Surging ahead: Energy M&A in 2017

The energy sector is officially back when it comes to dealmaking. After a lackluster 2015, energy M&A rose to new heights last year and is hitting its stride in H1 2017 as the price of oil stabilizes. Renewables are beginning to make their mark on the landscape as well. What will the rest of the year hold for the industry? Four leading experts weigh in.

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We are seeing very robust activity in the midstream, both in terms of dialogues between companies as well as private companies seeing an opportunity to sell themselves.

Part 1: Oil and gas M&A

Mergermarket: The Permian Basin has seen a large amount of M&A activity lately. What other regions are ripe for dealmaking at the moment? Can bargains be had in regions with less buzz around them?

S. Trauber, Citi: The answer is yes – there are plenty of good opportunities outside the Permian. In particular, the SCOOP and STACK areas around Oklahoma are becoming very robust with activity. It’s a much smaller basin, so it will probably never reach the feverish pitch of the Permian. But as those regions in the core have been identified and people have begun drilling, the results have been spectacular. And as those results have started to get out into the marketplace, the area has drawn a lot of interest. Companies that have developed some of that acreage are now seeing the opportunity to monetize their properties, either by sale or by initial public offering. So the SCOOP/STACK is probably the second-most active region right now in terms of activity.

The other area I would mention is the Eagle Ford basin. That is an area that has been well-known, but now we’re starting to see consolidation activity take place. Companies that have held onto and developed their assets for a number of years are now seeing the opportunity to take that capital and redeploy it in other high-return areas. At the same time, others who view the Eagle Ford as their core focus are using the opportunity to get bigger in the Eagle Ford. So we are starting to see more activity pick up there as well.

S. Cochlan, Torys LLP: Currently, the US shale plays tend to attract larger investments. For investors looking at Canadian plays there are concerns about pipeline access, regulatory hurdles, carbon tax and other environmental regulations that aren’t as relevant to the investments in the Permian. However, the cost of land is lower in Canada and the exchange rate is favorable for US investors.

In Canada there are deals to be had in acquiring “tuck-in” assets or purchasing a small or micro-cap company where the acquirer believes it can cut costs and make money on the efficiencies. In terms of whether there are any preferred dealmaking regions in Canada, the Montney formation in northeast British Columbia and northwest Alberta and the Duvernay formation in Alberta (particularly the east oil zone) have most recently been attracting attention and money. Another area that you might see attracting investors is Mexico. The denationalization of Mexico’s oil and gas sector has provided the first opportunity for foreign investors to enter this market. Attractive features there include low production costs, previously undeveloped fields, existing infrastructure and a regulatory framework that is favorable for foreign investors.

Mergermarket: The North American midstream segment saw major consolidation in 2016. What do you see in store for the coming 6-12 months? Do you think we could see a comeback of the MLP structure this year?

S. Trauber, Citi: We are seeing very robust activity in the midstream, both in terms of dialogues between companies as well as private companies seeing an opportunity to sell themselves. We
recently saw EagleClaw Midstream sold to Blackstone for US$2bn, and there are a number of other private companies out there that are also thinking about selling.

In general, there is a lot of private equity in the marketplace right now for acquisitions. Given that many of the bigger public companies are working on their own internal structures and internal growth opportunities, it may be one of the better times for private equity to make acquisitions in the midstream space.

The reason is that they don’t have the same level of competition that they have historically faced from the bigger public companies. At the same time, public companies such as NuStar are making acquisitions, and obviously Enbridge made the big purchase of Spectra last year. So it’s not that there aren’t deals happening in the public arena as well.

I would expect over the next 12 months that we will see more deals happening in the segment. I would also expect private companies that have been able to grow because of the upstream activity will seek to monetize their assets because of the valuations being paid.

