Oil and Gas Companies Brace for Borrowing Cuts

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October is shaping up as a scary month for oil and gas explorers and producers, but their fright has nothing to do with ghosts or goblins.

Twice a year, banks that lend to oil and gas companies do what's called a "redetermination," which involves a formula that takes into account how much oil and gas the companies have, where oil and gas prices are expected to be and what they have hedged, and -- poof -- out spits how much they can borrow. During the last oil and gas price drop in 2008-09, banks reduced companies' borrowing bases by around 10% to 20% on average.

This time may be worse. Many companies won't have new proved reserves coming on line because they stopped drilling. Add that a lot of companies' hedges are starting to fall off and regulators are pressuring banks to fix their energy-related portfolios, and you have a recipe for disaster. "You have a convergence of factors that likely won't play out well for borrowers," said Will Bos, a corporate partner specializing in commercial lending and financial transactions at Kirkland & Ellis LLP in Houston.

Akin Gump Strauss Hauer & Feld LLP partners Tom McCaffrey and Sarah Schultz called the next redetermination period a potential "tipping point" for the industry as part of a midyear webinar for clients last month.

Analysts at Tudor, Pickering, Holt & Co. Securities Inc. said recently that banks will be less likely to "kick the can" again after last spring's redetermination season, which proved to be a nonevent. "We expect fall's redetermination to be more punitive than the spring's," they said. They expect banks' long-term price decks for oil could flip from a premium to a discount over strip prices given the duration of the downturn. "The wildcard in this equation is how banks will respond to the additional pressure reserve-based lending has been under by regulators during this cyclical trough," they said.

Borrowers, of course, can seek amendments and waivers. But observers think oil and gas companies will be limited in their ability to borrow, which will lead to reduced liquidity at a time when they really need it, given lower commodity prices.

THE BORROWING BASE redeterminations coming this fall are going to hit the small and midcap exploration and production companies harder than the larger-cap companies because the smaller companies tend to rely more heavily on bank debt than high-yield bond debt, according to Kim Brady, a partner at SOLIC Capital Management LLC. It's also difficult to predict who may have borrowing base reductions, as the formula used to calculate it isn't public information, he added, but the severity of a borrowing base redetermination will come down to whether companies have been able to increase their production and decrease their capital expenditures.

Analysts who follow these companies have some ideas about who might be most at risk. Houston-based Swift Energy Inc. (SFY), led by CEO Terry Swift, is on the list of Global Hunter Securities Inc. analyst Patrick Rigamer. In May, its borrowing base was reduced to $375 million from $417.6 million, and it had $247 million drawn as of March 31, giving it $128 million in liquidity, which led it to hire Lazard to advise it on capital structure alternatives. "In this low price environment, we see risk for further borrowing base reductions in the fall redeterminations, which could negatively impact SFY's liquidity," Rigamer said.

Goodrich Petroleum Inc. (GDP), led by CEO Walter Goodrich, may be another. While it was able to sell its assets in South Texas' Eagle Ford Shale last month to an undisclosed buyer for $118 million, bringing in much needed capital, the price came in below expectations of $200 million. Global Hunter Securities Inc. analyst Mike Kelly wrote in a report July 27 that the deal brings into question the status of the company's $150 million borrowing base and sees it struggling to generate positive cash flow next year without major cuts to leasing operating expenses and general and administrative costs given price expectations. He reiterated his sell rating on the stock and lowered his price target to 25 cents per share versus 50 cents previously.

Simmons & Co. International analyst Pearce Hammond dropped coverage of Goodrich even before the Eagle Ford sale was announced, saying the firm struggled to see a clear path to free cash flow and balance sheet deleveraging. Tudor Pickering said Goodrich's liquidity constraints and marginal returns on its properties in the Tuscaloosa Marine Shale keep it "sidelined" on the stock.

Another at-risk company is Magnum Hunter Resources Corp.(MHR), which has idled drilling with the drop in commodity prices. Topeka Capital Markets analyst Gabriele Sorbara said the company is in a tight situation, but management -- led by CEO Gary Evans-- has several plans to shore up its balance sheet and externally fund a drilling program through next year, including $1 billion in asset sales.

It's making some progress: On Tuesday, the company said in a filing with the Securities and Exchange Commission that it inked a letter of intent with an unnamed private equity fund that will finance $430 million of its development costs in exchange for a stake in its Utica properties (analysts had thought the move would bring in $450 million). It's also selling its Eureka Hunter Midstream assets, which are expected to generate another $460 million to $600 million (Morgan Stanley, which owns 53% of the 175-mile Eureka Hunter pipeline, is expected to get around $50 million, according to Wunderlich Securities estimates).

