The Outlook for Energy Prices

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Exploration and production (E&P) investors have been in for the ride of their lives since the precipitous decline in oil prices started in the summer of 2014. To be sure, oil is a cyclical commodity that has always required investors to have a strong stomach. As the story goes – “high prices cure high prices and low prices cure low prices”. Having said that, this price correction has always made me a bit more uncomfortable than usual. As a commodity strategist, one of the first things I strive for during market extremes is an analog. While history is not perfectly repeated, it certainly rhymes. However, we have never experienced a cycle in U.S. shale oil. In short, there is no analog. Forecasting cost deflation, rigs to production and, ultimately, price and supply has become very difficult.

Consequently, the fundamental opaqueness of this cycle, coupled with the level of industry leverage, has led to outsized concerns that a massive fiscal crisis in the E&P sector would lead to a balance sheet-driven supply shock. While these concerns have eased since the market rally, Brexit (and its consequential price carnage) will undoubtedly reignite this concern. This article addresses these concerns and concludes that overall liquidity available to U.S. oil and gas producers remains strong. When looked at holistically, the net flow of capital to the sector should prevent a liquidity-induced supply shock, even if we retest the lows as a result of Brexit.

- Projected liquidity outflow as a result of bankruptcies and reductions in commercial lines of credit is likely just shy of $60 billion.
- As of 1/1/2015, the realized inflow of liquidity via the equity market already stands at roughly $40 billion USD.
- A projected $100 billion in dedicated oil and gas private equity capital on the sidelines should ensure a net positive liquidity outlook for the industry until prices recover and cheaper forms of capital can be raised.
- The net positive liquidity outlook will ensure a slower, more moderate price recovery as capital will ultimately find its way beyond balance sheet repair to reserve and production growth.

Liquidity concerns will not portend a balance sheet-driven supply shock:

A bit on (the often-mentioned) bank E&P loans redeterminations……

Aside from the recent macro threat posed by Brexit, there has always been much speculation around the effect of redeterminations on E&P liquidity, solvency and, consequently, production in North America. While future redeterminations are sure to be more impactful due to relatively anemic hedge profiles, it should not be assumed that the outcome will be as cataclysmic as the market seems to expect. In fact, the mere assumption that redetermination outcomes are predictable should cause pause. Redeterminations are not nearly as programmatic or inflexible as perceived. The notion of a redetermination “season” is as misplaced as the notion that there is commonality in credit agreements. To be sure, collateral evaluations are not as static as April and October. In fact, most credit agreements allow lenders to evaluate collateral more than twice annually. Higher frequency collateral valuation over different time frames lends itself to less dramatic and more uniform reduction in capex. This intrinsically reduces the chance for a dramatic reduction in production at any specific time. It also eases producers into liquidity reduction as opposed to creating liquidity shocks.

Credit agreements are written to meet the specific profile of each borrower. Agreements can dictate spending caps on certain line items on the income statement and most certainly mandate specific hedging profiles based on the unique type curve characteristics of each producer. Unless there is a clear understanding of the specifics of each credit agreement, it is very difficult to determine the outcomes of future redeterminations other than to extrapolate from pending announcements. However, even this exercise is difficult given the aforementioned bespoke qualities of each lending relationship. Moreover, extrapolating upon redetermination results from 2015 can be equally misleading as hedge profiles were much different than they are today. While hedge books were considerably larger during the fall 2015 redetermination season, the forward curve has also rallied significantly. This is important to note as credit capacity can be as easily reinstated as it is taken away. Adding to the uncertainty is the fact that this is the first true economic cycle in the shale phenomenon. While it may be tempting to look to 2008 as an analog, we must remember that extreme fiscal and monetary measures were used to combat an unprecedented housing bubble. This event should not be confidently used to draw expectations around how this supply side price rout will play out.

However, there are other aspects of current market dynamics that can potentially assist in determining the likelihood of a liquidity induced supply shock**.** *First, we can stop trying to look at credit availability on a micro level (which may be impossible) and start to look at liquidity on a macro level. If we were to look at the overall, NET capital flow in the E&P sector we may be able to get a more accurate, predictable picture.*

Capital outflows

We can first start by looking at all possible capital outflows from the industry. Immediate liquidity reductions can come in two main forms – bankruptcy and reductions in commercial bank lines of credit.

Bankruptcy

Since the beginning of 2015, there have been over 60 U.S. bankruptcies announced with obligations at risk totaling over 40 billion USD. The question then becomes – what is the likely outcome of these filings on future liquidity and capex? A key to answering this question is to understand the role or private equity/alternative funding players during bankruptcy, both as incumbent and new credit providers.

