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KEEP IT FLOWING

RAISING CAPITAL FOR DISTRESSED OIL AND GAS COMPANIES

Crude oil and natural gas hit peak prices in mid-2014, with U.S. crude oil hitting $107 per barrel in June of last year. Since then, prices have fallen precipitously, reaching a low of less than $50 per barrel for U.S. crude in late January before rising somewhat in recent months and then falling once again. Forecasts of where oil and gas prices are headed in coming months and years differ wildly.

In the wake of the sharp commodity price declines and facing future uncertainty, many upstream exploration and production (E&P) companies and, in turn, midstream companies and oilfield service providers have found themselves facing significant challenges. These include acute liquidity pressures, depressed trading prices for their debt and equity securities, potential borrowing base reductions, reduced growth opportunities, and increased interest from distressed investors.

A company's particular level of distress depends on, among other things, its asset base,[1] the extent to which it has developed its reserves to bring unproven or undeveloped reserves into production, and the extent to which it has hedged against price declines. In response, companies have taken a variety of steps to reduce costs, preserve liquidity, and raise capital to weather the downturn. As a general matter, upstream companies have found that the capital markets have remained fairly open thus far during the crisis, providing them with a degree of flexibility and, in some cases, opportunity.

Each company's response to the crisis depends on a variety of factors, including its particular level of distress, the degree of cooperation of its incumbent stakeholders, and market perception. Across the board, however, companies have drastically cut 2015 capital expenditure budgets. Most companies in the E&P space are scaling back or even completely halting drilling programs, cold-stacking rigs, and focusing on improving efficiency at producing wells. Rig counts in the U.S. fell to a 12-year low in June 2015, down by more than 55 percent from the year before. However, companies' ability and desire to scale back drilling may be limited in some instances by their lease terms, as many oil and gas leases require either that the company drill within a certain period or pay a specified rental amount to retain the lease.

In addition, a number of companies have slashed jobs to reduce costs, resulting in over 100,000 layoffs nationwide in recent months. Finally, E&P companies are cutting costs by demanding price reductions from or terminating agreements with oilfield service providers, thereby passing the pain on to that sector of the industry.

On the other side of the equation, companies have successfully pursued and will likely, in coming months, continue to pursue a variety of options to raise capital, including:

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- Preserving or increasing their borrowing base and obtaining covenant relief under their reserve-based revolving credit facilities
- Issuing new second or third lien secured debt
- Issuing additional secured or unsecured notes
- Exchanging additional debt for equity or for different debt, potentially at a discount or coupled with a new money obligation
- Issuing convertible debt or equity
- Engaging in sales of non-core assets or other M&A transactions
- Entering into new joint venture, production payment, farmout, or other similar arrangements

Strategic Considerations

Each company's decision with respect to its capital raising strategy is based on its unique circumstances, but there are a few general considerations.

Most E&P companies have in place a reserve-based revolving credit facility with a twice annual borrowing base redetermination, usually in the spring and fall. If a company's borrowing base is reduced to a number below its then outstanding borrowings, it will generally have to repay the excess, further taxing an already distressed company.

The borrowing base is redetermined with reference to a reserve report, which analyzes the value of the company's proven oil and gas reserves. Accordingly, the falling oil prices would suggest that borrowing bases across the industry should or, in upcoming redeterminations, will similarly decline. And indeed, for many companies, that has been the case. If prices do not improve very soon, the fall 2015 redetermination is expected to be even more difficult, with forecasts of reductions in the neighborhood of 30 percent, on average.

However, revolving lenders generally have substantial discretion to set the borrowing base, regardless of the findings in the reserve report. Accordingly, a company may be able to negotiate to preserve its borrowing base or to limit the reduction to a less than dollar-for-dollar adjustment for the decline in reserve value. A number of companies did so successfully in the spring redetermination.

Similarly, most revolving facilities impose financial covenants, which are likely at risk of being tripped in the current environment. Not surprisingly, many companies have negotiated with lenders, seeking to amend their credit agreements to loosen or remove these covenants to prevent a default. In some cases, companies have also sought amendments to allow flexibility for future secured or unsecured financing. It appears that lenders have been fairly willing to make these concessions—sometimes in exchange for fees or additional collateral—while they wait for a market recovery, perhaps because they believe that many companies will be able to weather the current downturn through proactive measures and are reluctant to force a default or preclude rescue financing.

When preserving existing availability is insufficient, new term loan debt or notes may also be an option, likely coming in on a junior secured or unsecured basis. A common E&P capital structure, prior to the current crisis, was comprised of a secured revolving facility and one or more issuances of senior unsecured notes. These notes generally provide baskets for so-called credit facility debt and for liens to secure that debt. To the extent that companies have availability in these debt covenant baskets, they may be able to layer in secured debt over their existing notes without noteholder consent—although revolving lender consent would likely be required under their stricter debt covenants unless these were previously amended.

