ON THE BRINK

As oil and gas companies face a hard-scrabble commodity price environment, E&Ps and participants in other industry sectors are already rushing to restructuring advisers in hopes of staving off cash flow calamities, unpaid debts and bankruptcies.

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As the financial picture for the oil and gas industry has become increasingly jigsawed, E&Ps are scrambling to fill in the gaps with smaller and smaller puzzle pieces.

Amid the U.S. health and economic crisis, oil and gas asset valuations have been thrown into ruin. Production has turned, in a brief but literal sense, worthless. And cash, like a true monarch, not only reigns supreme but is rarely seen.

The chaos in the broader markets and in the oil and the oil sector has resulted in robust demand for advice. E&Ps have rushed to restructuring advisers, retaining their services as a result of the tumult.

Restructuring advisers say the carnage in the oil markets—with WTI prompt month prices falling to negative $37 on April 20—has driven many companies to seek immediate aid while others are working to keep restructuring and bankruptcy at bay.

"It's the entire spectrum. We are seeing distress in all corners of the energy complex right now," said Scott Cockerham, a director in the turnaround and restructuring practice of AlixPartners in Houston.

Once COVID-19 hit the U.S., it became apparent that demand for hydrocarbons would drop precipitously and storage would immediately become a critical issue, "which we are witnessing immediately," Scott Cockerham, a director in the turnaround and restructuring practice of AlixPartners LLP in Houston, said.

The collapse in oil demand has not only been felt by already burdened E&Ps; other parts of the sector are in disarray, too.

"It's the entire spectrum. We are seeing distress in all corners of the energy complex right now," Cockerham said. "When you get to the point where midstream operators are saying, 'Look, I want to make sure you have a buyer on the other end before you transport through my line because I don't want it to be a proxy for storage,' that's extraordinary," he added.

The pandemic has pushed forward the timetable for companies already on a troubled path and sent restructuring practices, including AlixPartners, into overdrive, he said.

Prior the downturn and price war, some companies were in for a challenging year with oil prices even at about $50/bbl.

"No one saw this coming, but what we knew was looming was nearly a $100 billion in debt coming due this year for U.S. companies focused in the energy space," Cockerham said.

Companies now face the dilemma of continuing to meet monthly debt service obligations while also funding essential expenses such as payroll.

Finding capital in the weeks and months ahead will become even more vital, as will be negotiating with lenders.

Haynes and Boone LLP partner Jeff Nichols, co-chair of the firm's energy practice group, said that companies financially healthy before the crisis should have an easier time with a few adjustments, such as refinancing debt at a higher rate.

"Where you are in this process depends on where you started back in February," he said.

Liquidity drought

Merely existing as an E&P in June 2020 implies a certain level of pain. Companies are first and foremost struggling with liquidity, said Charlie Beckham, a partner at Haynes and Boone LLP who advises companies on bankruptcies, M&A, debt restructuring and insolvency.

"The biggest crisis or struggle that any of these companies are facing right now is liquidity," Beckham said, adding that, "Companies that are not hedged right now are facing a liquidity cliff in the near short term."

However, at current prices Beckham said that he would be surprised if any E&P company is operating profitably in the short term.

"It is almost impossible to maintain profitability unless they have no costs associated with that production," he said. "The companies that we will first see tumble into Chapter 11 or worse will be companies that are facing this liquidity cliff. They can't afford to operate at current levels."

Haynes and Boone's Nichols added that companies' hedged production is now one of their most valuable assets since they could have a large amount of money payable to them.

To survive, those companies may want to monetize their hedges, start shutting in wells, and, with enough liquidity, bridge the gap between now and when WTI increases. "That's what a lot of them are doing right now," Nichols said.

As companies implement various survival strategies, firms are working diligently alongside them.

David Cunningham, a managing director and head of U.S. oil and gas at Moelis & Co., said that the firm is quite busy, particularly in oil and gas but also more broadly in businesses that support other major sectors of the economy.

In the past four years, Moelis has participated in 50 oil and gas companies' restructurings. Like other such firms, it's been thrown into a tumultuous environment that seems unlikely to normalize anytime soon.

