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Drilling down:
The state of distressed debt and bankruptcies in US oil & gas

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As we enter 2018, we look back on a year that saw a slowing in the wave of exploration and production bankruptcy filings, while the expected increase in mid-stream filings never quite came to fruition. We ask a panel of experts what they think this coming year holds for the distressed oil & gas space.

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Debtwire: September and October 2017 saw a number of bankruptcy filings in the offshore space, including by Pacific Drilling and Seadrill. What are the biggest pressures currently facing the segment that are driving these bankruptcies? Do you see additional offshore companies filing for bankruptcy or restructuring their balance sheets in the coming months?

Emanuel Grillo: It's all about pricing in oil and gas, and the problem with offshore is that it's more expensive than the fracking that's taking place in the Permian and elsewhere. As long as the cost structure is higher and prices are below the break-even point, you're going to have a mismatch and you're going to have a problem, unless prices continue to rise.

Josh Friedman: One interesting thing I've been seeing with the offshore companies is that they've been de-leveraging to a much smaller degree than the E&Ps. Seadrill, Ocean Rig, and Pacific Drilling are not cleaning up their balance sheets completely – they're leaving a lot of debt outstanding, often collateralized by specific ships. I'd be interested to see in the future whether any of these come back and we have "Chapter 22" filings for any of these larger companies, or if the impact leads to other big deals down the pike.

On the flip side, all the filings we've been seeing with offshore have been Chapter 11s, except for Ocean Rig. And in Ocean Rig, you got to see some of the benefits of finding a favorable jurisdiction, limiting the avenues in which junior creditors can litigate their claims.

Emanuel Grillo: Right, they used the jurisdictional opportunity they had to create some uncertainty, which gave them leverage in a negotiation. At the end of the day, those negotiations are all about predictability, and to the extent that you can offer some uncertainty, you can increase your leverage.

Paul Jansen: I think there are two main pressure points that are impacting the offshore drillers. One is that there is significant overcapacity of rigs. If you look at the current data, rig utilization is about a third of what it was at the peak levels. Simple math indicates that about two-thirds of rigs are on the sideline not being deployed at this point.

The other issue is that a number of offshore E&P companies filed for bankruptcy starting in 2015 and subsequently rejected their drilling contracts with companies such as Seadrill and Pacific Drilling. Those offshore drillers experienced depressed cash inflows because the E&P companies cancelled contracts with them as part of the bankruptcy process. However, the offshore drillers still had the obligation to take delivery of vessels that were no longer under contract. Both Seadrill and Pacific Drilling had contract rejections claims in the hundreds of millions of dollars when they filed for Chapter 11.

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Debtwire: There seems to be a trend of consolidation developing in the O&G space, as some companies that have emerged from bankruptcy with reduced balance sheets prove to be appealing targets. Do you expect more tie-ups in 2018 among distressed companies?

Emanuel Grillo: If there's still an ounce of leverage out there, then yes, I think you're going to see some more of these tie-ups. There are people that have been holding out until now, and the question is whether the knife has stopped falling or the market can rebound enough to save them. As much leverage as there was out there, I find it hard to believe that we're done, and I'm also not sure how appealing these targets will be once de-leveraged. It depends on what your prognosis is for the marketplace.

Josh Friedman: If you look at the current environment, some investors have a lot of clean balance sheet E&P companies, but the price of oil is staying flat and they need it to go up to get the returns they're looking for. One way in which companies might look to speed up their returns or improve matters is to consolidate. We've seen some initial headway in this direction already, with a now-aborted merger of SandRidge and Bonanza Creek. With certain distressed investors either looking to consolidate or to get out of some of these investments, this might be one of their means of exit, instead of holding on long-term and perhaps needing to inject new money to keep drilling.

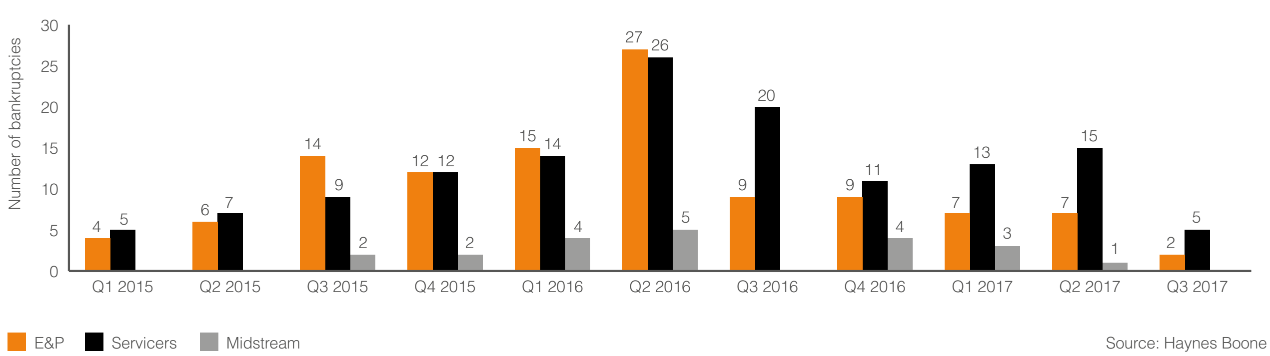
Paul Jansen: After the wave of filings that started in 2015, investors really wanted to see E&P companies focus on one or just a few main things and moved away from investing in diversified E&P companies. Investors are able to diversify themselves, similar to what occurred a number of years ago when integrated oil and gas companies, such as Marathon and Conoco, spun off the midstream and downstream sectors due to discounted investors' valuations. You now see a number of E&P companies, especially the ones that restructured, that are divesting their non-core assets and focusing their operations and asset base more narrowly.

