turnarounds & workouts

Oil & Gas Companies at Risk: Bank Redeterminations May Increase Bankruptcies
December, 2015

During the last oil and gas price drop in 2008 and 2009, banks reduced companies' borrowing bases by an average of 10 to 20 percent. This time around it may be worse and could potentially result in increased bankruptcy filings, says Ron Meisler, a partner at Skadden, Arps, Slate, Meagher & Flom LLP.

Twice a year, in the spring and fall, banks that lend to oil and gas companies conduct a "redetermination," which involves running the numbers to determine how much oil and gas the companies have, the likely future of oil and gas prices, and hedging. They plug those numbers into a formula, and the result is how much oil and gas companies can borrow.

It's difficult to predict which companies will be hit hard because the formula used to calculate redeterminations isn't public information, but professionals who follow these companies have some idea. **For example, Kim Brady, a senior managing director at SOLIC Capital Advisors, LLC, says the severity of a borrowing base redetermination typically depends on a number of borrower variables, including expected oil or gas prices, proven reserves, the discount rate, and price-hedging programs.**

Because commodity prices have been depressed throughout 2015, many industry observers have speculated that a large number of bankruptcy filings by domestic exploration and production (E&P) companies could happen. **"As a result of the prolonged slump in oil and gas prices, fewer can borrow against reserves," observes Brady. "A reduction in capital expenses for new wells means many potential borrowers don't have new, proven reserves."**

In the spring, several factors delayed that expected surge. For example, domestic E&P companies raised approximately $15 billion of equity and $20 billion of bonds in the first half of the year, according to The Economist. Many oil and gas companies also used derivatives to hedge their exposure to volatile oil and gas prices. And, banks generally made modest reductions to E&P companies' credit lines. "Nobody knows the duration of the price decline and, as we understand it, the banks were not eager to act as a catalyst for some sort of liquidity event," says Meisler.

Many industry observers speculated that the fall redeterminations will be different. They're coming at a time when low commodity prices show no signs of rising, and there's increasing regulatory pressure on U.S. banks lending to oil and gas companies to reduce their exposure to the highly leveraged sector. Federal banking agencies, including the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Federal Deposit Insurance Corp., have reportedly encouraged banks to increase the frequency of oil and gas loan reviews, and classify a significant number of outstanding loans to E&P companies as "substandard" (indicating uncertainty as to the underlying collateral value and/or the borrower's ability to repay the loan).

Banks are about halfway through the fall redetermination cycle, however, and so far there have been few companies that have had a heavier redetermination.

“We’re hearing that the average decline in borrowing base is 5 percent,” says Meisler. “That’s surprising because the government is putting a lot of pressure on oil.”

That said, Meisler is also hearing that banks are doing the easier redeterminations first, leaving the more difficult ones for the end of the cycle.

Regardless, one thing is clear: “It is highly likely that the distress in the oil and gas industry will persist in the near term,” Meisler says.

In late 2015, E&P companies will face an additional challenge: hedges are rolling off, giving them increased exposure to market prices. “With hedges falling off for a lot of companies, there is further pressure on redeterminations,” says Brady.

“It’s definitely a matter of time,” adds Meisler.

In this environment, cash-strapped E&P companies will have to look beyond the traditional commercial banks for capital. Doors may also close to alternative financing options that provided liquidity during the first half of this year, including equity offerings, the high-yield bond market, and second-lien or mezzanine loans.

That could leave E&P companies with limited options to secure sources of capital needed to increase production volumes and build up their proven developed producing reserves, which would restore collateral to the borrowing base and maintain cash flows.

Meisler says E&P companies may look to execute debt exchanges, sell non-core assets, turn to alternative third-party lenders (such as private equity funds or hedge funds), or implement farm-out financing arrangements.

If E&P companies are not successful in finding financing, they may be forced into an in-court process. And, indeed, that’s already happening. Over the past year, Meisler says roughly 20 oil and gas companies have filed for bankruptcy. Some have been successful, including Hercules Offshore, Inc., which entered Chapter 11 in August and obtained confirmation of its prepackaged plan of reorganization just 45 days later.

Others have hired restructuring advisers before resorting to bankruptcy, such as Houston-based Swift Energy Inc. In May, its borrowing base was reduced from $417.6 million to $375 million, and by March 31 it had $247 million, giving it $128 million in liquidity. That led it to hire Lazard to advise it on capital structure alternatives.

But many more companies are in trouble. “Countless others have been flagged by analysts and ratings agencies alike as over-leveraged, high-default risks,” Meisler says. **“We expect to see more bankruptcies,” predicts Brady.**

The first measure for E&P companies in this environment, Meisler says, is to talk to their advisors about what happens if prices continue on this trajectory or get even worse. “They have to consider what their duties are and to whom they owe those duties.”

For industry professionals, Meisler says creativity is key. “Circumstances differ by company, but filing for bankruptcy is generally not the best option because it’s expensive and time consuming.”

“Because the capital structure is likely the issue,” Meisler continues, “it may be better to negotiate an out-of-court restructuring or initiate a quick and cost-efficient prepackaged

Chapter 11 filing, both of which permit the companies to right-size their liquidity risk profiles and minimize any disruptions to their business operations.”

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