CALLON PETROLEUM'S BID FOR CARRIZO OIL

Woodrow Richardson
John Marsh
University of Mary Washington

Since the fall of the price of oil in 2015, there had been significant consolidation among unconventional oil and gas producers in Texas, so initially few were shocked when in July of 2019 directors of Callon Petroleum and Carrizo Oil & Gas announced agreement on a $3.2 billion merger. However, 9.5% of Callon Petroleum was owned by Paulson & Co., a Wall Street hedge fund that strongly disagreed with the deal. Directors had cited numerous advantages, like administrative consolidation, but the hedge fund had alleged the benefits were constructed to justify management bonuses and buy-outs. Furthermore, Paulson & Co. asserted that instead of buying Carrizo, management should be focused on selling *Callon. This conflict brought into focus concerns about the value of the deal.*

INTRODUCTION

Lin Sarkar saw the rather large envelope peaking from under the stack of mail on her desk and knew instantly this was another mailing from Callon regarding its proposed purchase of Carrizo Oil. A little over a year ago, Lin had invested in Callon Petroleum to get in on the Permian Basin oil boom but it was quickly turning into a bigger and bigger headache. Back in July, Callon Petroleum had made an offer to acquire Carrizo Oil & Gas. At first, it sounded like a great deal but as the deal dragged on Lin was starting to have second thoughts. A hedge fund had been fighting it and had raised some significant concerns as to whether or not Callon was overpaying for Carrizo. As more press releases and proxy statements came in the mail, Lin had a lot to consider before the formal shareholder vote in November.

THE OFFER

Last July, Lin had been excited to hear about Callon Petroleum Company's (Ticker: CPE) proposed acquisition of Carrizo Oil & Gas, Inc. (Ticker: CRZO). On July 15, 2019 both companies issued announcements that their respective board of directors had agreed to a $3.2 billion acquisition of Carrizo by Callon. The takeover would be entirely stock-based. Carrizo shareholders would receive a fixed exchange ratio of 2.05 Callon shares for each share of Carrizo common stock. Given Callon's stock price of $6.40 prior to the announcement, this figured to be

$13.12 per Carrizo share or a 24% premium based on Callon's closing stock price on July 12. Upon completion, Callon shareholders would own approximately 54% of the combined company, and Carrizo shareholders approximately 46%.

Directors of both companies pledged to vote his or her shares in favor of the merger. If approved the Board would consist of 11 member that included Callon's eight existing directors and three to be appointed from the Carrizo board. The company would be led by Callon's executive team and remain headquartered in Houston (Callon Petroleum Company, July 2019). To Lin, this was a good sign. If the Carrizo's directors resisted the takeover, Callon could still complete the deal by making an offer directly to Carrizo's shareholders. But all too often when that happens, the acquiring firm ends up in a bidding war and overpaying for the deal. To make matters worse, those kinds of deals often resulted in internal conflict after the merger as managers of the acquired company struggle to find a place in the new culture. That both boards agreed to the deal suggested that it would be a smooth transition.

Callon's executives touted great benefits from the merger. Joe Gatto, CEO of Callon stated, "Together with Carrizo, we will accelerate our free cash flow, capital efficiency and delivering goals through an optimized model of large-scale development across the portfolio" (Callon Petroleum Company, 2019). S.P. Johnson, CEO of Carrizo added, "We believe that Callon is an ideal partner for Carrizo. Through our combination, we bring together a strong foundation of Midland Basin and Eagle Ford Shale assets and overlay a substantial Delaware acreage position and value proposition" (Callon Petroleum Company, July 2019).

