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DISCUSSING THE TRENDS

Q&A with J. Michael Chambers and Mitchell A. Seider

What Lenders and Investors in E&P Companies Need To Know As Oil Prices Drop

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"In 2008, the United States produced on average approximately 5 million barrels of oil a day. By the end of 2014, that number had increased to more than 9 million barrels and the Energy Information Agency predicts production will continue to increase through 2015," explains Latham & Watkins partner Michael Chambers. "However, during that same period worldwide demand increased by less than 1 million barrels a day, and in the US oil consumption has actually declined since 2008. The fact that US production has been growing faster than US consumption, and even world growth, together with the slowing of growth of some of the world's major economies, has resulted in a classic oversupply situation."

"The question is: Where is the bottom? How far will prices drop?," added Chambers. "Some analysts are predicting the price of crude to fall below $30, while others are predicting a recovery to $75 or so by the second half of 2015. In any case, whether a company can continue to make money depends in large part on the location of its assets. Not all oil and gas properties are the same — the cost to drill and operate wells in some basins is significantly higher than in others, and the returns on the investment to drill a well are significantly lower. At today's prices, some properties are at break even, the price a company needs to receive for a barrel of oil to make it economical to drill for that barrel, while others are no longer economical."

Michael 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.

Mitchell Seider is a partner in Latham's New York office and global Co-chair of the Restructuring, Insolvency & Workouts Practice. He focuses his practice on business reorganizations and financial restructurings and regularly represents secured lenders, bond holders, creditors' committees and debtors in chapter 11 cases and workouts.

In this lw.com interview, Chambers and Seider explore the considerations lenders must weigh when extending financing to exploration and production (E&P) companies grappling with declining oil prices.

Where are the potential entry points in the capital structure for lenders and investors?

Chambers: With lower equity valuations, many companies are reluctant to issue additional equity and instead are considering additional secured debt issuances to provide near-term liquidity.

Seider: The amount of additional debt that can be raised, and whether that is secured or unsecured debt, will depend on an issuer's existing bond credit facility and bond covenants. In particular, a lot of companies, and their investors, are focused on the amount of additional secured debt that can be raised. Lenders offering credit to upstream companies that are having liquidity issues will want security for the new money to increase the likelihood of being repaid in the event of a bankruptcy filing. Potential lenders and investors must understand the covenants and what they allow — many investors in unsecured debt may find themselves primed by the issuance of additional secured debt.

Why is liquidity tightening for these types of upstream companies?

Chambers: Commodity prices for oil and natural gas have dropped more than 50 percent in the last six to seven months. And while many companies have been protected from this decline by commodity hedges that provide them a

fixed price, very few companies have 100 percent of their projected production hedged.

Seider: Also important is the availability under their revolving credit facilities, which provide the day-to-day working capital to fund operations. The amount of credit available to borrowers is dependent on the value of the company's oil and gas properties which in turn is calculated based on the price of oil. If oil drops 50 percent, you can be sure that a company's borrowing base will be reduced. Suddenly they have less revenue and less ability to borrow, but the costs have remained fixed.

Beyond asset values, what issues should investors focus on in extending credit?

Seider: Investors should consider the company's costs in getting the oil and gas out of the ground and to market. Unsecured investors in particular should focus on the priority of the claim relative to other creditors, keeping in mind the rights of vendors to place M&M liens on certain assets that may be pledged to support the credit.

Chambers: Investors should think specifically about the location and nature of a company's assets. The returns on wells in the Permian Basin of west Texas, for example, are still attractive even at today's prices. That is not the case everywhere.

What risks are investors taking in production payment, net profit interest and overriding royalty interest transactions?

Seider: When these types of interests are structured correctly, the party advancing the money is treated as a purchaser of the future production. If the borrower fails, the oil and gas subject to the production payment belongs solely to the investor and cannot be borrowed against or sold by the debtor. Other creditors of the borrower have enormous incentive to attack the transaction and have it characterized as a financing rather than a sale of assets. If an attack is successful, an investor may find themselves a creditor holding a secured claim against a debtor as opposed to holding what they thought was a separate property. That claim will be subject to treatment in a plan of reorganization.

How can stressed borrowers take advantage of hedges to improve liquidity?

Chambers: In the money hedges, that is, swap agreements where the counterparty is obligated to pay a higher price for the borrower's production than the current market price, is an asset that can be monetized. Companies can negotiate with their swap counterparty to unwind a hedge at a negotiated price that results in a present cash payment to the company in exchange for termination of the obligation to continue to make payments over the term of the swap agreement. And maybe you don't completely unwind them — companies can also negotiate to reset the swap price from $75 to $65, for example, which would enable realizing a portion of the market-to-market gain but retain some future price protection. Of course, unwinding hedges leaves a company exposed to the risk of further decline in commodity prices.

Seider: From the counterparty's perspective, the risk is that if it isn't willing to discuss unwinding commodity hedges, upon a bankruptcy filing the company can forcibly terminate the hedges. That would crystallize the positions of the parties to the hedge.

How should stressed borrowers engage with senior lenders and with their junior lenders to weather the current price environment until more favorable pricing prevails?

Seider: From my perspective as a bankruptcy lawyer, it's almost always beneficial for a company to begin discussions sooner rather than later when it expects that there is significant risk it may default or need additional liquidity. Knowing the preferences and goals of lenders is important. Traditional senior bank lenders may focus on avoiding default and be receptive to allowing the borrower some time as long as doing so does not impair their collateral value. Secondary debt purchasers and junior lenders may be more focused on time adjusted returns on their investments and may be interested in creating ownership opportunities at low valuations.

Why is Latham & Watkins uniquely positioned to work with distressed E&P companies?

Chambers: Latham is unique in that it has great depth and product expertise — some of the best finance, capital markets and restructuring lawyers in the country, as well as deep experience in the oil and gas industry. Companies and creditors will need both to navigate these waters.

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