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Another Energy Bust? Nope, It's the Same One



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It was three years ago that the price of West Texas Intermediate (WTI) oil bottomed out near \$26 per barrel amid what turned out to be the worst rout of the U.S. energy sector since the mid-1980s. This three-year period of depressed energy prices hit hard, with some 300 energy-related chapter 11 filings in 2015-17, according to data from Haynes and Boone LLP, not to mention dozens of out-of-court workouts. Thankfully, that painful episode is behind us, right? Not quite. With U.S. oil production soaring to an all-time high of 11.6 million barrels per day and WTI crude unexpectedly plunging below \$50 in December to its lowest closing price since mid-2017 (when it was headed in the other direction), it is time to consider whether another energy downturn has begun — or resumed.

How Did We Get Here?

The initial slump in energy prices began in late 2014 when the Organization of Petroleum Exporting Countries (OPEC) surprised global energy markets by announcing that 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 news set off a collapse of global oil prices, with WTI crude oil plunging 52 percent in just six months, from \$105 per barrel in mid-2014 to \$50 by January 2015, before bottoming out in February 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. U.S. production of shale oil and other tight oil has nearly doubled since early 2014 and soon will account for 8 million bar-

rels per day of supply. However, tight oil is more expensive to develop than crude oil from conventional sources, while the production profile of these wells is typically more front-loaded and short-lived, so independent shale oil producers, who significantly increased leverage in 2011-14 when oil prices were high and capital was abundant, were not prepared for the rapid price decline. Many upstream exploration and production companies (E&Ps) saw leverage quickly climb in excess of 4x EBITDAX as operating earnings fell sharply with lower oil prices. Furthermore, borrowing base redeterminations by lenders reduced access to liquidity at the worst possible moment. Consequently, the active U.S. drilling rig count fell by 80 percent between late 2014 and mid-2016. Nearly 46 percent of the 300 energy-related chapter 11 filings noted earlier were E&Ps, while 54 percent were oilfield service (OFS) providers.

The ensuing financial restructuring and deleveraging of the energy sector since 2015 — combined with a reduction in drilling and operating costs and a rebound in oil prices from cyclical lows as global economic growth accelerated — helped to revive the U.S. energy sector by mid-to-late 2017 — or so the storyline goes. In reality, the energy bust of 2015-17 was never entirely resolved, even as WTI oil prices briefly topped \$70 in mid-2018. There is now mounting evidence that another 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 2015-17 had been worked through by the time that global oil prices began to rally in 2017. In fact, a sizeable reservoir of business challenges remained in place long after the worst of the downturn had passed. The default rate in the U.S. energy sector declined significantly from its worst level of 26 percent in mid-2016, but

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recently at 9 percent (as shown in Exhibit 1) it is still triple the corporate default rate. Similarly, the distressed-debt ratio for the energy sector remains elevated and persistently higher than the overall distress ratio; it now hovers at a low double-digit rate.

The energy sector led all industry sectors in bankruptcy filings in 2017 and trailed only retail/restaurants in 2018. These are not indicators of an industry that has recovered. The U.S. energy sector may have averted the total collapse that OPEC intended (and it has come a long way back from the edge of the precipice), but the industry has remained fertile ground for restructurings and workouts, 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. To be sure, much has been said about the efficiencies achieved by U.S. producers in lowering break-even costs for shale oil to the mid-\$40 range, which is an impressive accomplishment. Some of these efficiency measures are genuinely innovative, such as more intense pad drilling, longer laterals and more targeted well fracking. The prevalence of pad drilling in particular has reduced rig activity and some related services associated with traditional drilling.

However, the bulk of E&P efficiencies has come from squeezing hard on OFS firms (the firms that drill, complete and maintain the wells) by negotiating steeply lower prices from suppliers of nearly every OFS, from day rates for drilling rigs to fracking sand and everything in between. As key industry activity metrics, such as rig count and well completions, plummeted in 2015-16 when oil prices fell and capital availability dried up, OFS companies had little choice but to accept severe pricing concessions in order to hold market share, keep experienced crews employed and maintain