Along with liability management and M&A projects, Moelis is also working to identify sources of capital for oil and gas companies, which remain difficult to come by for most of the industry, particularly after the catastrophic value-loss the sector has endured in the past couple of years.

While traditional access to capital from public-equity issuances and banking is closed, Moelis has been successful in finding alternative sources of liquidity.

"Some alternative financing sources, like credit funds, hedge funds and pension funds, are saying that they have capital to deploy. However, it's expensive on a relative basis from where it was even six or nine months ago in the oil and gas space," Cunningham said.

The company has also found success raising capital from international entities, which are generally more stable than some of their U.S. oil and gas counterparts.

Lenders and private-equity owners also appear willing to continue working with companies to find solutions or give companies more time.

"We do see where they are willing to really try to work hand in glove with the companies in order to find a solution," Cunningham said. "Because if they don't find a solution, there is growing concern that the end result could be a bad outcome for all parties."

Terms of indenture

Lenders are in their own scramble as all industries suffer from the pandemic. AlixPartners has surveyed the lending landscape, including reserve-based lending providers, "and their portfolios are universally distressed," Cockerham said.

Developing an executable plan will give companies an edge in dealing with lenders. Unlike during the most recent downcycle, other E&Ps' troubles don't serve as examples for others needing relief.

"Where we are now is unprecedented," Cockerham said. "There's no impact in telling a lender, 'We need relief just like other companies need it.' That doesn't work."

But he said that an E&P management team doesn't want to be the 10th company in line asking a lender for help.

"You need to have a proactive plan that starts with a bridge to profitability, details measures that you're going to implement and shows that the plan is actionable," he said.

Haynes and Boone's Beckham agrees that lenders are "disturbed" by the economic crisis. He said it's important to have clear communication with customers and employees, especially lenders.

"Lenders are afraid that their borrowers are not doing the things that they need to do," Beckham said. "So communicate with [your lenders] that adjustments are being made and that cost savings are being applied to manage the crisis."

Nevertheless, many companies may falter, should management teams' expertise at building E&P companies fail to translate fluently into managing a crisis.

Debt service, while governed by schedules that companies plan for, may also push some companies into insolvency, Cockerham said.

"You might see some overnight bankruptcies filed by companies that genuinely come up against immediate liquidity constraints coupled with mounting debt service. Management teams with a little bit of foresight can proactively plan," he said.

"The bottom line is that if you think that you're not going to be a solvent entity, [then] the moment you realize that, you should be talking to advisers to prepare your company because of the enormous shift that occurs in how you operate and whom you ultimately serve in a crisis," he explained.

However, some lenders may agitate for transactions, even preferring to take the stock of another company and reduce their ownership stake if that means owning a more viable business.

Companies may be engaging earlier because lenders, which will eventually be equity owners in a reorganization, "may actually be supporting and encouraging M&A … because they want to be part of a better organization going forward," Cunningham said.

Transactional limbo

Inevitably, some companies will end up in bankruptcy and liquidation, particularly for those backed by lenders no longer willing to wait for recovery. And certain buyers are waiting for bankruptcies before engaging in transactions.

Nichols said many companies that had marketed assets have pulled them back because prices weren't what sellers needed to pay off debt or for other purposes. "Unfortunately, the market rest right now is really sales through bankruptcy," he said.

Those sales may be forthcoming, Nichols' colleague Beckham added, as some capital providers have run out of patience and are willing to "force the issue and complete an orderly liquidation of sales of assets."

Because of oil's devaluation, the value of assets has similarly collapsed. That's likely to spell chaos, at least initially, for asset deals.

"Where you are in this process depends on where you started back in February," said Jeff Nichols, a partner at Haynes and Boone LLP.

"The biggest crisis or struggle that any of these companies are facing right now is liquidity … Companies that are not hedged right now are facing a liquidity cliff in the near short term," said Haynes and Boone partner Charlie Beckham.

"Consolidation offers tremendous benefits in a world that appears to have fundamentally changed," said David Cunningham, a managing director and head of U.S. oil & gas with Moelis & Co.