S. Cochlan, Torys LLP: Our feeling is that there’s unlikely to be further major M&A deals in the Canadian midstream segment. There was significant consolidation in the last year and we don’t expect there to be much of an appetite or opportunity for further major consolidation. I think we’re more likely to see strategic, value-add M&A deals in the small to midsize range. And I think these could be driven by midstream players that are looking to diversify, create greater efficiencies or purchase non-core assets from upstream companies looking to shore up their balance sheets or by large institutional investors with available liquidity. I think we will see that LNG projects will likely be slow to advance, primarily due to regulatory hurdles and burdens. Midstream companies looking to expand but who are unable to construct new projects or are being discouraged by uncertainty in the current regulatory climate in Canada may look elsewhere for growth opportunities. And I think the fundamentals for the sector are more attractive in the U.S. than Canada, which has driven recent outbound activity, such as the Enbridge/Spectra transaction US$37bn merger and the TransCanada/Columbia Pipeline Group deal, which was a US$13bn acquisition. Those were both driven by a perceived lack of growth opportunities for these companies in Canada, so they’re looking outside of Canadian borders to continue to grow their businesses.

Mergermarket: North American targets have drawn increased interest from overseas buyers in recent years, including from a new type of Chinese acquirer - smaller, private investor groups such as SinoEnergy, which recently bought Long Run Exploration for US$578m. What do you think is driving M&A interest by foreign buyers in North American energy assets? Do you think activity will continue?

S. Trauber, Citi: I think the inbound interest into the US actually remains relatively limited. We always thought that we’d start to see some of the international majors step in and acquire a larger position in unconventional oil & gas than they currently have. Major oil companies tend to want to focus on oil...Continued on page 4
Private equity is betting big on the energy sector. In 2016, the number of PE energy buyouts in North America more than doubled, increasing from 36 to 78. At the same time, the value of such deals more than tripled, going from US$7bn to US$24.8bn year-over-year. Through Q1 2017, volume is down somewhat, but value remains on pace to match last year’s total.

The appeal of the energy segment to private equity can be attributed to three key factors. The first is the current macro-trend in fossil fuel prices. Oil has hovered around US$50 a barrel for the better part of two years, falling from around US$100 a barrel. To many potential buyers, this indicates a down cycle that will soon turn upward again – thanks especially to rising demand from emerging markets.

Secondly, PE investors have more money to deploy than ever before. At the end of 2016, financial buyers held US$820bn in dry powder, a 9% increase from the prior year, according to Preqin. The third major trend at play is efficiency gains made by the industry. As producers have been forced to cope with lower prices, many have found ways of using better processes to decrease their break-even price. In early May, a senior VP of Texas-based shale producer Pioneer Natural Resources said their break-even oil price had dropped all the way to US$20 a barrel. This means that PE buyers can potentially make excellent returns even if prices stay “lower for longer.”

These dynamics look set to push private equity even deeper into the energy space over the coming months. As a result, one can also expect PE exits in the energy sector to rebound from their recent two-year lull in 2018-2020.

### Private equity energy buyouts in North America, 2012 - Q1 2017

![Graph showing private equity energy buyouts in North America, 2012 - Q1 2017](image)

### Private equity energy exits in North America, 2012 - Q1 2017

![Graph showing private equity energy exits in North America, 2012 - Q1 2017](image)

### Top 3 private equity energy buyouts in North America by value, YTD 2017*

<table>
<thead>
<tr>
<th>Deal value</th>
<th>Target company</th>
<th>Bidder company</th>
<th>Date</th>
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<tbody>
<tr>
<td>US$6.2bn</td>
<td>WGL Holdings (USA)</td>
<td>AltaGas (Canada)</td>
<td>1/25/2017</td>
</tr>
<tr>
<td>US$2.3bn</td>
<td>Anadarko Petroleum Corporation (Eagleford Shale assets) (USA)</td>
<td>Blackstone Group (USA), Sanchez Energy Corporation (USA)</td>
<td>1/12/2017</td>
</tr>
<tr>
<td>US$2bn</td>
<td>EagleClaw Midstream Services (USA)</td>
<td>Blackstone Group (USA)</td>
<td>4/17/2017</td>
</tr>
</tbody>
</table>

*YTD 2017 is as of May 1
today, and they tend to want to make sizeable acquisitions that will move the needle for them, and given the relatively rich valuations being paid for these unconventional assets, it makes it very difficult for them to buy into the space.