Other companies that analysts have mentioned may be at risk include Energy XXI Ltd. (EXXI), Approach Resources Inc. (AREX) and Penn Virginia Corp. (PVA), which bond rating agencies have downgraded recently. Moody's Investors Service Inc. said Wednesday it expects Penn Virginia's borrowing base to decline in November and that lower earnings next year may require the company to seek a waiver of its financial covenants. "The company has disclosed that the sale of assets in East Texas will reduce the borrowing base by $30 million in the third quarter," Moody's said, but added that the company has limited ability to raise additional funds from further divestitures.

Other at-risk names include SandRidge Energy Inc., Comstock Resources Inc. (CRK),W&T Offshore Inc. (WTI), Halcon Resources Corp.(HK) and Emerald Oil Inc. (EOX).

SOME HAVE ALREADY been hurt. Denver natural gas explorer, developer and transporter Escalera Resources Co. (ESCR) fell into default earlier this month when the borrowing base on its $250 million credit facility was reduced to $44 million from $50 million through a redetermination, which resulted in a deficiency of $3.5 million. It struck a forbearance agreement with lenders through Sept. 1 that requires it to sell certain assets to reduce what's outstanding on its debt.

Jefferies & Co. analyst Brad Handler said concerns over the upcoming loan redetermination process are hurting the prospects for oilfield services companies as well, with bank regulators' pressure threatening to cut into exploration and production companies' ability to outspend their cash flow next year.

Topeka Capital's Sorbara doesn't expect broad-based cuts in borrowing bases, especially after the round of capital markets financing in the first half of this year. "Overall, we think many concerns are overblown, at least for our group of companies that are better positioned with strong asset bases and balance sheets," he said.

He noted that both EP Energy Inc. (EPE) and Bonanza Creek Energy Inc. (BCEI) mentioned they will receive benefits from operating and service cost reductions since the spring redeterminations and that Bonanza pointed to a potential 10% downward impact to its $550 million borrowing base, which will still leave it in a solid total liquidity position of $443.3 million. He also mentioned that Linn Energy LLC (LINE) doesn't expect banks to lower their price decks with the fall redeterminations and some other companies believe their borrowing bases will remain unchanged or increase with their growing proved developed producing reserves.

Moody's still has its doubts about Linn. Despite the fact that the company completed its last semiannual borrowing base redetermination with a liquidity position of $1.5 billion as of June 30, earlier this month the bond rating agency downgraded the company's corporate family rating to B2 from Ba3 with a negative outlook. It said the company's alternative liquidity is declining, with borrowing base cuts expected on its revolving credit facilities in the upcoming redetermination period and the need for debt reduction to have sufficient Ebitda/interest covenant compliance of at least 2.5 times through next year.

Some private equity-backed companies are also in trouble, including Alta Mesa Holdings LP, which has properties in Oklahoma and Louisiana and backing from Highbridge Principal Strategies LLC (it bought out Denham Capital's stake in March for undisclosed terms).

In late July, despite having closed a $125 million second-lien senior-secured term loan with Morgan Stanley Energy Capital Inc., Moody's downgraded the Houston oil and gas company's corporate family rating to Caa1 from B3 and lowered its probability of default rating to Caa1-PD from B3-PD and senior unsecured rating to Caa2 from Caa1. Moody's said its rating outlook was negative because of Alta Mesa's weak liquidity, high leverage and the low oil and natural gas price environment. The company's next scheduled borrowing base redetermination is in November, and Moody's said there is risk that the base could be further cut. With almost all of the partnership's assets pledged as collateral for the revolving credit facility and the term loan, "Alta Mesa's ability to raise alternate liquidity is limited as we expect that any proceeds from asset sales would be used to pay secured lenders," Moody's said.

Some companies are finding a way out. Fort Worth oil and gas explorer Lonestar Resources Ltd. (LNREF) said July 28 it inked a $100 million joint development agreement in the Eagle Ford with IOG Capital LP, which is led by former Chesapeake Energy Corp. CFO Marc Rowland and backed by Fortress Investment Group and Metalmark Capital. Global Hunter analyst Andrew Smith wrote in a note that the agreement allows Lonestar to continue to expand its acreage position at trough-level valuations and that the increased borrowing base and additional liquidity are positive in the current commodity price environment amid worries about lower borrowing bases across the industry during the fall redetermination season. Lonestar may be one of the lucky ones, as other companies struggle to find tricks that will coax treats from their banks.

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