Just in December, Linn Energy announced that it's splitting the company into three pieces, with the goal to be very focused. They announced that they will have a SCOOP-STACK entity, an entity holding the Oklahoma pipelines, and then a third entity that basically owns the remaining assets. This new structure makes it easier for investors to invest more specifically in those assets that they want to invest in. By being that focused, I think the size of the company is going down, which makes a merger of companies with the same asset focus more likely and increases the opportunity for synergies.

Debtwire: Rights offerings have become a popular financing option for distressed O&G and energy companies, with more than US$4.5bn in such restructuring deals over the past two years, according to Debtwire's recent Rights Offering Report. Do you think this strategy is here to stay? What do you see as the lessons learned for investors and operators in the energy space?

Josh Friedman: I think the rights offering has been a boon over the last two years as investors look to invest at a discount and back-stop rights offerings that allow them to have greater control of the companies upon emergence. So far, much of the reorganized equity of O&G companies has traded down after emergence. I know we've looked at many of the larger companies that have emerged in this recent wave and the initial results have

Number of US oil & gas bankruptcies by quarter, 2015 - Q3 2017



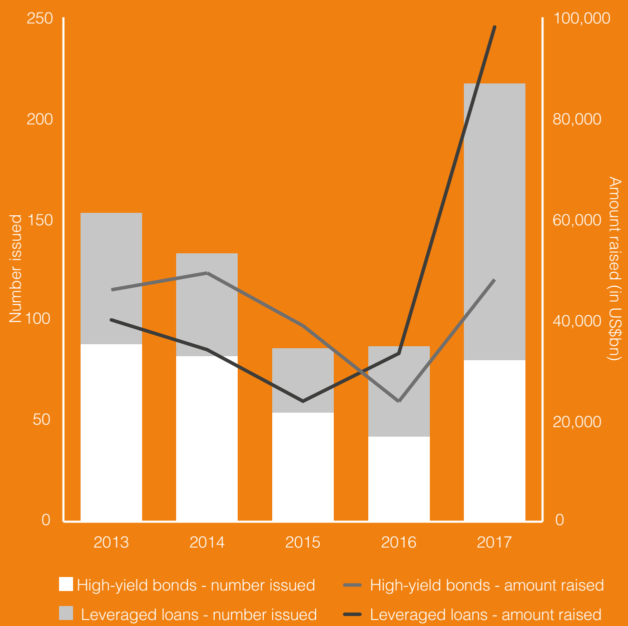
Source: Haynes Boone

been generally negative. In other words, you're getting in at a discount and this looks appealing, but as the companies continue to look like they need more money, or as the market hasn't improved, people might be seeing that injecting new money in this way isn't all that it's cracked up to be.

Emanuel Grillo: That's just it. Rights offerings have become very popular in the last five to ten years in restructurings more broadly. It's a natural way for existing investors to improve the profile of their investments, without getting into the question of whether or not those rights offerings, even priced at a discount, are successful. It has become the way for investors to create another opportunity to capitalize on an existing investment when companies emerging from restructurings need more money, and the question becomes where to get it. You may be in a position where you can't take on any more bank debt or look for any more senior financing, so if you need equity financing, you can go to your existing investors and raise that money pursuant to a rights offering. Offer the equity to them at a discount, and then incentivize them to effectively double down or put more money into the deal. Given the capital structures today, I think the rights offering has just been an extraordinarily popular way to raise money for troubled companies on exit.

Josh Friedman: This is definitely a way to double down, but another way in which I found this interesting is that it also allows you to work against the either less-liquid or other fellow creditors in the same class that aren't going to be willing to put up the money. So instead of it being a way that everyone gets an equal pro-rata share of ownership, you're now changing the math.

Primary issuance of leveraged loans and high-yield bonds by US energy companies, 2013-2017



Source: Debtwire

Paul Jansen: I think rights offerings are here to stay. They are typically a time- and cost-efficient way of raising capital with investors that are familiar with the assets. It makes it easier and quicker to raise additional capital when needed. Additionally, right offerings also provide a potential tax benefit compared to a 'normal' equity raise as future use of net operating losses might not be subject to limitations.