I also think that many of the international oil companies don’t necessarily feel competent operating in the current unconventional market in the US. They would need to have a management team to run the company, and often it’s challenging to retain a management team when a large foreign entity comes into the US. So, clearly there have been obstacles in entering the US market.

Then finally, you have the Committee on Foreign Investment in the United States (CFIUS), which limits foreign investment by certain companies. Recently, we saw a proposed deal by L1 Energy, which is a Russian-backed private equity firm, for Permian-based assets, and it was precluded from happening by the federal government under the CFIUS regulations. I think there could be a similar situation with Chinese buyers if the target was an operated property. If they are non-op assets, it might be a little bit easier.

The deal you referred to by SinoEnergy was in Canada, where the doors are a bit more open to foreign investment opportunities from nations such as Russia and China. And we’ve seen companies come in and make acquisitions of Canadian companies that had operating positions there. You really haven’t seen that in the US.

S. Cochlan, Torys LLP: One of the drivers is that the US and Canada are generally free market energy economies where foreign interests are free to invest without requiring a resident partner or government interest participants. Favorable exchange rates are also a driver. And foreign spending, from our perspective, is expected to trend toward quicker returns such as those in the US shale basins and away from more long-term investments like the oil sands in Canada. There’s uncertainty by foreign investors regarding pipeline access, regulatory hurdles, carbon tax and other environmental regulations, which may dampen their appetite for Canadian investment. Although, there is some speculation of investment by Chinese companies into North America; no longer just the state-owned players but smaller investors with a longer-term views. And more on exploration and production-type assets in the private sector by private investors as opposed

Median EBITDA/EV multiple for North American energy M&A deals, 2012 - Q1 2017

![Graph showing the median EBITDA/EV multiple for North American energy M&A deals from 2012 to Q1 2017.]

Top three inbound North American energy deals, YTD 2017

- **$3.9bn**: Saudi Aramco purchase of Motiva Enterprises
- **$2.5bn**: Royal Dutch Shell purchase of Athabasca Oil Sands
- **$1bn**: Delek Group purchase of Ithaca Energy

**Surging ahead: Energy M&A in 2017**
North American energy M&A deal volume by segment, 2012 - Q1 2017


to the former state players and longer-term investments in oil sands and more capital-intensive investments.

Mergermarket: Private equity buyers have taken a greater interest in energy assets over the last three years (as indicated by Mergermarket data). Are there any niches within the sector that PE acquirers have focused on in particular? And how do financial buyers — which typically have a set exit timeline — manage the risks that come with commodity price volatility?

S. Trauber, Citi: There are typically two ways that private equity funds try to manage the volatility in prices. One is obviously hedging, which gives you a known commodity price. And the other one is strategizing about when to enter into an investment. That typically means trying to buy at the bottom of the cycle, because it gives you some period when you expect commodity prices to improve. If you look back over the last five decades, we’ve seen a down cycle about every eight to nine years, and those down cycles tend to last around 18 to 24 months. We’ve been in that down cycle, and the expectation is that we’re coming up now and we’ll see a nice rebound over the next six to eight years, and therefore now would be the right time to buy. Of course, it doesn’t always happen that way – there are swings up and down even within those longer cycles. But typically if you hold long enough, you can manage that.

In terms of the segments that PE firms target within the oil & gas sector, this has evolved over a long period of time. It used to be that PE buyers were only interested
Crossing the border

The appetite of foreign buyers for North American energy assets has seen a steady decline over the last five years — trending in the opposite direction of cross-border M&A globally. The decline has coincided with a period of lower commodity prices and the emergence of the US shale boom that caught the energy world off-guard.

