DISTRESSED FINANCE

With E&Ps facing a three-headed dragon of low commodity prices, closed financial markets and lender redeterminations, five industry experts suggest ways to get over the hump.

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Some oil and gas producers are being caught off guard by falling oil and gas prices and reserve values as they head into borrowing-base redetermination season this spring. In fact, almost any producer that made a large acquisition with debt within the past 30 months with an expectation of higher commodity prices, but didn't hedge against price risk, is likely facing some form of financial distress.

So are producers that entered large drilling commitments or farm-outs and now find it hard to keep up, or those that unexpectedly suffered an abrupt decline in production due to a well blowout, hurricane or pipeline damage or other unforeseen event.

While negative price-based reserve revisions are not expected to affect the liquidity of most investment-grade issuers, E&Ps with reserve-based revolvers could experience reduced borrowing capacity, thus a limited ability to fund operations.

At press time, Standard & Poor's had red flags on about 25% of the oil and gas debt issuers it covers, and that percentage is expected to increase through this half, especially for high-yield issuers. The common concerns are liquidity, borrowing-base resets, capital-spending constraints, counterparty risk, refinancing risk and the expectation that oil and gas prices will remain at or near current levels in the near term.

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"If a majority of the producer's borrowing base is drawn, it may find itself with a borrowing-base deficiency at the time of redetermination solely due to reduced commodity prices," says David Baggett, founder and managing partner of Houston-based consulting, technology, outsourcing and restructuring firm Opportune LLP.

Although there were few E&P-company bankruptcy filings as of press time, Baggett expects filings to increase at the end of this quarter and throughout the second as E&Ps find it difficult to access capital or sell enough properties to pay down debt and to cure the borrowing-base deficiencies.

"The last public equity deals were done in August 2008," he says. "It was the last chance for producers to bolster their balance sheets by raising cash. After that time, equity markets fell and that option closed. With the borrowing and equity markets under duress, some debt facilities are going to be underwater in the next six months."

When an E&P has more debt than borrowing base, it should buy time by negotiating a three- to six-month forbearance agreement with its bank syndicate, Baggett advises. During this period, companies must optimize cash by reducing capex, cutting G&A expenses and selling noncore assets.

"Producers with cash-flow issues are going to be shrinking and redirecting their capital budgets in 2009 to prioritize short-term returns." As an example, long-term exploration projects may be scratched in favor of recompletions that provide quick cash-on-cash returns. "We are also going to see more farm-outs in 2009 as cash-strapped companies look for partners to help them fulfill their drilling and land commitments."

There were few property sales in fourth-quarter 2008, but divesting will soon recommence. "The first items to come to market will be nonstrategic assets," he says.

Borrowing-base season

Even though a number of E&Ps are heading into the spring collateral-redetermination season facing a reduction in their borrowing base, "it doesn't mean the world has come to an end," says Buddy Clark, a Houston-based partner of Haynes and Boone LLP and an energy attorney since 1982.

"Where an E&P is fully borrowed, and the redetermination results in a borrowing-base deficiency, that doesn't mean the loan is automatically in default," he says.

"In fact, most borrowing-base credit facilities give an option to repay the deficiency in equal monthly payments, typically within three to six months, or to pledge additional collateral to the extent they have not already pledged all assets, or some combination of the two."

Also, some companies may be able to increase their borrowing base by layering on additional hedges or raising cash by monetizing hedge contracts, although some current hedges may be rolling off soon.

The correct choice depends on several variables, including an E&P's property mix, hedge position, the marketability of its properties and the mix of its lender group, says Clark. Variables such as these also determine which types of cutbacks are best: selling properties, canceling drilling contracts, soliciting farm-outs or other strategies.

At the first sign of financial distress, management should proactively approach its lender with a solid business plan for solvency and access to supporting data, advises Buddy Clark, partner with Haynes and Boone LLP.

SIGNS, REMEDIES

There are signals that a joint operating agreement (JOA) partner may be in financial distress.

• Late payment on disbursements.

• Pressure on joint-interest obligations and acceleration of billing cycles including the pre-billing of authority-for-expenditure contracts.

• Delay or refusal to undertake needed capex, repairs and maintenance.

• Disconcerting press releases, financials, form 8-Ks, status of operations and bank-loan issues.

• Indications from vendors and other partners that payments are late.

• Lawsuits by vendors for collection, or lien filings.

• Derogatory reports from royalty owners or media sources.

Remedies can be proactive or reactive.

Proactive remedies include:

• Ensuring the title is properly filed in the county in which a property is located.

• If the JOA provides for cross-lien rights, a memorandum of these rights should be filed. If a memorandum is not on file, the American Association of Professional Landmen has a recording-supplement form that should be circulated, executed and recorded, including proper descriptions of the contract area.

• Ensuring the operator's insurance is current for coverage against property and casualty loss.

• Demanding a meeting of all owners to discuss well status and be included in planning and resolution discussions.

