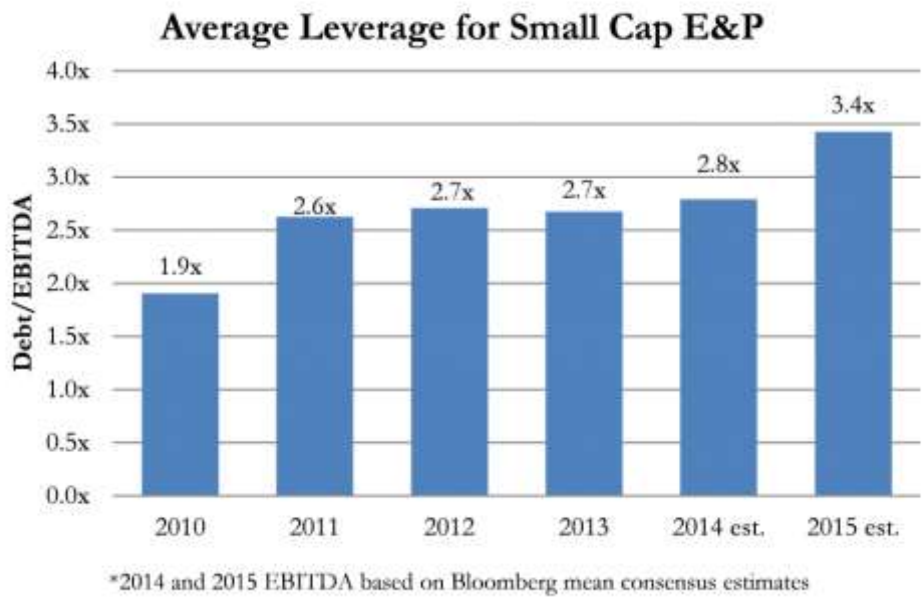
The Domestic Oil & Gas Industry's Current Debt Problem – A New Chapter of an Old Book

By Ned Kleinschmidt, Barry Kesler and Joseph Wielebinski

The price of oil has dropped precipitously to half its June 2014 peak. Natural gas prices have experienced a similar recent collapse. The oil and gas ("O&G") industry has continually demonstrated a "boom and bust" market dynamic. The failure to manage through periods of low prices can result in disastrous consequences. Unfortunately, the recent dramatic increase in debt load has compounded the problem. A complete understanding of the challenges presented by price volatility and proactively implementing appropriate solutions to address these challenges are critical to surviving in the current environment.

Over the past five years, a perfect storm of stable, high oil prices, new opportunities to develop tight oil and shale reserves and readily available debt financing lured a rush of capital into the O&G industry. Companies borrowed heavily to pursue lucrative new opportunities. According to the *Wall Street Journal*, American O&G companies have borrowed an incremental $200 billion in [2014], a dramatic increase of 55% since 2010.



Many public companies utilized high yield debt to fund the majority of their drilling and acquisition expansion programs.

Now that oil prices have collapsed and are expected to stay low in the medium term, O&G companies are heading into this current downturn with significantly higher debt levels than prior bust cycles. For organizations with debt in excess of 2.5x annual EBITDA earnings, their debt problems are more imminent. While prices remain depressed, industry participants will have limited ability to raise new capital, obtain funding for new drilling and capital expenditure programs, and ultimately, service their debt.

Typical Debt Structure

The debt structure for O&G companies typically consists of a senior debt revolving reserve based loan ("RBL") facility. Borrowing under an RBL is based upon, and secured by the value of, a company's reserves. Bonds or other junior debt are normally subordinated to the RBL facility. As the company increases its reserves and drills more producing wells, the available borrowings under the RBL facility increase, which provides additional liquidity.

RBL revolvers are subject to periodic measurements of the borrower's reserves to determine if more or less debt will be made available. These "redeterminations" typically occur in April and October, but lenders usually have the right to request a redetermination at any point.

Covenants for these loans typically require a borrower to have sufficient earnings to cover a multiple of either: i) their annual interest expense or ii) their total debt. Additionally, the company is expected to have sufficient current assets to meet their current liabilities.

Liquidity and Covenant Challenges Are Coming on a Widespread Basis

Given that the debt for most O&G companies has maturity dates of two to three years, distressed O&G companies are primarily struggling with covenant compliance issues and maintaining sufficient liquidity. Declining oil prices and the corresponding drop in earnings will stress these measures and limit production growth, which will lead to reduced borrowing bases on RBL facilities when redeterminations are made.

In recent months, lenders have been patient and flexible in allowing management teams more time to formulate plans and implement short-term solutions. In general, lenders have not called for a redetermination of RBL facilities based on current depressed prices. However, without a significant rebound in prices, the borrowers will have to negotiate covenant waivers or longer term loan amendments with the lenders. For example, the lenders to Resolute Energy Corporation and Venoco, Inc. demonstrated a willingness to provide flexibility on enforcing existing covenant defaults. This allowed the borrowers to develop a combination of short-term solutions, such as obtaining incremental subordinated second-lien debt and implementing a sale process for non-core assets to pay down the revolver.