Indeed, the rapid adoption of fracking across US territories has been led almost exclusively by domestic players. Over the last 18 months, foreign buyers have made virtually no purchases of US shale assets. In one of the few exceptions, Hong Kong-based E&P investment firm Shun Cheong Holdings paid US$278m for assets of the Stonegate Production Company, including in the Eagle Ford region of south Texas.

Instead, most of the inbound activity to North America has involved Canadian targets. Part of the reason is Canada’s more open policy toward international acquirers, especially from China. In one recent inbound deal to Canada, Hong Kong-based Cheung Kong Infrastructure Holdings paid US$1.3bn for midstream assets owned by Husky Energy.

Examining inbound activity by country, buyers from the UK have made by far the most acquisitions of energy assets in North America over the last five years with 46. China (26), Japan (25), and Australia (22) follow far behind.

Top international acquirers of North American energy assets by volume, 2012 - Q1 2017

Top international acquirers of North American energy assets by value, 2012 - Q1 2017 (in US$m)
in oilfield services, because it resembled industrials, which is what private equity was much more facile with. And they thought that if they wanted to bet on commodities, there were bigger and more liquid ways of doing so. It was also very difficult to buy into upstream companies, at least for the bigger funds, because there are some smaller, niche funds that have always been comfortable with the space.

But what’s happened over time is that the bigger funds have started to look more at where the opportunities are, and given the fragmented nature of the sector, upstream is where more opportunities exist. So that tends to be where more of the private equity goes now, because the competition is a little bit less. In the midstream sector, the cost of capital for an MLP is quite competitive with private equity, so those companies were typically the best-suited acquirers of opportunities in the midstream space during the last cycle.

Private equity has taken advantage of the decline and the current restructuring of the midstream space, however, to look at opportunities, which is why you saw Blackstone acquire EagleClaw.

But I would say that first and foremost, the opportunities continue to be in the upstream space, due to the sheer number of opportunities, and secondarily in the midstream space, because of the decrease in competition from public companies.

S. Cochlan, Torys LLP: Typically, private equity investment has been focused on upstream investments with the potential for higher returns than midstream and downstream investments. With regard to risk management, commonly used tactics are hedges against price fluctuations; a cautious approach to identifying suitable assets; minimizing exploration risk and extraction costs per unit; and aligning with experienced and strong management teams. On the exploration and production side, not wildcatting so to speak, but being very selective on finding suitable assets that have good recovery rates.

Mergermarket: After an extremely weak H1 2016 for energy IPOs, the public offering window has opened again. What level of IPO activity do you expect in the coming 6-12 months? What are the current key considerations for investors?

S. Trauber, Citi: We are currently retained on several upstream IPOs and a number of oilfield services IPOs. All told, there are probably upwards of 20 companies that are either preparing IPOs or that have filed recently in the space, around half of which are on the upstream side.

We are seeing more interest in IPOs because oil prices had increased significantly this year. Now we’ve come

Number of energy M&A deals by North American region, 2012 - Q1 2017
We believe that energy companies will likely continue to access the IPO market over the next 6-12 months.

Scott Cochlan, Torys LLP

S. Cochlan, Torys LLP: From the start of 2017, we’ve seen an increased number of IPOs, such as BOS Solutions announcing a C$90 million IPO in March; Kinder Morgan Canada recently announcing a major C$1.75 billion IPO; Source Energy Services’ C$175 million IPO; and STEP Energy Services’ IPO for C$100 million. We believe that energy companies will likely continue to access the IPO market over the next 6-12 months — although this may be tempered by mixed success of other IPOs and dependent on commodity prices and demand. I think the recent lack of profitability for energy companies, combined with the continued weakness in oil prices and low projected growth in global oil demand over the next few years, has somewhat dampened investor enthusiasm for energy IPOs. Uncertainty has resulted in delays and significantly reduced offering sizes, and a number of recent IPOs on the NYSE have been priced below the low end of the initial filing price range. So, while we expect and hope there will be continued IPO activity over the next 6-12 months, overall what we have seen during the past number of years has been generally a diminishing IPO market.