TAKING PAINS

As the E&P situation worsens, companies will need to shift how they view their responsibilities—not merely to shareholders and the company itself—but to all stakeholders, including lenders, trade counterparties and other unsecured creditors.

"There are steps that can be taken to shorten the time to manage cash flows on a daily basis because … it's extremely difficult to make that shift overnight," Scott Cockerham, director at AlixPartners in Houston, said.

One tool employed by AlixPartners involves a detailed examination of cash management at the "granular level … where operators scrutinize receipts, disbursements and develop specific plans to ensure that they can show transparency as well as a path to improvement to all stakeholders," he said.

Scrutiny of expenditures at a minute level can reveal waste and challenges that allow performing areas to stand out and point the way toward targeted belt-tightening as well as the magnitude of problems, he said. Such methods can sometimes produce enough cash flow to potentially avoid missing a bond payment.

"Then, it's possible to make structural changes and even consider alternative sources of capital to pursue if needed. But it all starts with the ability to see what you have on a finely sliced and examined basis," he said.

The alternative is a more haphazard cutting of expenses that may be too little.

"The first point of focus is identifying what's needed to bridge the profitability gap [fiscally] and what the potential downside is," he said.

As E&Ps' capex guidance has fallen by roughly 30% and forward strip prices head for a year-end sub-$30/bbl, the idea is to quantify how badly an upstream company will get hit and how long it needs to implement stopgap measures.

"Once you understand the impact, then you can realistically start looking to constrain your capex," he said.

Companies are also grappling with general and administrative (G&A) expenses and might assume the need to reduce, say, 30% of overhead expenses.

But the potential damage to the company, as well as compliance with federal regulations, may warrant a more finessed approach.

"Slashing production and withdrawing from an area that's been part of a company's identity can limit its eventual return, and getting that back may be extremely difficult, especially with mineral rights holders," he said.

Rather than artificially reducing G&A, companies should be more surgical in how they cut.

"Instead of saying … I need to cut 15% of G&A wholesale, it's far more productive to be sensitive and conscientious in how you do it," he said.

"From the lender's standpoint, [they don't] want to own the assets," Beckham said. "They just want their borrowers to sell their assets, but they want to sell the assets for more than the market will allow."

However, Beckham said prolonged, low prices will open the door to opportunistic buyers.

"As long as they have cash or adequate access to capital, there are going to be folks that see this as an opportunity to come in and acquire good assets with a long-term future," he said.

Moelis' Cunningham said most potential buyers don't appear able to pay cash for any assets, commenting, "We're not expecting to see the A&D market … coming back with any velocity anytime soon."

M&A amid chaos

Still, in a market focused on preservation of liquidity, M&A can flourish.

Consolidation, particularly in merger-of-equals transactions, was already gaining momentum toward the end of 2019. In a down market, companies with equal footing may see benefits and even survival in joining their organizations together.

"We could envision that continuing to happen," Cunningham said. "If your strategy is consolidation, taking costs out … high-grading portfolio, high-grading capex matters …We want to do those M&A transactions.

"In today's world, the majority of M&A transactions are going to be stock, and the majority of stock transactions are going to be between parties with similar types of capital structure," he said.

After all, the industry doesn't need the number of companies operating in many regions and subsectors as it once did.

