Has Another Energy Bust Begun?

Probably Not, But It's Worth a Discussion

By Michael Eisenband

It was exactly four years ago this month that OPEC surprised global energy markets by announcing it would end its long standing role as a swing producer of crude oil, a role that supported oil prices in periods of oversupply. This announcement set off a collapse of global oil prices, with WTI crude oil plunging 52% in just six months, from $105 per barrel in mid-2014 to $50 by January 2015, before ultimately bottoming near $30 in early 2016. OPEC's purported intention was to hit American shale oil producers, whose vast production of oil from unconventional fields had become a contributing factor to global oversupply.

Shale oil is more expensive to develop than crude from conventional sources, while the production profile of these wells is typically more front loaded and short lived, so U.S. shale oil producers, who increased leverage during the period of higher commodity prices and capital availability, were not prepared for the rapid price decline. The ensuing two-year period of depressed energy prices hit U.S. producers hard, with some 225 energy-related Chapter 11 filings in 2015-2016, not to mention dozens of out-of-court workouts. It was the worst rout of the U.S. energy sector since the mid-1980s.

The financial restructuring of an over-leveraged energy sector combined with a reduction in drilling and operating costs and a rebound in oil prices resulting from global economic growth helped put this painful episode in the rearview mirror by mid-to-late 2017 — or so the storyline goes. In reality, the energy bust of 2015-2017 was never entirely resolved, even as WTI oil prices briefly topped $70 in mid-2018. There is now mounting evidence that a new round of energy-related busts is upon us — just when you thought it was safe to drill again. How did this happen?

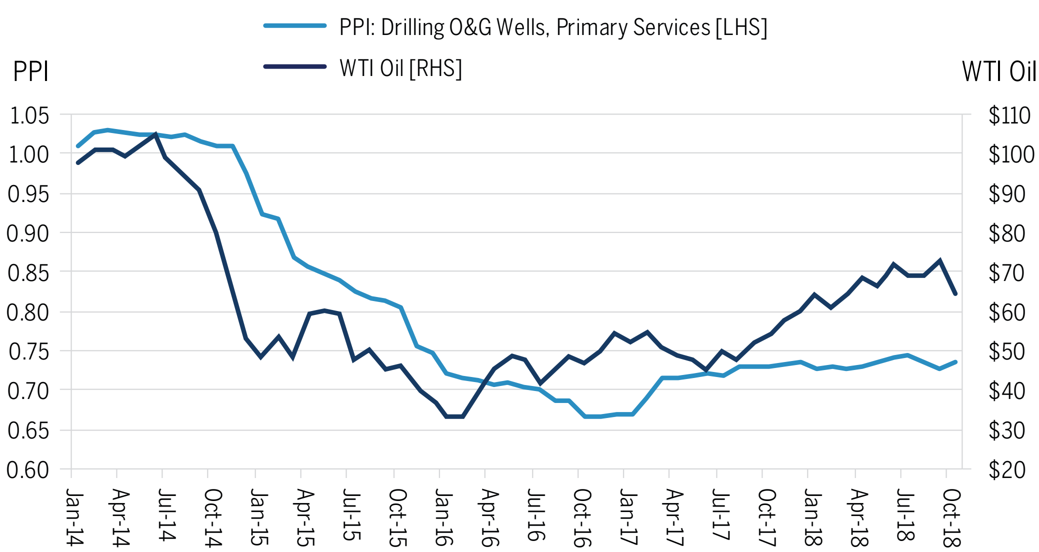
For starters, there is a general misconception that the energy bust of 2015-2017 had been worked through by the time that global oil prices began to rally in late 2017. In fact, a sizeable reservoir of business challenges remained in place long after the worst of the downturn passed. The default rate in the U.S. energy sector declined significantly from its worst level of 26.5% in mid-2016, but at 9% currently, it is triple the corporate default rate. Similarly, the distressed debt ratio for the energy sector remains elevated and is persistently higher than the overall distress ratio; it currently hovers near a double-digit rate. The energy sector led all industry sectors in bankruptcy filings in 2017 and trails only retail/restaurants so far in 2018. These are not indicators of an industry that has fully recovered. Yes, the U.S. energy sector averted a total collapse that OPEC may have intended and it has come a long way back from the precipice, but the industry has remained fertile ground for restructurings even with drilling activity having more than doubled since mid-2016.

