringing together the complementary capabilities of GE and Baker Hughes means enhancing their portfolio of operations, both from a qualitative and a quantitative point of view.
The new Company will be an industry leading integrated oil field equipment and services firm. This is one of the main reasons why the deal makes sense at this specific point of the oil industry cycle. Indeed, a stronger and larger company can weather the current adverse environment in the oil field and better position itself for an awaited recovery.

Focusing on General Electric, the deal can be justified also by looking at the strategy put in place by the company's CEO - Jeff Immelt. Indeed, considering future possible developments, this agreement is in line with the conglomerate's plan to slim down its huge structure. Such a strategy seems to be appreciated by investors lately.

Regulatory issues

Several analysts expressed their concerns about potential regulatory issues arising from the merger. Indeed, the deal might follow the same fate of the failed $25bn takeover of Baker Hughes by Halliburton, which was stopped due to regulatory issues.

In the specific market of oil pumps and artificial lifts, the new company will hold a combined market share of c. 30%, a significant figure that could likely attract regulators' attention, according to oilfield market research firm Spears & Associates.

Despite such concerns, other analysts do not expect divestitures to be demanded by regulators, as GE manufactures equipment such as pumps and valves, on top of providing services such as drilling support, whereas Baker Hughes is specialized in drilling technology, including fracking.

Market reaction

On Friday - Oct. 28, 2016 - when the companies confirmed they were in talks, both GE's and Baker Hughes' shares performed well, with their price increasing by 0.86% and 12.93%, respectively. Nonetheless, on Monday, when the transaction was formally announced and its terms were released, GE's stock fell by 1.29%, whereas Baker Hughes' shares lost everything they had gained before the weekend, falling by 10.64%.

Some of the stock prices' decline on Monday may be attributed to the fact that, upon release of the full terms, analysts concluded that GE was offering a lower than expected control premium. Moreover, as mentioned before, there are concerns that the deal might face thorough regulatory scrutiny.

General Electric stock price reaction

Baker Hughes stock price reaction

Source: Yahoo Finance

Advisors

Morgan Stanley and Centerview Partners LLC will be advising General Electric, while Baker Hughes will be advised by Goldman Sachs.