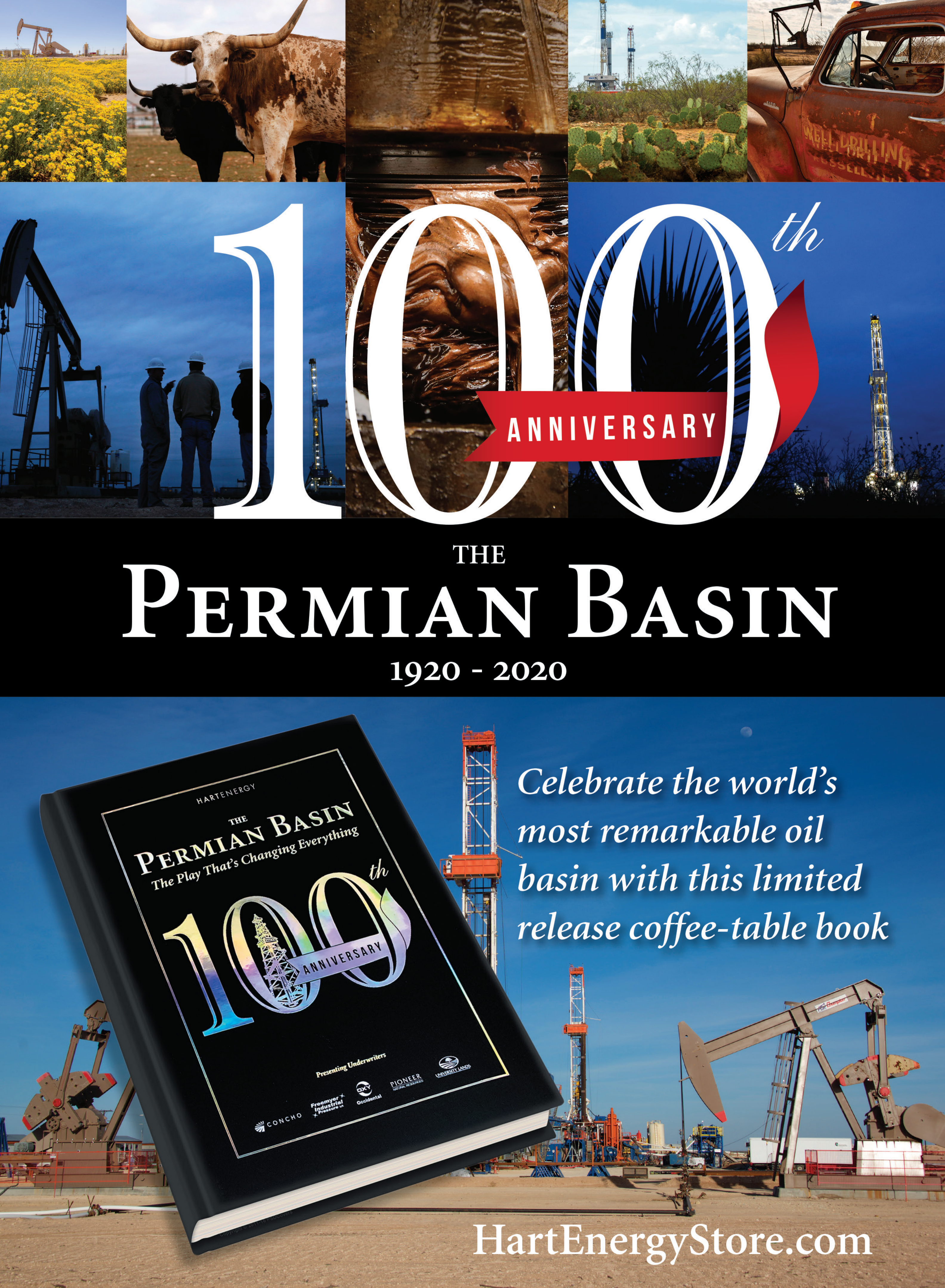
Consolidation offers benefits "in a world that appears to have fundamentally changed, at least over the last four years and even more meaningfully over the last four weeks," Cunningham said.

Still, he said the industry's pain will likely be prolonged, even as people return to work, because it appears the supply/demand imbalance will persist.

"It would not be surprising if we undergo 18 to 36 months of prolonged stress for the entire industry across all three streams," he said. "The supply fundamentals don't seem to portend a V-shaped recovery."

April oil demand is estimated to be 29 MMbbl/d lower than this time last year, down to levels last seen in 1995, according the International Energy Agency. Overall, demand in the second quarter is expected to trail 2019 by 23.1 MMbbl/d.

"The last downturn really showed us the resilience of different markets when A&D activity dries up and new capital enters the space to bridge the gap for challenged operators," Cockerham said. However, he added, "It's tough to look at what's happening right now and think, 'If our economy started going back to work immediately, we'll be at $65 oil in six months.'" □



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