I believe that there is an incredible amount of incumbent private equity capital available to prepackage and pre negotiate reorganization plans that will more than likely swap debt for larger equity interests and even potentially inject more capital to take advantage of lower valuations. Incumbent alternative investors are likely to invest more for a larger equity interest at a lower valuation than abandon the investment for pennies on the dollar. In addition, new private equity capital will unquestionably enter the market at the most distressed levels to take advantage of the funding needs of companies that are unable to get more capital from banks. Alternative investors are in business to operate when traditional forms of credit are unavailable. They can demand better terms precisely because they are the only show in town, notwithstanding the fact that yield in other asset classes are paltry compared to the likely view that they are buying assets at the low end of the cycle. For example, take the case of Samson Resources. Samson filed for Chapter 11 protection in September 2015. Samson will continue operations because it is going to offer up equity in a restructured company to PE firms Silver Point Capital, Anschutz Investment Co, and Cerberus in exchange for debt absolution. Moreover, these PE firms have also offered to recapitalize the company with over $400 million in fresh loans.

There will be more than enough capital available to recapitalize a large percentage of bankrupt producers. In fact, the real issue for private equity is the competition they are seeing in their own industry to find and compete on deals.

Based on reviewing several private deals and having detailed conversations with large private equity sponsors, I believe that the actual capital at risk from bankruptcies will be closer to 20 billion when all is said and done. Even though private equity sponsorship has been relatively muted thus far, it should be highlighted that bankruptcies have not had a material impact on U.S. production. The company's filing are simply not volumetrically significant. Moreover, bankruptcy protection has enabled producers to focus and maintain profitable assets resulting in continued production.

*Filings since the second half of 2015 in excess of 250 mln in liabilities

E&P	Bankruptcy Date	Assets	Liabilities	Exit Date
Venoco Inc	3/18/2016	NA	962.10 M	
New Gulf Resources LLC	12/17/2015	25.7 M	576.34 M	
Goodrich Petroleum Corp	4/15/2016	98.97 M	507.06 M	
Samson Resources Corp	9/16/2015	4.25 B	4.33 B	
Ultra Petroleum Corp	4/29/2016	1.28 B	3.92 B	
Energy XXI LTD	4/14/2016	1.76 B	3.62 B	
Sabine Oil and Gas Corp	7/15/2015	2.48 B	2.91 B	
Midstates Petroleum Company	4/30/2016	679.17 M	2.01 B	
Swift energy Inc	12/31/2015	1.02 B	1.35 B	4/22/2016
Energy and Exploration Partner	12/7/2015	222.74 M	1.19 B	
Magnum Hunter Resources Corp	12/15/2015	1.46 B	1.12 B	
Milagro Oil and Gas Inc.	7/15/2015	NA	1.07 B	10/30/2015
Total Liabilities			**23.57 B**	

Reductions in commercial bank lines of credit

The next form of immediate liquidity reduction can come in the form of bank credit lines.

When discussing total liquidity to the U.S. oil and gas sector it is important to differentiate between the type and nature of liquidity. Effectively, traditional liquidity comes in the following forms:

Traditional revolving lines of credit: these lines of credit are usually 3 to 5 years in duration and do not have a first lien on assets. Revolvers are covenant light and typically tied to financial ratios. These lines are not subject to redeterminations and are typically extended to larger, investment grade names.

Borrowing base / asset-backed loans: the notional value of these loans are based on some haircut to the expected value of production. In these facilities, the lender has a first lien position against production upon breach of covenants. The term of these loans is typically based on the unique production profile of the borrower, but the average is roughly 5 to 7 years in duration.

It should be noted that for the aforementioned credit lines there is “drawn” and “undrawn” exposure. For example, an E&P can have total credit capacity with a lender of $50 million but only be utilizing $15 million, leaving $35 million “undrawn.” As long as there have been no triggers of default or breach of covenant, the undrawn credit is available at the E&P’s beckon call. Producers facing poor credit conditions usually draw upon all lines of credit before a breach of covenant is realized. In fact, sharp increases in credit utilization tend to foreshadow dire credit conditions.

Here is a snapshot of credit line exposure among the top U.S. commercial banks in the E&P space (in billions):

	Drawn	Undrawn
Comerica Bank	30.0	20.0
Bank of America	13.3	22.5
JP Morgan	13.4	28.8
Wells Fargo	17.4	24.6
Citibank	20.5	37.5
Total	**94.6**	**133.4**

Total drawn and undrawn credit line exposure

at the top U.S. commercial banks $228 billion

Here is an estimate of small lenders in the space, which include investment banks and large regional banks:

	Drawn	Undrawn
Morgan Stanley	4.8	10.6
PNC Bank	2.6	5.7
US Bancorp	3.1	6.8
Goldman Sachs	2.1	8.8 (estimate)
SunTrust	.98	1.7
Fifth Third Bank	.85	.85 (estimate)
Total	**14.4**	**34.4**

Total drawn and undrawn credit line exposure

at top Investment and regional banks $48.8 billion

Please note that there are several other regional banks and boutique investment banks that lend into the oil and gas sector. However, their numbers are relatively small. A decent assumption is that the smaller players would perhaps add an incremental $10 billion to the U.S. total.