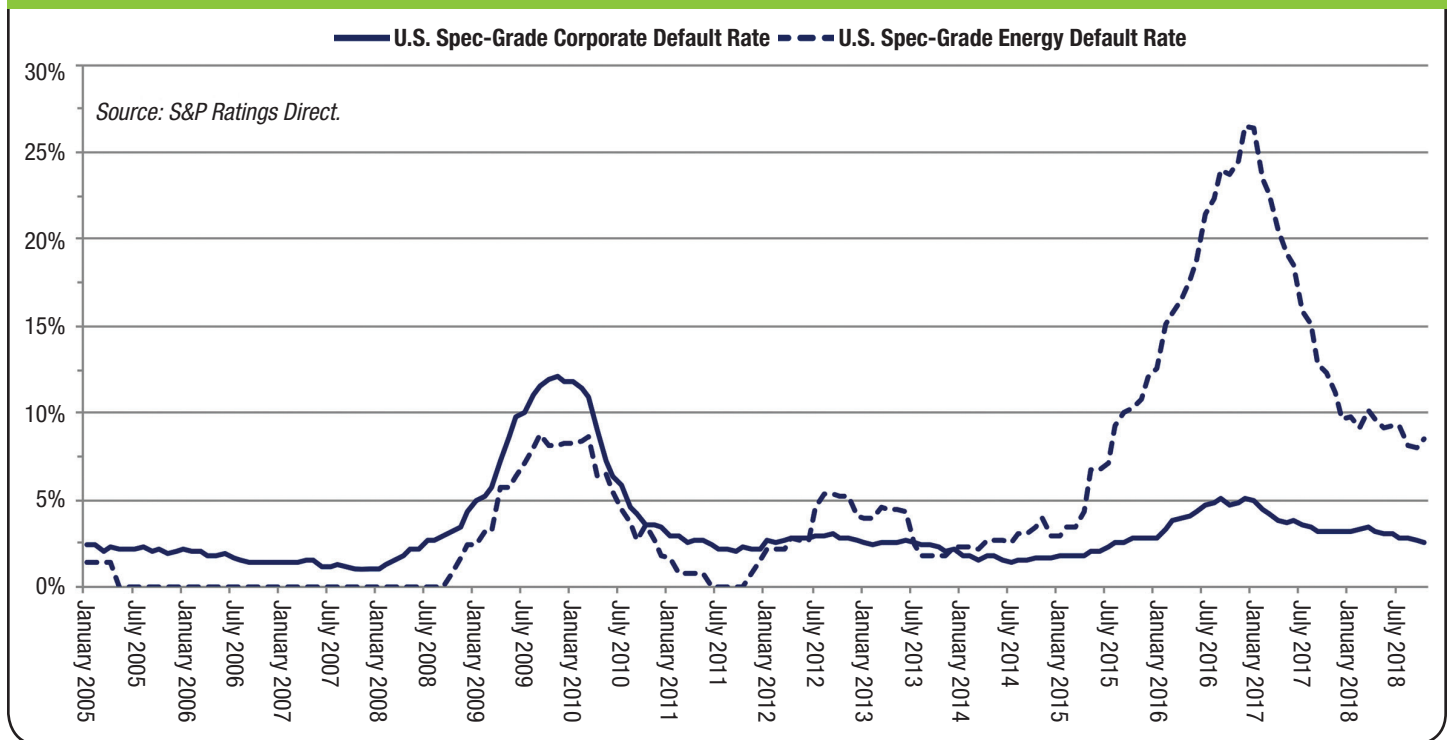
equipment utilization. Without these concessions by the OFS firms, drilling activity would not have recovered to the degree it did. Moreover, there has been a notable increase in drilled-but-uncompleted (DUC) wells in and around the Permian basin due to pipeline constraints in that region that will not be resolved until mid- to late 2019, thereby postponing completion activities for many months.

Despite a robust response by OFS firms during the crisis, including tens of thousands of layoffs, many OFS providers remain barely profitable (or worse) today and have been unable to raise prices or exert pricing power much above levels at the lowest point 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 percent below levels of early 2014, just a slight improvement from late 2016, when OFS prices fell on average by one-third. Price competition among OFS firms remains fierce as providers vie to stay busy in an oversupplied market for their services.

For energy producers intent on lowering their costs further, there is not much more blood to get from the stone. In December, Parker Drilling Co., a venerable provider of contract drilling and other drilling services for more than 80 years and an NYSE-listed stock since 1975, filed for chapter 11 protection, stating that it had “been unable to sustain pricing and margins for its services.” This was an understatement, with its revenues and EBITDA margins each cut by one-half in 2017-18 compared to 2013-14. Parker Drilling is hardly alone. Some 85 OFS firms have seen EBITDA margins stuck in the mid-to-high teens compared to a mid-20s range prior to 2015. In contrast, E&Ps have come closer to reclaiming their pre-2015 operating margins since 2017.