There are a few considerations and tradeoffs to weigh in pursuing this path, however. While providing liquidity, adding additional debt may exacerbate problems for already overleveraged companies. In addition, such junior debt often has fairly tight covenants, high interest rates, significant fees, and make-whole payments. This debt may be especially attractive to more activist investors who wish to come in as the fulcrum security, which may translate into an opportunity for them to acquire control of the company in the future. Finally, even when permitted by the revolving lenders, such new financing may trigger a reduction in the borrowing base available under the revolver in cases in which the borrowing base is automatically decreased by a portion of any additional debt, offsetting some of the liquidity gains from the financing.

When a company doesn't have availability to layer in debt under its debt baskets for its existing notes or when it wishes to couple the new money with a deleveraging, it may choose to pursue an exchange offer, exchanging existing debt either for equity, or unsecured debt for secured debt at a discount. The latter debt-for-debt exchange allows a company to take advantage of the current low trading price of many outstanding senior note issuances in the industry and could potentially be coupled with a new money obligation from exchanging noteholders. Transactions of this type are necessarily more complicated, and thus potentially more costly, but offer the combined benefits of added liquidity and decreased leverage.

Somewhat simpler capital raising strategies, and ones likely to be more palatable to existing debt holders, include issuing convertible debt or new equity. Convertible instruments are likely to be less costly and have few or no restrictive covenants. However, with respect to more distressed or highly leveraged companies, there may not be an appetite for convertible notes or equity in the current market, given their position in the capital structure. That said, a fair number of companies in the E&P space have successfully pursued public offerings and private placements of stock, indicating that it remains a viable option for those on the healthier end of the spectrum (*i.e.*, stressed as opposed to distressed).

Indeed, in the first quarter of 2015, upstream companies raised approximately $10.8 billion in gross proceeds from equity offerings, more than the amount of debt raised in the same period.[2] The proceeds of these stock offerings have generally been used to repay revolver borrowings or buy back other debt, thereby reducing leverage and freeing up revolver availability.

A different approach to funding necessary drilling and production obligations is for a company to enter

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into a joint venture, joint operating agreement, production payment, farmout, or similar arrangement with an investor or another E&P company. Doing so may help unlock the liquidity in previously undeveloped acreage without increasing leverage.

It may also be more appealing to counterparties because it offers certain bankruptcy protections. In particular, the Bankruptcy Code specifically provides that certain farmout and production payment arrangements are exempted from property of the estate, meaning that they cannot be rejected and must ride through the bankruptcy unaffected.[3] However, such arrangements may have implications under a company's revolving credit agreement. For example, to the extent that they constitute asset sales, the company may be obligated to use proceeds to pay down debt or may experience a reduction in the borrowing base. Such arrangements also likely require the company to cede some control and future revenue.

Finally, not surprisingly, in addition to or in lieu of the strategies discussed, many companies are shedding non-core assets or subsidiaries, both to reduce costs and raise liquidity. Other companies are choosing to wait, however, in the hopes that prices will rally, allowing them to obtain a better recovery for such assets. As a corollary to the sale of non-core assets, certain companies are pursuing more comprehensive merger transactions. These asset sales and mergers also provide key opportunities for healthier E&P companies and investors to take advantage of lower prices to make strategic acquisitions.

Uncertainty Remains

The distress for many in the industry has created opportunity for a few. Healthier E&P companies have been able to snap up assets at fire sale prices, effect advantageous mergers, and take advantage of low trading prices to buy back debt at a discount. Distressed investors have also been eagerly watching for opportunities to take advantage of the upheaval in the industry by buying into existing debt or equity or participating in the transactions described in this article. A number of investors have built up significant funds for investment in energy. Overall, in the first quarter of 2015, private equity funds raised approximately $13.9 billion of capital for investment in the energy sector.[4]

However, as mentioned earlier, many revolving lenders have been willing to grant the covenant or other relief needed to allow companies to avoid defaults that could otherwise force them into more desperate action, and the capital markets have been fairly open. In addition, many companies are well-hedged, such that they have not yet felt the full impact of the price declines. Finally, by cutting costs and halting drilling activities, companies have managed to reduce liquidity needs. As such, there has not been the level of distressed investing that the market originally anticipated or funded.

Notwithstanding all of that, the industry is far from unscathed. Aside from the transactions previously discussed, many of which carry costly terms or may provide only short-term fixes, a number of upstream and midstream companies in the U.S., Canada, and elsewhere have been forced to seek bankruptcy protection. In particular, in recent months, American Eagle Energy, BPZ Resources, CalDive, Dune Energy, Quicksilver Resources, Saratoga Resources, and WBH Energy all have filed for Chapter 11 protection.

As a general matter, upstream companies have been fairly successful in raising capital to address liquidity pressures resulting from low commodity prices. They have done so in a variety of ways, from secured debt to equity issuances to asset sales. It remains to be seen the extent to which access to capital continues and helps to forestall a more complete industry collapse. It will likely depend in large part on the length of the downturn, the level at which oil and gas prices stabilize, and whether companies reduce production or whether, perversely, the availability of capital causes companies to continue to increase supply to the already oversaturated market.

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[1] For example, certain drilling areas have higher breakeven prices based on geological considerations, the availability of pipelines for affordable transportation, and other factors.

[2] Goldman Sachs Global Investment Research.

[3] See 11 U.S.C. § 541(b)(4).

[4] Goldman Sachs Global Investment Research.