• Organizing an ad-hoc owners' group to spread the time commitment and costs to retain counsel to assist in restructuring issues.

• Demanding payments directly to vendors or causing joint-interest billing payments to be maintained in a separate account. (An operator may "rob Peter to pay Paul" and use funds to pay costs for other wells while stockpiling unpaid bills. If third-party funds held by an operator are commingled with the operator's general funds, they can be difficult to identify and recover.)

• Demanding adequate protection via guarantees, letters of credit or other documentation.

Reactive remedies include:

• Acting quickly to preserve and protect lien rights and, if enforceable, actimg early to ensure adequate protection of lien rights. In addition to contractual lien rights under a JOA in Texas and a handful of other states, a producer may be entitled to assert a statutory producer's lien for production proceeds. (A producer lien is not the same as the oilfield mechanics and materialman lien, which working-interest owners are typically not entitled to assert.)

• Seeking to separate production revenues to ensure payment and that royalties are paid and conditions of oil and gas leases are met that could otherwise void leases.

• Offsetting and recovering any amounts due and owed by defaulting party.

• Monitoring bankruptcy filings and reviewing monthly operating reports to determine if revenues and expenses are reasonable.

• Taking action in the bankruptcy case to assert rights and interests.

• Requesting information from the creditors committee (if unsecured) on the debtor, its operations and the steps the committee is taking to protect the unsecured interests.

—Buddy Clark, Haynes and Boone LLP

At the first sign of financial distress, management should proactively approach its lender with a solid business plan for solvency and access to supporting data, advises Clark. Preserving the lender's long-term confidence is key. The lender may then offer a waiver to forgive a default, a forbearance or amendment to loosen up financial covenants, or some other workout program to "get over the hump" of low oil and gas prices.

This strategy is easier when working with one banker as opposed to a syndicate. In a large group, one of the lenders might resist a workout program. In the past, that bank could be replaced or other lenders in the group might increase their commitments, through a "yank a bank" provision, but current debt capital constraints have made that option problematic.

"Also, companies with credit-facility problems should be mindful that opportunistic noncommercial lenders may be looking to buy debt at a discount, accelerate the default process and cause a liquidation to get a better return on their investment," Clark says.

If nothing can be worked out, it's time to negotiate with critical vendors and determine ways to raise additional cash, including approaching equity owners and industry partners. A couple of Clark's E&P clients have found that larger oilfield-service providers, such as Halliburton and Schlumberger, are willing to work on terms to assist valued customers because they have a vested interest in their customer's survival.

Meanwhile, E&Ps should be aware that, in most states, unpaid vendors have 180 days after invoicing to file a lien under the mechanic's and materialman's lien law, gaining a protected

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and secured position. If these liens are unresolved, they can trigger a cross-default with the company's lender facilities. Other secured creditors will be forced to accelerate notes and even post properties for foreclosure.

"The last resort, once a company reaches the zone of insolvency, is to file bankruptcy," Clark says. "It's very expensive, inefficient and time consuming, but it does allow a company to reorganize rationally."

In the past, bankruptcy allowed a company to get debtor-in-possession, bridge or exit financing, but that may not be possible now, given the stress in current capital markets. Nevertheless, seeking refuge under the automatic stay of bankruptcy may be the best hedge against low commodity prices, assuming the cycle turns before it's time to emerge from the protective shield of the bankruptcy court, he says.

Bank examiners

The timing of low oil and gas prices, borrowing-base redeterminations, tight capital markets and the release of E&P audited financial results nearly coincides with an important time for commercial banks—their own national bank examination process in the spring.

This confluence of events is unfortunate for distressed companies. A bank with E&P clients with borrowing-base deficiencies will soon see those loans downgraded to the high-risk category by examiners, says Tim Murray, Houston-based managing director of private energy capital provider Guggenheim Partners LLC, and formerly an energy commercial banker.

The more high-risk loans a bank holds, the more capital it is required to reserve as bank examiners determine necessary capital ratios to protect depositors from bank failure. Some, but not all, banks can get additional capital from the U.S. Troubled Asset Relief Program, the Federal Reserve window, or by paying a visit to Wall Street for debt or equity.

"Wells Fargo recently raised money on the Street, but that's not available to Citibank, for instance," says Murray. If a bank can't get additional capital, it has to sell assets, like loans, to shrink its balance sheet to meet mandated capital ratios.

"Any bank anticipating capital constraints will not make new loans," says Murray. "Until that examination process is completed in May or June, I don't expect to see much new lending activity from energy banks." After the process is complete and capital ratios are affirmed, banks will either resume lending or start selling assets to generate liquidity and pare bad loans.

"Make sure you are not surprised by this action," Murray says. "An E&P borrower should have a direct line of communication with its lenders. If your first clue of a problem is an introduction to a workout guy, you know the redetermination didn't go well. Or if they have sold your loan to a vulture fund, you know you are not in good standing."