While talk of a new or renewed energy bust might seem speculative or premature, consider this: The S&P

Exhibit 1: U.S. Speculative-Grade Default Rate (Non-Financial Corporates vs. Energy)



1500 Energy Equipment and Services Index currently is lower than it was at the depth of the previous downturn in early 2016 (see Exhibit 2). Furthermore, the two primary S&P 1500 Energy Indexes (E&P and OES), which had moved in near lockstep since 2014, have now decoupled — reflecting the uniquely daunting challenges for OES in the current environment.

The sudden and sharp pullback in global oil prices since September 2018, which qualifies as a bear market downturn, was unfortunately timed, as many E&P companies were finalizing their capital-expenditure budgets for the upcoming year. With the focus now on capital discipline and price volatility, many E&Ps have become cautious regarding committed drilling budgets for 2019, which presents certain challenges for the sector. A reduction in capital expenditures would result in slower reserve replacement and faster depletion of the reserve base, reduced future cash flows, and negative market reaction for E&Ps — not to mention the negative repercussions for the OES sector.

Another Round of Energy Restructurings Would Play Out Differently

If indeed oil prices slump below \$50 for any prolonged period, there are some likely restructuring outcomes that will differ distinctly from the first go-around.

RSAs and Preliminary Reorganization Plans for Energy-Related Cases Might Be Revisited and Revised to the Detriment of Junior Creditors

Many energy companies that filed for chapter 11 in 2016-17, particularly E&Ps, ultimately benefited from recovering oil prices during the pendency of their cases. As WTI prices began to recover after mid-2016, estimated

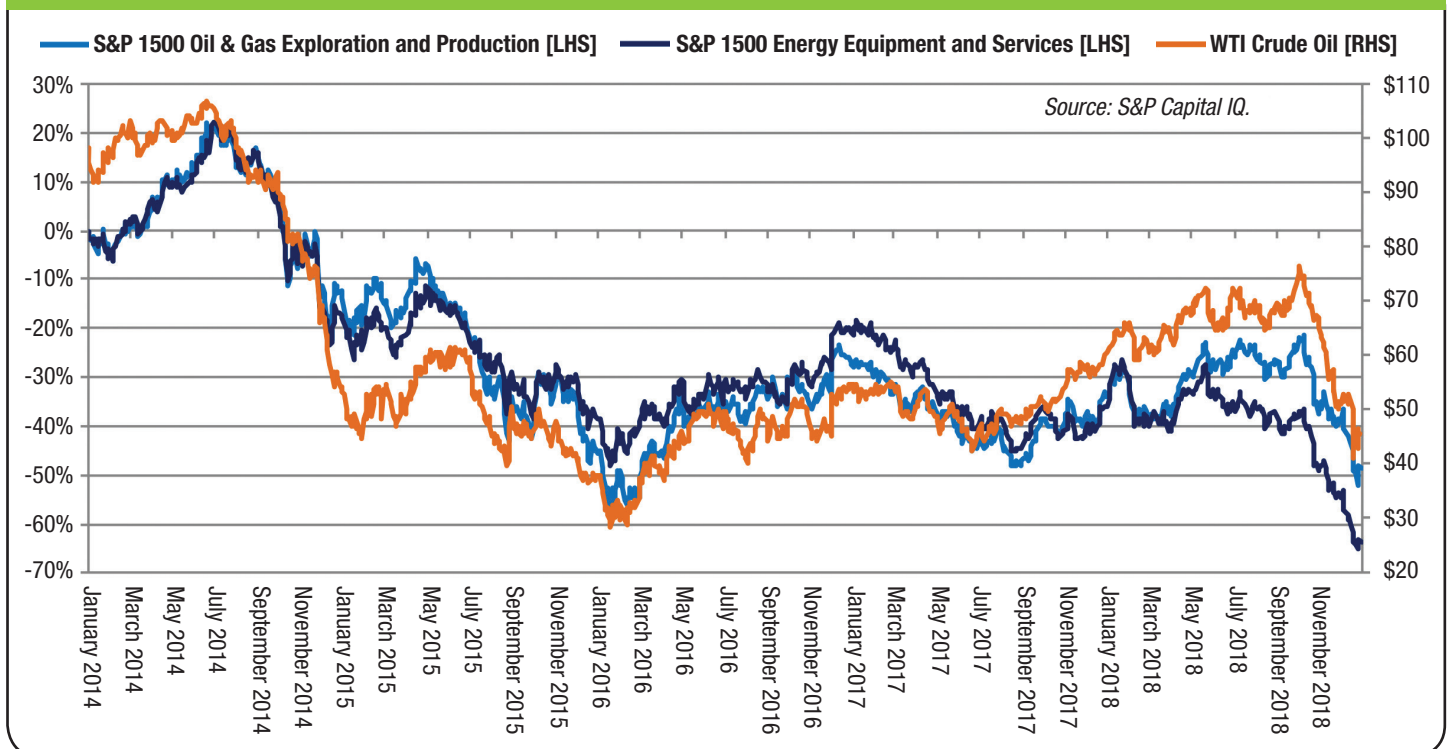
enterprise values of some reorganizing debtors were revised upward; consequently, recoveries for creditors improved, some materially, compared to security market prices shortly after filing. In some instances, equityholders petitioned the court for official committee status in mid-case as the prospect of a meaningful recovery for the equity class became defensible. This could play out in reverse for some of the 55 energy companies that were already in the midst of chapter 11 prior to October 2018 should oil prices remain depressed, especially those debtors with RSA or reorganization plans with estimated creditor recoveries predicated on \$60-plus WTI prices.

