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DISCUSSING THE TRENDS

Q&A with J. Michael Chambers

Are You an E&P Company Facing a Liquidity Crunch and Considering Restructuring?

April 22, 2015

In this lw.com interview, Latham & Watkins partner Michael Chambers looks at the impact of borrowing base redeterminations on exploration and production (E&P) companies. He also discusses additional debt capacity under high yield notes indentures, second and "one and a half" lien financings, strategies for how to buy in or tender for bonds and other debt, and the asset-level transactions that can be used to raise liquidity.

Chambers is a partner in Latham's Houston office who focuses his practice on leveraged finance and other debt and equity capital markets transactions. He has particular expertise in high yield bond offerings and institutional term loan facilities.

How is the borrowing base calculated for E&P companies? What does it mean for liquidity?

Chambers: The vast majority of E&P companies typically rely on reserves-based revolving credit facilities, also known as RBL facilities, for their working capital needs, drilling programs and even acquisition finance. These RBL facilities provide availability to E&P companies based on the lower of the lenders' aggregate commitments and a borrowing base determined by the lenders.

If you've worked in another industry segment, you are used to asset-based loans (ABL) or cash-flow loans and are accustomed to a borrowing base set on a very specific formula that has very little discretion. When you get into the E&P world, there is no specific formula for calculating the borrowing base. For the most part it is based on a review of the reserve report that the borrower provides. However, the administrative agent is also entitled to consider other such information it deems appropriate in its sole discretion — the only requirement being that it treat a particular borrower as it does all its other borrowers. In other words, the borrowing base is whatever the lenders say it is.

When and how will borrowing bases be redetermined?

Chambers: Your typical RBL facility will require scheduled redeterminations on a semi-annual basis — typically once in the spring and once in the fall. This is intended to give the banks a little time to review the most recent year-end and mid-year reserve reports before they set the borrowing base. The banks also have the ability, on a special basis, to ask for at least one and sometimes two more redeterminations at any time during the year. Additionally, a borrower will have the right to ask for one or two additional redeterminations, which they would seek following a large acquisition.

Maintaining an existing borrowing base requires the approval of lenders holding at least 66 2/3 percent of the commitments. Likewise, reductions in borrowing bases are to the level that the lenders with at least 66 2/3 percent of the commitments agree. It is really debt by consensus among the lenders.

A reduction in the borrowing base to an amount below the aggregate outstanding loans results in a borrowing base deficiency. The typical RBL allows borrowers to cure a borrowing base deficiency through equal monthly installment payments – usually between three and six installments. Our experience shows that once you are in a borrowing base deficiency, it is pretty difficult to claw out of it. From everything we've heard during the recent borrowing base redetermination season, borrowing bases came down but not as much as companies were worried they would. A number of companies also executed amendments that gave them some near term covenant relief. There is a certain sense that banks are letting this play out until the fall redeterminations, but if the commodities prices are still in the

US$50 to US$60 range in the fall, and borrowers have not raised additional liquidity or otherwise shored up their balance sheets, a number of borrowers are going to have some tough conversations with their banks.

What type of additional debt capacity is available under high yield notes indentures?

Chambers: No one ever wants to have to ask for an amendment from its bondholders — it's often very expensive. As a result, high yield bond covenants are generally more flexible than RBL covenants. The basic provision in high yield indentures that regulates how much debt can be incurred and how much secured debt can be incurred is the defined term Adjusted Consolidated Net Tangible Assets (ACNTA).

For example, the credit facility basket in a high yield indenture is usually something like — you are permitted to incur the greater of US$300 million or 30 percent of your ACNTA. The idea is that, as your asset base, and therefore ACNTA, grows, so too does the amount of debt you can incur. And unsecured high yield indentures don't distinguish between whether it is first, second or third lien secured debt. What people don't appreciate sometimes is that the ACNTA definition, which is mostly is based on the PV-10 value of proved reserves, is based on Securities and Exchange Commission (SEC) pricing at year-end, which is a backward looking average of commodity prices, as opposed to current or strip pricing.

In addition, ACNTA holds that price constant throughout the year. However, to give effect to adjustments for acquisitions, extensions, dispositions, discoveries, and upward and downward revisions during the year, adjustments are done on a rolled-forward basis — using SEC pricing as of the most recently ended quarter. It kind of creates a disconnect. For example, if you had a property that was worth US$50 million at year-end, by the time you go to sell it in the summer of the following year, if prices have declined and the SEC pricing has come down, it may only be a US$25 million property, so you are backing US$25 million out of the valuation, but you are still left with a residual $25 million in the year-end calculation.