back down to under US$50 a barrel, but expectations are that prices will continue to improve. Certainly coming into the first quarter of 2017, the market was extraordinarily receptive to IPOs in the upstream and services segments. We expect that to be the case in the second half of this year and into next year as well. M&A activity is ramping up as well, and when you see multiples that are fairly strong and you have receptive buy-side investors, then the environment will also be ripe for initial public offerings.
IPOs staging a comeback

The market for initial public offerings by North American energy companies has rebounded after a steep slump in 2016. Through the first five months of the year, there were six energy IPOs that collected US$1.79bn in proceeds, compared to just five debuts with proceeds of US$1.55bn in all of 2016.

However, investors have cooled somewhat to energy IPOs in recent months as the price of oil has dropped. After rising to nearly US$55 a barrel in February, oil slipped below US$48 in early May before rallying somewhat. In addition, energy IPOs were the only losers among all sectors in Q1 2017, dropping an average of 12%, contrasting with average returns of 16% for companies from all other industries. Two oilfield firms from Canada, STEP Energy Services and Source Energy, abandoned IPOs in March due to poor market conditions. In early May, Texas-based services firm Solaris Oilfield Infrastructure pulled the trigger on its initial public offering, pricing at US$12 per share, below its planned US$15-18 range.

Given the boom in M&A activity, many companies are now favoring a dual-track process instead of committing fully to an IPO. In one recent example, midstream giant Kinder Morgan filed in May for a US$1.3bn IPO for its Canadian unit, but reportedly remains open to raising funds through private equity or a joint venture instead.

Overall, energy IPOs are clearly drawing a great deal more interest than in 2016. The question is whether the price of oil will stabilize enough to convince more firms to go public.

North America energy IPOs, 2012 - YTD 2017*

Average share price performance of energy IPOs one day after listing, 2012 - YTD 2017*

Top 3 energy IPOs of YTD 2017*

<table>
<thead>
<tr>
<th>List Date</th>
<th>Issuer</th>
<th>Offering Size USD (m)</th>
<th>Date Post-Listing Performance Share price One Day After</th>
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<td>1/20/2017</td>
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<td>508.44</td>
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<td>1/27/2017</td>
<td>Jagged Peak Energy Inc.</td>
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<tr>
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<td>ProPetro Services, Inc.</td>
<td>350</td>
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* YTD 2017 is as of April 28
Part 2: Alternative energy M&A

Mergermarket: The solar industry is undergoing rapid change, as the leasing model is being challenged by smaller home solar companies and prices continue to drop. How do you expect these trends to affect M&A activity? Could there be consolidation either among the biggest players or at the lower end of the market?

A. Redinger, KeyBanc Capital Markets: Within the solar sector, there are really three distinct markets: residential, commercial-industrial, and utility-scale. Projects are typically considered utility-scale if they are 50 megawatts or larger with long-term utility off-take agreements. There have been several utility-scale projects sold in the last six months.

The deals tend to be much larger and garner a lot of attention from both US and international investors.

A few years ago, the market was primarily dominated by utility-scale deals, but the market has changed quite a bit, and now there are fewer utility-scale deals and more distributed deals, or commercial-industrial deals. These deals tend to be small in size and have a mix of off-take arrangements. It’s a booming market because the country is moving more to this distributed model. Institutions like hotels, hospitals, and schools are realizing there is a tremendous amount of energy savings by putting solar panels on their roofs. At the moment, this is a very fragmented market, and it will be interesting to see how it develops over the next few years. We could see these different players merging – or it could remain fragmented, similar to the HVAC business model.

The residential market is very different from commercial-industrial and utility-scale. There are a handful of residential players...
that operate nationally, and then there are hundreds of local companies doing it. Out of all three segments the residential segment has the most challenges.

The question the market is trying to figure out is: Can a national player exist in the residential space? Can a national player find customers, design systems for those customers, finance the panels, and then service those customers? That is a lot to do and ultimately the million-dollar question the market is trying to figure out.