Total estimated U.S. financial institution credit line exposure $286.8 billion

It should be noted that oil and gas credit line exposure only represents, at most, 5% of U.S. banks total loan exposure. The chances of a systemic bank-centric crisis due to oil and gas loans is negligible, particularly given the increases in reserve requirements against these loans mandated by the Fed as oil prices collapsed. Having said that, listed below are the banks that have the highest concentration of oil and gas specific loans as a percentage of their overall portfolios. As imagined, the equity markets have not been kind on a relative basis to these names as crude prices hit bottom:

Energy Loans as a % of all loans:

MidSouth Bancorp	20.5%
Green Bancorp	19%
BOK Financial	18.5%
Cullen/Frost Bankers	14.9%
Hancock Holding	13%
Comercica Bank	7%

Theoretically, a lender can cut availability of undrawn credit and also demand a portion of drawn lines back if the collateral value were to fall low enough to warrant a deep capital call. *If there was ever a risk to bankruptcy rates exploding it is the risk of banks asking producers for a check on cash that they have already spent. It is one thing to cut unused credit lines but quite another to ask a company for cash while it is teetering on the edge of bankruptcy.*

It is safe to say that if banks start demanding cash be returned they are effectively forcing a company into bankruptcy. In this scenario, lenders deem the situation hopeless and exercising a first lien position on assets is the only recourse. As logical or illogical this action may seem, I still view this scenario as both rare an uneventful to the overall production profile. Companies that are in this kind of trouble – zero access to capital, poor acreage and limited cost cutting ability - are generally limited and volumetrically insignificant. Consequently, if we are concerned with redeterminations and the effect on liquidity, *then we need look no further than estimating the degree to which credit is reduced on the undrawn portion of credit lines. Specifically, we need to look at undrawn credit on ABL specific lines, as producers being lent money based on revolving lines of credit have access to capital at still reasonable costs.*

ABL facilities as a % of a banks overall lending portfolio are generally around 30%. This would theoretically equate to total liquidity at risk of being pulled from the ABL space at roughly $52 billion USD. However, that implies ALL undrawn credit being pulled, which will simply not happen. I believe that a conservative estimate of ABL liquidity at risk is 40%, or roughly $20 billion. I base this on public comments made by producers themselves going into upcoming redeterminations and the max reductions realized last fall with names that had hedge profiles as low as they are in the overall universe now. *Therefore, a decent assumption is that the ABL space will lose roughly $20 billion USD in liquidity throughout into the next redetermination season* - barring another collapse in deferred pricing to the lows.

The grand total of imminent liquidity at risk between bankruptcies and reduction in bank credit is $60 billion – $40 billion bankruptcy related and $20 billion bank line related.

Capital Inflows

An accommodative equity market: ADDED LIQUIDITY – roughly $40 Billion USD:

Now we must assess capital entering the space in order to get a *NET* liquidity picture. In this case we must start with the success of secondary share offerings. *Since 1/1/2015, the E&P sector has successfully raised close to $40 billion of the cheapest and most efficient form of capital available – public equity.* In essence, banks and rating agencies have encouraged oil and gas companies to transfer a portion of their balance sheet risk to the Institutional and retail investor base in order to reduce debt, retain reasonable cost of capital and even grow select production to ensure debt service. Market appetite for these offerings has remained strong. The majority of deals have been well subscribed and have performed reasonably well post offering. Despite the fact that existing investors have been diluted (as much as 15% in some cases), there seems to be enough positive sentiment that the worst is behind the E&P space and that raising capital at these price levels is a long term positive.

The relative success of secondary offerings is a game changer. Not only does this cheap source of capital allow for the reduction of debt but it starts to position the strong hands to be able to capitalize on acquiring cheap assets. Moreover, some companies will be able to develop their best reserves while they still maintain cost leverage over oil service companies. The magnitude and success of recent equity market liquidity is more than a life line, it is a free option on future reserve and production growth. Even with investor motivation changing from pure upside oil exposure to a more return driven mindset it suits producers well to capitalize on raising free equity now as a means to ride the cycle and focus on return driven metrics.

Alternative finance: Potential liquidity – $100 billion

Industry estimates put private equity capital for allocation to the oil and gas space at over $100 billion. Private equity will generally continue to serve their traditional function in the current environment. Specifically, alternative funds will finance distressed situations with first lien advantage and, to a lesser extent, provide traditional credit lines to poorly rated producers at attractive risk adjusted rates. Activity in private equity sponsorship picks up after bankruptcy filings, when debt is wiped out and fields become very cheap. In this scenario, the price of oil or gas required for profitable ongoing operations is lower than prevailing prices. While the specific role of PE firms will remain the same, it is likely that the frequency of their participation will increase as/if bankruptcies increase and as traditional lending institutions focus on higher credit quality players and more stringent reserve requirements.

Conclusion

While a positive net liquidity picture greatly negates the probability of a balance sheet-driven supply shock, it does reinforce the reality that a pronounced price rally is unlikely in the medium term. Ultimately, as liquidity flows from balance sheet repair to reserve and production growth, prices will reset within slowly escalating ranges, rather than develop a distinct trend higher. Early 2000s like "super cycles" are only possible if outsized demand takes root. Prior to Brexit, a more moderate demand profile began to clear a path towards market rebalancing starting in Q3 of this year. Only time will tell if Brexit materially derails that time frame.

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