Lingering distress in the oil patch is largely attributable to the way in which U.S. energy producers addressed their crisis — by passing on much of their pain to the oilfield services sector ("OFS") — the myriad firms that drill, complete and maintain their wells. We hear much about the efficiencies achieved by U.S. producers in lowering breakeven costs for shale oil to the mid-$40 range — an impressive accomplishment for sure. Some of these measures are genuinely innovative, such as more intense pad drilling, longer laterals and more targeted well fracking. But the bulk of these efficiencies came from squeezing hard on OFS firms by negotiating steeply lower prices from suppliers of nearly every oilfield service, from day rates for drilling rigs to fracking sand and everything in between. Key industry activity metrics, such as rig count and well completions, plummeted as prices fell, capital availability disappeared, and capital expenditure budgets were slashed. OFS companies were forced to accept pricing concessions to maintain market share, keep experienced crews employed and maintain equipment utilization. Without these concessions, drilling activity would not have recovered to the degree it has. Moreover, there has been a notable increase in drilled-but-uncompleted ("DUCS") wells in and around the Permian basin due to pipeline constraints in that region which won't be resolved until mid-to-late 2019, thereby postponing affected completion activities for many months. Despite a robust response by OFS firms, including tens of thousands of layoffs in the midst of the crisis, many OFS providers remain barely profitable (or worse) and have been unable to raise prices much above levels at the nadir of the crisis.

Incredibly, the Producer Price Index ("PPI") for oil and gas services, a measure of inflation/deflation for the OFS sector, remains nearly 30% below levels of early 2014, just a slight improvement from late-2016 when OFS prices fell, on average, by one-third (**Exhibit 1**). For energy producers intent on lowering costs further, there isn't much more blood to get from this stone.

EXHIBIT 1

O&G Producer Price Index (PPI) vs. WTI Oil

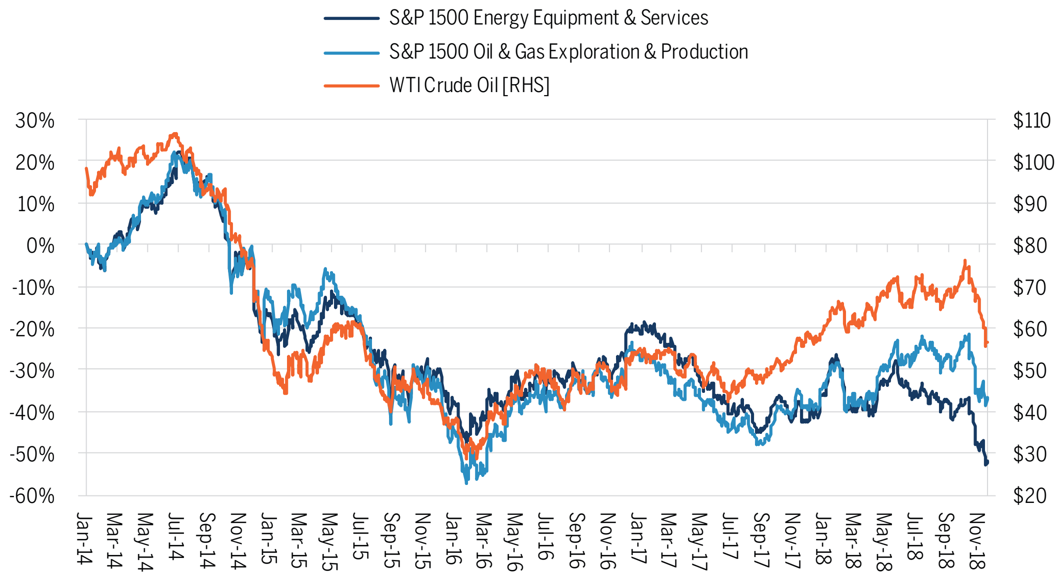


Source: Bureau of Labor Statistics and S&P Capital IQ

Talk of another energy bust may seem speculative or premature, but consider this: the S&P 1500 Energy Equipment & Services Index is lower today than it was at the depth of the previous downturn in early 2016 (**Exhibit 2**). Furthermore, the two primary S&P 1500 Energy Indexes (E&P and OFS), which had moved in near lockstep since 2014, have decoupled to some degree of late, reflecting the particular challenges for OFS in the current environment.

EXHIBIT 2

S&P 1500 Energy Index Returns Since Jan. 2014



Source: S&P Capital IQ

The sudden pullback in global oil prices since September, which technically qualifies as a bear market downturn, is unfortunate timing, as many E&P companies finalize capital expenditure budgets for 2019. With the focus on capital discipline and price volatility, many companies may become cautious regarding committed drilling budgets for next year, which presents certain other challenges for E&P companies. A reduction in capital expenditures could result in reduced future cash flows, reserve depletion and negative market reaction — not to mention the knock-on effect for OFS companies.

There is no consensus that another energy bust lies in wait, despite a 25% correction in oil prices and a recent uptick in energy-related bankruptcy filings. Many energy analysts believe there are specific factors behind the latest drop in oil prices that will subside, mostly related to the Trump administration's recent six-month waiver of sanctions on oil imports from Iran granted to eight countries that are large buyers of Iranian crude. Global oil markets were not expecting this reprieve and Middle East producers were geared up to offset the 1+ million barrel per day supply loss that has now been pushed out to May 2019, thereby creating oversupply conditions at the moment.

We dare not predict where oil prices will go in 2019; there are too many variables at play, including an expected slowdown in global economic growth. Although, if WTI crude cannot sustain $50, then there will certainly be more energy-related casualties and increasing chatter of another down cycle. It could get ugly again.

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