P. Molchanov, Raymond James: We are seeing continual consolidation on the downstream of the solar value chain: that is to say, installers and project developers. We’ve counted at least eight such deals year-to-date (and many more if we look back to 2016 and prior years). To clarify, almost all of these transactions involve private companies.

Mergermarket: Wind power has been gaining momentum and popularity, especially with the arrival of offshore wind farms. How is the deal landscape shaping up for the industry? Will incumbent power generators begin to acquire more wind assets?

A. Redinger, KeyBanc Capital Markets: There is a great deal of interesting offshore wind activity happening. Five states on the East Coast have recently put out requests for offshore wind proposals. For example, Massachusetts has a mandate for 2,800 megawatts of offshore wind, hydropower and other renewables over 10 years.

In terms of concrete projects, the groundwork is being laid. There are a number of auctions being held now to secure blocks of offshore leases that states are making available, and the idea is that the buyers will build offshore wind projects. This process will probably take three-to-five years.

Looking at the wind sector more broadly, there are several large wind platforms in the market for sale. There is quite a bit of activity, and these are all billion-dollar-plus deals on an enterprise basis. There is a significant amount of capital in the marketplace, and increasing interest in renewables more generally, because this market has matured – wind and solar are no longer considered new technology. We’ve also seen the cost of capital come down significantly on both the debt and

Looking at the wind sector broadly, there are several large wind platforms in the market for sale. There is quite a bit of activity, and these are all billion-dollar-plus deals on an enterprise basis.

Andrew Redinger, KeyBanc Capital Markets
equity side, and that’s attracting more interest in the market. For those who have been in the space for a while, it may seem like a good time to sell.

**P. Molchanov, Raymond James:** The wind value chain is more mature than solar, and thus there is relatively less room for consolidation. But insofar as there is M&A in wind, it is similar to solar in the sense of being focused on the downstream (rather than hardware suppliers).

**Mergermarket:** With a new administration in the White House, do you expect any policy or regulatory changes that will affect the electricity generation market? E.g., do you envision coal and natural gas assets becoming more attractive at the expense of renewables?

**P. Molchanov, Raymond James:** The short answer is no. Notwithstanding the Trump administration’s decision to review (and likely set aside) the EPA’s proposed Clean Power Plan, the combination of public perception, economics and continuing state-level policies (e.g., Renewable Portfolio Standards) is likely to keep coal’s market share on a firmly downward trajectory. Over the medium term, we expect gas and non-hydro renewables to capture share at broadly comparable rates, with coal’s share of the domestic power market ending this decade in the mid 20% range, gas in the high 30% range, and non-hydro renewables in the mid-teens.

**A. Redinger, KeyBanc Capital Markets:** I agree with Pavel – I don’t know what kinds of policies the administration could put forth that would give natural gas or coal an advantage. And the solar tax credits are already on the verge of being phased out. Even more important, wind and solar have come down so much in cost that they are now competitive with those other sources. This is especially true thanks to the distributed model gaining popularity for renewables. Natural gas prices may be low, but if you’re burning natural gas, you still have to get the power from Point A to Point B, and there are tremendous transmission constraints in the US. Given the current costs, a distributed model with solar and wind has become very competitive.

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**Top three North American alternative energy deals, YTD 2017**

- $4.2bn: Brookfield’s acquisition of TerraForm Power
- $1.5bn: AES’s acquisition of Sustainable Power Group
- $1.2bn: Brookfield’s acquisition of TerraForm Global
About Mergermarket

Mergermarket is an unparalleled, independent mergers & acquisitions (M&A) proprietary intelligence tool. Unlike any other service of its kind, Mergermarket provides a complete overview of the M&A market by offering both a forward-looking intelligence database and a historical deals database, achieving real revenues for Mergermarket clients.

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**Note on Mergermarket data:**
Mid-market deals are defined by Mergermarket as those valued at US$5m to US$250m. Mergermarket does not include deals with undisclosed value in its mid-market figures.

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