The other significant component of the ACNTA definition is capitalized costs attributable to properties without proved reserves, such as lease acquisition costs, at the most recent year- or quarter- end. This can be a really significant number that people sometimes overlook. It is not a valuation that you get any credit for in your RBL borrowing base, but you will get credit for it in your high yield definitions. Next you add to it your net working capital at the most recent year- or quarter- end. And finally you subtract out things like minority interests, gas balancing liabilities and reserves subject to production payments.

If you think about it, in the first part of 2015, this number is going to be considerably higher than true market value of the properties, but likewise in 2016 — even if we've had a significant recovery in prices — you'll still be calculating this number on a backwards-looking 12-month average. The debt that these baskets will support will be much diminished if that average is a US$60 or US$70 average.

What do E&P companies need to know about second and 1½ lien financings?

Chambers: Under the typical unsecured high yield indenture, the lien priority of permitted additional secured debt is not restricted. In most cases the incurrence of second lien debt requires an amendment under the existing RBL facility — the borrower, senior lenders and trustee for the notes would have to enter into an intercreditor agreement satisfactory to the senior lenders and it almost always results in a borrowing base reduction. In fact, that aspect of it is often formulaic; it is usually a US$0.25 reduction in your borrowing base for every US$1 incurred. But many high yield indentures provide the issuer considerable ability to incur additional, and in some cases, very significant amounts of additional secured debt without further approval or consent from the note holders. The amount of additional secured debt permitted often exceeds the amount that commercial banks will provide under an RBL.

1½ lien financings are additional secured debt that is senior in lien priority to existing second lien debt, but junior to existing first lien debt. The concept is to layer in some additional debt that is behind the RBL but ahead of the second lien. Most of the 1 ½ lien deals done over the last couple of years were in the Canadian market, with some in the US. It is a way to slide more debt in when your reserve based lenders are not willing to provide any more liquidity. In terms of the amendments that are required from an RBL to allow slotting in additional debt, our experience has been that the commercial banks today are quite happy to provide that amendment to allow the borrower to put in some second or 1½ lien debt, provided the borrower also pays down some of the exposure on the revolver.

What are some key liability management solutions to consider?

Chambers: Liability management solutions are really strategies around how to buy in or tender for bonds and other debt. One fact investors sometimes don't fully appreciate is that high yield bond covenants almost never prohibit buying in your own bonds, so you can do this without restriction. Today, if you are a CFO of a company whose bonds are trading at US$0.70, you would much rather extinguish that liability at US$0.70 than pay par, which is where you are carrying it on your balance sheet. There have been a number of deals recently where companies and investors did exactly that — selling notes back to the company at a discount in exchange for either common stock or new secured debt of the company. If it's part of a significant deleveraging transaction — an exchange of notes for equity for example — our experience is that banks will usually allow that. Surprisingly we haven't really seen many of these transactions so far. I think a lot of companies are waiting to see what happens in the second half of the year.

What type of asset-level transactions can be used to raise liquidity in a distressed situation?

Chambers: One of the most common forms of asset level financings are production payments. In short, a production payment is a present payment for the reserves, which are delivered to the counterparty if and when produced. So the counterparty takes the risk the reserves may not be produced — but the counterparty is also betting that the price of the hydrocarbons will increase above its purchase price. It's almost like a hedging transaction. Production payments are a great tool because there is a specific exemption in the bankruptcy code that makes it clear a production payment, properly structured, is a sale of assets from the debtor's estate — a bankruptcy remote transaction.

Farmins and farmouts happen when one party agrees to drill a well and complete it, but they don't earn an interest in the well until it is completed to an agreed depth. There are some bankruptcy code exceptions here as well. If the company files for chapter 11 before you've had a chance to drill the well, as long as the party completes the well as promised, it still receives the property interest, even after chapter 11 has been initiated.

We are hearing more about the monetization of commodity hedges than we have in the past. No one really expected commodity prices to drop into the US$40 to US$50 dollar range. Right now, all hedges should be in the money at this point. That represents a present asset in that those hedges can be unwound for a cash payment to the company. However, producers typically do not have the unilateral right to unwind hedges and so must negotiate with their counterparties for the amount of the early termination payment. A company can also negotiate with the counterparty to reset the swap price to a lower amount, thereby monetizing a portion of the mark-to-market gain while leaving in place some commodity protection. However, any kind of unwinding of hedges or resetting of the price will almost certainly result in a borrowing base redetermination.

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