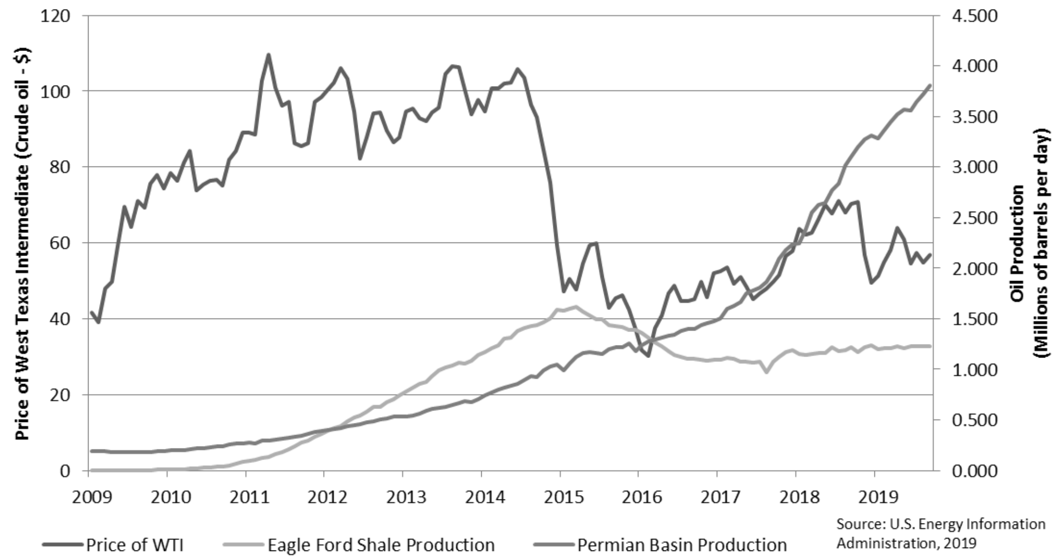
THE PERMIAN BASIN

Both Callon and Carrizo were smaller, independent unconventional oil and gas developers located in the U.S. state of Texas. While oil production has been a massive global industry with some big name players like ExxonMobil, Chevron, ConocoPhillips, and BP, Callon and Carrizo competed in a dynamic corner of this world. They specialized in unconventional Texas oil reserves, specifically using hydraulic fracturing ("fracking") to extract oil from shale rock formations. Callon focused on what is known as the Permian Basin concentrated in western Texas while Carrizo was split between the Permian Basis and the Eagle Ford Shale in southern Texas (Callon Petroleum Company, July 2019).

The production of oil from fracking is more complicated and costly than conventional drilling and as a result, unconventional oil has been a much more volatile business. When oil prices rise, unconventional developers can make fortunes. But when oil prices fall, unconventional wells quickly become unprofitable (IBISWorld, 2019). As a result, when oil prices rose in 2010, there

was an explosion in production from these unconventional reserves as shown below in Figure 1. Both Callon and Carrizo were a part of this dramatic growth. However, oil prices have fallen from their 2011-2014 highs and developers consolidated as a result. From Lin's perspective, consolidation need not be a bad thing – especially if it allowed Callon to exploit more wells.

FIGURE 1
UNCONVENTIONAL OIL PRICES AND PRODUCTION



AFTERMATH OF THE OFFER

Despite all of the potential gains from acquiring Carrizo's oil fields, Lin became concerned by shareholders' reactions to the merger. The day the deal was announced, Callon's shares fell 16% to $5.38 while Carrizo's stock rose 1.9% to $10.70. As Callon's shares continued to slide, Paulson & Co., a New York hedge fund founded by billionaire John Paulson, who held 21.6 million shares or 9.5% of Callon's outstanding shares voiced its opposition to the deal in a letter to Callon's board on Sept. 9th. Paulson indicated it would vote its shares against the acquisition of Carrizo Oil & Gas and it believed Callon shareholders would be better served by a sale of the company. In its letter to the board, Paulson noted the following reasons for opposing the deal:

- Callon's stock price had declined by 36% since the announcement,
- Shareholders had lost $530 million in value,
- The 25% premium was unjustified,
- Callon would lose its premium valuation as a "pure-play" Permian producer, and

- Adding Carrizo's Eagle Ford assets would reduce Callon's attractiveness to potential suitors (Deveau, 2019).

Callon's directors strongly disagreed and authored a press release saying it felt confident in the benefits of the combination with Carrizo. Specifically, it cited the following:

- A critical mass of complementary assets in the Permian basin,
- An integrated development program meaningful cost reductions,
- An accelerated free cash platform that de-risks the capital structure by driving leverage below 2x,
- Operational synergies of $65-$85 million and cash General & Administrative savings of $35-$45 million per year, and
- Total synergy present value of $850 million (Callon Petroleum Company, Sept. 2019).

While the additional clarity on the benefits of the acquisition seemed to address concerns, it did not help Paulson & Co. By late October, the hedge fund still voiced its opposition to the deal. It extended its previous arguments by citing the continued loss of shareholder value. Callon's stock price was down 42% since the July announcement accounting for loss to shareholders of $614 million. The hedge fund also made a new allegation that the deal enriched management, not shareholders citing a $10.7 million 'success fee' to Callon executives, a $29 million payment to Carrizo management for change-in-control, and advisory fees of $30 million. Paulson also claimed the deal would balloon debt from $1.2 billion to $3.5 billion and that the synergies touted by Callon were overstated.

> In response to Paulson's allegations, the next day Callon provided an update where it stated that the Paulson letter contained false and misleading statements. It its update Callon specifically claimed there was no 'success fee' for completing the transaction. Callon stated that the methodology Paulson used to claim that the transaction diluted free cash flow per share was flawed because it excluded free cash flow from capitalized G&A and interest while including it for the pro forma free cash flow figure. Finally, Callon claimed that Paulson ignored many analysts that expressed support for the transaction.