The best remedy can be as simple as adding hedges, advises Murray. While a hedge might not enhance the value of the collateral, it mitigates the risk of further commodity-price-driven cash-flow decline.

"If that is not possible, the E&P borrower should seek alternative capital from a private equity or mezzanine provider, an angel investor or from existing shareholders who have some liquidity."

Meanwhile, a mezzanine provider such as Guggenheim Partners can analyze loan covenants and coverages and might suggest an increase in amortization that uses a high percentage of cash flow to pay down debt.

"An amortization workout strategy is a good route to go because this is a cyclical industry and prices will rise again. There is probably not an experienced lender in this industry that hasn't been through that."

The last remedy should be bankruptcy, he says. "Banks don't want to own oil and gas properties, due to the environmental and opera-

"If your first clue of a problem is an introduction to a workout guy, you know the redetermination didn't go well," says Tim Murray, managing director for Guggenheim Partners LLC.

Above: Dean Swick, managing director for Alvarez and Marsal Holdings LLC, says, "This is not a time for growth. It is a time for survival."
At right: "In the oil and gas world, there are always cycles in which it will have been proven to have been a very attractive time to acquire assets or companies," says Jim Rogers, managing director for Deutsche Bank and head of North American energy.

tional demands. It is very rare for an E&P company to go Chapter 7. The only time we see that is if the company has poor managers. You don't want to go down the road with the guys who drove into the ditch."

If the borrowing-base redetermination gives a lender a reason to remove bad managers, it will, he says.

If the only option is bankruptcy, the E&P company or lender might find a partner, neighboring operator or a lender's existing client willing to assume the note, which wipes out the equity of the troubled company. Otherwise, the lender can trade the debt for the collateral. In that case, a new company is formed and the operations are outsourced. When prices are better, the assets are sold to recoup the loan balance.

"Typically, though, lenders are motivated to assist companies in times of financial distress. Once the economy recovers, all this will be a painful, but distant, memory," says Murray.

Convert PUDs

The simultaneous challenge of low prices and tight capital is particularly difficult because, for growth, E&Ps typically need access to more cash flow than they can generate internally, says Dean Swick, Houston-based managing director for energy-banking and restructuring firm Alvarez & Marsal LLC

"Borrowing-base redeterminations are going to cause a ripple effect," he says. "If an E&P cannot make the payment required to reduce the borrowing base, it will trigger defaults in the bank revolver and ripple into public-debt instruments."

Swick advises financially distressed E&Ps to clearly recognize that market conditions have dramatically changed. "The next step is to focus on improving internally generated cash flow," he says. "It's better to spend capital on projects that have near-term conversion of capital into cash flow, such as converting PUDs and PDNPs into PDPs.

"Producers that take this strategy will have the best access to capital when the markets open up again. Long-term payback and exploratory projects should be delayed for now."

Also, E&Ps might restructure lender agreements for a reduced required amortization, coupled with a plan for recapturing excess cash flow. If the company performs better than expected, both company and lender can share excess cash flow.

"This helps bring the stakeholders together to maintain production volume and asset values. This is not a time for growth. It is a time for survival."

Cure period

For producers that are offside on their debt covenants, banks usually offer a cure period, says Jim Rogers, managing director and head of the North American energy practice for Deutsche Bank. Producers can take action to sell assets, cut capex and pay down debt, among other options, to remedy financial distress. He agrees that valuable hedges can be monetized to pay down bank debt.

"Many of these producers have been through down markets before, but the difference now is that, up until recently, there hasn't been a functioning capital market," he says. "The access to term debt has not been available in sufficient size and at reasonable rates to allow them to issue subordinated debt and preferred stock to term out their capital structure. That has started to change. The bond market has windows that open and close."

For example, in January, Deutsche Bank was the lead book-running manager for a $1-billion senior-debt offering for Chesapeake Energy Corp. and sole book-runner for a $265-million convertible perpetual preferred offering for SandRidge Energy Inc.

Chesapeake offered the senior notes, due 2015, at 9.5% per annum. The senior notes were priced at 95.071% of par to yield 10.625%. Meanwhile, SandRidge privately placed 2.65 million shares of a new-series 8.5%-convertible perpetual preferred stock. Both companies used the proceeds to pay down borrowings on their revolvers.

"That capital was not available in the fourth quarter of 2008," Rogers says. "It's a sign the debt capital market is opening. While capital is more expensive, there is a good chance that we will see more capital issuance this year than last year, given the delay in functioning capital markets being available for the last six to eight months."

Despite depressed stock prices, a healthy amount of equity-oriented issuance could come to market as producers position themselves for future growth, he says. Deutsche Bank will encourage its energy clients to think very carefully about accessing them when markets open.

"In the oil and gas world, there are always cycles in which it will have been proven to have been a very attractive time to acquire assets or companies," says Rogers. "We think this is going to be one of those interesting periods of time. When we look back three or four years from now, the winners are going to be very clear." □