Ongoing negotiations with debtors and among credit groups could turn contentious, and some RSAs might unravel under such a scenario, derailing prior efforts to have a pre-negotiated filing quickly navigate its way through reorganization. Valuation fights could become intractable as ranges of value-estimation grow farther apart.

Fewer Standalone Reorganizations, and More Distressed M&A Deals or Liquidation Outcomes

The OES sector is especially vulnerable to this scenario, as many struggling OES firms are modestly leveraged but operationally break-even or unprofitable, with little room to cut costs further. Many would not benefit sufficiently from a financial restructuring if operational profitability remains elusive or distant. Under these conditions, debtor-in-possession (DIP) financing could be problematic except to get a debtor through a quick sale or asset-liquidation process. Large global OES firms would likely be acquirers of OES-related assets at sizeable discounts to replacement cost. Some superfluous OES assets would be scrapped. The bottom line is this: Further industry consolidation in the OES sector would be inevitable, and small-to-mid-size OES providers would be front-line casualties.

Exhibit 2: S&P 1500 Energy Index Returns vs. WTI Crude



Independent E&Ps Will Have to Curb Fixations with Growing Reserves

“Drill, baby, drill” has been the mantra of most independent E&Ps in shale oil regions, even as the price of WTI whipsaws. Shale oil wells can be drilled fairly quickly and produce sizeable cash-flow returns in their first few years, so E&Ps have continued to acquire acreage and drill intensely even as oil prices vacillate. Drilling in the Permian Basin, a major shale oil play, now accounts for 46 percent of all U.S. drilling rig activity, compared to 29 percent at the end of 2014. Should an energy slump persist, independent E&Ps will not be able to squeeze service providers as they did previously and might finally be forced to curb their ambitious drilling and investment activities and focus more intently on liquidity, debt-reduction and cash-preservation. Private capital, currently a huge source of investment in the shale play, might be curtailed or sidelined if low oil prices and high volatility persist.

Greater Participation by “the Majors” in M&A Deals for Shale Assets and Acreage

From its inception, the shale oil boom has been led by independent E&P companies, many privately owned or financed. The global majors in energy were late to this party but are determined to get into the game in a big way. Should the independents face another round of restructuring activity, global majors will be poised to swoop in and acquire producing properties and acreage, outbidding distressed investors and private equity for these assets while increasing their exposure to coveted shale regions. The sheer size of the majors, coupled with the added efficiencies they potentially bring to these plays, make them less sensitive to a weak pricing environment than the independents.

Conclusion

There is no consensus yet that a prolonged energy slump will prevail in 2019 despite a 33 percent correction in oil prices to date and a recent uptick in energy-related bankruptcy filings. Some energy analysts believe that there are specific mitigating factors behind the latest drop in oil prices that will subside, mostly related to the Trump administration’s 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 more than 1 million barrel-per-day supply loss that has been pushed out to May 2019, thereby creating temporary oversupply conditions. However, increasing investor worries of a global growth slowdown or recession also have contributed to concerns of an oversupplied oil market and falling prices. Such a scenario is less transient and more worrisome.

We dare not predict where oil prices will go in 2019; there are too many variables at work, including an expected slowdown in global economic growth. If WTI crude prices cannot at least reclaim and hold \$50 per barrel, then there will certainly be an acceleration of energy-related bankruptcy filings, perhaps setting off the next leg down in this cycle. It

could get ugly again, but much will depend on the severity of an expected global slowdown and other variables outside the control of the energy sector. That is the unenviable reality of being a price-taker. **abi**

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