If RBL borrowing base calculations are strictly enforced, liquidity will almost certainly begin tightening after April of this year. In addition, if prices remain low through October as hedges roll off, many highly levered companies will face serious liquidity challenges by late 2015 that will continue well into 2016. Wall Street analysts currently estimate loan defaults may exceed 20% in 2016 if oil prices stay below a $60 per barrel threshold.

Be Proactive: Find Internal Solutions …

The oil price recovery of 2009 took on the form of a "V" shape, as the drop in prices was triggered by factors outside oil and gas market fundamentals (e.g., the banking system meltdown, decreased world demand, etc.). Prices substantially recovered within 12 months. Today's price declines are due to a growing supply glut in the face of weakening demand. Therefore, industry participants should be preparing for a longer "U" shape recovery. In order to weather the storm, companies must be prepared to operate in a lower price environment for some time.

O&G companies have already begun to take dramatic action such as cutting back on capital expenditures and refocusing drilling activity only to areas that provide the greatest near term cash returns or protect their working interests in high value assets. Recent announcements demonstrate that many O&G companies plan to reduce capital expenditure programs by as much as 75% from 2014 levels. There are hedges in place that support drilling activity for some producers in 2015, but few producers are adequately hedged into 2016. Spending should be focused on enhancing and maximizing current production in the most profitable areas rather than considering any type of expansion. In addition, cost cutting plans are being implemented that require service providers to deliver 20% to 30% discounts to their previous rack rates.

Companies must also actively evaluate their general and administrative costs. Expenditures that appeared reasonable only one year ago may no longer be feasible today. Financial managers must focus on achieving covenant compliance and liquidity preservation in an environment of reduced available borrowing under RBL facilities.

… and External Solutions

The most difficult time to raise capital is when it is most needed. Taking an aggressive approach while there is still liquidity available may provide companies additional financial flexibility necessary to execute lifesaving contingency plans. Increased flexibility might afford companies the opportunity for a longer runway in the face of declining earnings and diminishing liquidity.

Examples include:

- Diamondback Energy, Inc. recently issued additional equity to raise approximately $100 million.
- Resolute Energy Corporation issued a $150 million second lien secured term loan in December.
- GSO Capital Partners provided interest in new Linn Energy, LLC wells in exchange for capital expenditure funding.

Credit documents should be reviewed to determine what limitations exist on issuing new debt, on granting liens and the requirements once new funds are raised. Typically, a revolving RBL credit agreement will require a partial pay down upon new debt issuance.

Too Much Debt and Too Few Options

The highest levered companies may already be too deep in debt to avoid restructuring.
A significant amount of "non-core" assets are currently being marketed. These assets are not as attractive to buyers, and to date, purchasers are limited. A number of highly levered companies have recently announced their inability to find buyers willing to offer adequate prices, including Midstates Petroleum Company, Inc., Alta Mesa Holdings, LP and Quicksilver Resources Inc.

The ability to raise new, albeit expensive, debt may determine if a company will have additional time to improve the health of their balance sheet. Once all strategic alternatives have been exhausted, a financial restructuring may be the only alternative.

Historically, in a capital restructuring, revolving facility lenders are repaid in full, but the question is primarily one of timing. Lenders may be refinanced as part of a debtor-in-possession loan, paid off through asset sales or a refinancing tied to an exit from bankruptcy, or be incentivized to provide an RBL facility to the newly reorganized entity.

The fulcrum of these restructurings will likely be at the junior debt/bond level. Both recent and historical restructurings have involved some form of debt-for-equity exchange where the bond holders exchange their debt claims for new equity. As part of these restructurings, new money debt is typically put in place to provide liquidity.

Some current restructurings adopted this approach. Connacher Oil and Gas Limited recently announced plans to restructure in this manner. Endeavour filed for bankruptcy in late 2014 with a "restructuring support agreement" organized around a debt for equity exchange.

Time for Action
In today's low price and high debt environment, it is incumbent on all parties to begin taking appropriate actions immediately.

Lenders must reassess their exposure, re-evaluate the borrower's business plan in the context of near-term forecasted oil prices and determine how to best protect themselves if their borrower is unable or unwilling to do what is necessary. They should be informed of all steps the borrower is taking to address its financial distress and the impact this will have on their interests.

Companies must assess their financial outlook using conservative assumptions and implement action plans to find effective internal and external solutions to their distress.

Vendors should actively monitor their customer's financial health and their collection exposure. When the situation warrants, they should explore their lien rights. They must actively engage with customers when payments start to be stretched.

All parties should be preparing for the worst and hoping for the best. Hope alone, however, is not a strategy.

URL: http://www.oilgasmonitor.com/the-domestic-oil-gas-industrys-current-debt-problem-a-new-chapter-of-an-old-book/9009/

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*Bloomberg, CBOE Crude Oil ETF Volatility Index (OVX)

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