CONCLUSION

All of the back-and-forth between Callon and Paulson & Co. left Lin confused. On one hand, Callon's directors asserted some pretty significant benefits to the acquisition. The combined firm would own a variety of oil-producing lands in south and west Texas. A combined firm would be able to reduce administrative

overhead, resulting in synergies that management claimed would reach $100 - $130 million each year. However, shareholders had not reacted well to the news. For all of the promised benefits, Callon's stock had fallen over 40% in the months since the announcement. To make matters worse, Paulson & Co. was alleging that the cost savings were insubstantial and that the deal was an excuse to pay bonuses to management. It didn't look like Callon and Paulson & Co. were likely to come to an agreement any time soon. The shareholders' vote on the deal was coming soon, but Lin was wondering if the critics were right. Was Callon overpaying for Carrizo with its all stock offer of a $1.2B? Should she vote for or against the deal in the upcoming shareholder meeting on November 14, 2019?

TABLE 1
INCOME STATEMENTS
(Dollars in 000's except per share values)

	Callon 2018	Carrizo 2018
Total revenues	$ 587,624	$ 1,065,942
Costs of good sold	104,935	222,609
Gross profit	482,689	843,333
Depreciation expense	181,909	299,530
General & administrative expense	35,293	68,617
Other expenses	(45,483)	3,173
Operating income	310,970	472,013
Interest expense, net of capitalized amounts	2,500	62,413
Earnings before taxes	308,470	409,600
Taxes	8,110	5,173
Net income	300,360	404,427
Preferred stock dividends	7,295	28,351
Net income available to common shareholders	$ 293,065	$ 376,076
Shares outstanding	227,583	91,628
Net income (loss) per share	$ 1.29	$ 4.10

TABLE 2
BALANCE SHEETS
(Dollars in 000's)

	Callon 2018	Carrizo 2018
Assets		
Cash	$ 16,051	$ 2,282
Accounts receivable	131,720	99,723
Other current assets	74,854	48,364
Total current assets	222,625	150,369
Proven oil & gas properties, gross	4,585,020	6,278,321
Less accumulated depreciation	2,270,675	3,944,851
Proven properties, net	2,314,345	2,333,470
Unproven oil & gas properties	1,404,513	673,833
Other fixed assets, net	37,690	27,428
Total assets	$ 3,979,173	$ 3,185,100
Liabilities		
Accounts payable	$ 261,184	$ 147,814
Accrued expenses	29,942	78,381
Other current liabilities	23,790	95,814
Total current liabilities	314,916	322,009
Long term debt	1,189,473	1,633,591
Other long term liabilities	29,576	74,174
Total liabilities	1,533,965	2,029,774
Equity		
Preferred stock	15	174,422
Common stock (par value)	2,276	916
Capital in excess of par	2,477,278	2,131,535
Retained earnings	(34,361)	(1,151,547)
Total equity	$ 2,445,208	$ 1,155,326
Total liabilities and equity	3,979,173	3,185,100

REFERENCES

Callon Petroleum Company. (2019, July 15). Callon to Acquire Carrizo in All-Stock Transaction. [Press Release]. Retrieved from https://www.prnewswire.com/news-releases/callon-to-acquire-carrizo-in-all-stock-transaction-300884540.html

Callon Petroleum Company. (2019, Oct. 23). Callon Provides Update Regarding Carrizo Transaction. [Press Release]. Retrieved from https://www.prnewswire.com/news-releases/callon-provides-update-regarding-carrizo-transaction-300944384.html

Callon Petroleum Company. (2019, Sept. 9). Callon Comments on Paulson & Co. Filing. [Press Release]. Retrieved from http://www.prnewswire.com/newsreleases/callon-comments-on-paulson-co-filing-300914557

Callon Petroleum Company Income Statements. (2018). Retrieved from http://www.mergentonline.com/companyfinancials.php?pagetype=asreported&compnumber=57493&period=Annuals&dataarea=PL&range=5¤cy=AsRep&scale=AsRep&Submit=Refresh

Carrizo Oil & Gas Co., Inc. Income Statements. (2018). Retrieved from http://www.mergentonline.com/companyfinancials.php?pagetype=asreported&compnumber=91383&period=Annuals&dataarea=PL&range=5¤cy=AsRep&scale=AsRep&Submit=Refresh

Deveau, S. (2019, Sep 10). Paulson Says Callon Should Target Sale Over Carrizo Purchase. *Bloomberg Wire Service* Retrieved from https://umw.idm.oclc.org/login?url=https://search.proquest.com/docview/2287178719?accountid=12299

Kalyani, D. (2018, November). IBISWorld Industry Report 21111 – Oil Drilling & Gas Extraction in the US. Retrieved from https://clients1.ibisworld.com/reports/us/industry/default.aspx?entid=103

U.S. Energy Information Administration. (2019). Spot Prices. [Data file]. Retrieved from https://www.eia.gov/dnav/pet/pet_pri_spt_s1_d.htm

U.S. Energy Information Administration. (2019). Tight oil production estimates by play. [Data file]. Retrieved from https://www.eia.gov/petroleum/data.php