Debtwire: In our Distressed Debt Outlook 2017 report, more than two-thirds of our survey respondents said they thought the Sabine Oil & Gas ruling would have a significant impact on the issue of midstream agreements. Have you seen this ruling have a major impact over the last 12 months? And why do you think the expected wave of distress in the midstream space did not come to pass this year?

Emanuel Grillo: Unfortunately, you can't really measure the impact of the ruling, because so many deals were cut knowing that it was out there. And because it was issued by a court in New York, the Texas bankruptcy courts that have led the large-scale oil and gas restructurings filed there have been waiting for the opportunity to put their own view out there as to how the agreements work.

But they just didn't get that opportunity. Everybody settled rather than assume the risk. So you'll never really know based on all the factors in those negotiations. I think you could say it probably had a material impact, but it would be really difficult to measure that under the circumstances.

Josh Friedman: Almost all of the E&P cases are filed in Texas or Delaware, so when you have a New York court ruling on it, the direct impact is going to appear to be small. It's only going to have the same sort of weight in Southern District of New York, where the ruling came out. I'd say people were aware of its potential, but everyone settled.

These are business issues in which the law is used to renegotiate a contract when the contract becomes out of market, and bankruptcy provides a tool by allowing companies to reject contracts. The question here was whether one could do that with these midstream agreements. But for the most part, the contract counterparty was the natural best fit, so it was usually in both sides' best interests to reach a new deal.

The question was just how that deal was going to be cut. It could have been substantial – there could have been these large renegotiations and recut agreements, but it's hard to put a number to how significant the change was, since many if not all of the revised terms were never made public.

Emanuel Grillo: Right, the problem was that, from a litigation perspective, it leads to a sort of binary result, and nobody really ever wants to get to that binary result. Nobody wants to win on a binary result and nobody wants to lose on one, because even if it occurs, you still have to cut some deal. If you reject it, you've got to go find somebody else to replace your midstream servicer, and that isn't the easiest thing in the world to do. In fact, it's extraordinarily difficult.

So you'd have to think that most of the people were going to reach agreements. Sabine was a problematic case because the parties were so far apart and because it was the first one. I think the original decision probably gave everybody a bit of religion, for lack of a better term, as to the importance of trying to cut a deal versus leaving it up to a court to make that decision.

Paul Jansen: I agree that the ruling had a significant impact, but maybe not in the way that everyone expected. After the ruling, midstream entities and their E&P counterparts have been proactive and flexible in restructuring the existing midstream contracts out of court. The 'old' contracts worked for both parties in a higher-price environment. However, in the current commodity price environment, the 'old' midstream contracts are disadvantageous to E&P companies while still providing the same economic benefits to the midstream entities. Many midstream entities realized this and opted for an out-of-court restructuring and renegotiate their midstream contracts. At the same time, E&P companies often have limited viable alternatives in the near term. Both parties negotiated a pricing mechanism that is more closely aligning the economic incentives between the E&P and midstream entities. For instance, the use of flexible pricing in which transportation fees are dependent on commodity prices has gained popularity. Under these revised contracts both sides to the contract have improved economics if commodity prices increase while an equal sharing of reduced economics takes place in a depressed commodity environment.

I also think that as commodity prices have stabilized, investments in onshore development have increased thereby improving midstream solutions in recent months.

Debtwire: Half of our respondents in the *Distressed Debt Outlook 2017* report planned to allocate more to the oil and gas sector this past year. Do you think investors were able to find good oil and gas opportunities in 2017? How do you expect investors to adjust their allocations to the sector in 2018?

Emanuel Grillo: There was a lot of capital dedicated to this portion of the market, and a lot of that money has been sitting on the sidelines. Even after the 2017 investments are accounted for, I think you're still going to see a large portion of capital that's out there looking for the right opportunities. The problem is that this capital pushed up prices for deals when people were looking to do them, and then all of a sudden they became less attractive at those higher price points.

As a result, the number of "good" opportunities became more limited, and some of the bigger players tried to scoop up as many of them as they could. So you had real competition for deals as far as that goes.

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In terms of how investors adjust their allocations, I think people are going to be a little bit more selective. I don't think people just want to dump their money in. And the question becomes, how do you do it? Some people are raising money through traditional capital markets transactions. We're working on convertible note offerings at present for people who typically might do more distressed-oriented deals. There are some equity offerings outside of bankruptcy that are taking place. So, interestingly, with the amount of capital that's out there, people aren't really pushing as hard on the distress as they would otherwise, thinking that the market's going to come back and they'll get some lower pricing in the first instance for equity.

Josh Friedman: I think this goes back to the time horizon discussion. From appearances, without the bounce back right now, it's hard to say that investors would have made out so well. I can think of numerous examples where more money needed to be put in or maybe they didn't expect a company to file. I do think people are still going to be interested in oil and gas investments. There's still market expectation that we're not at the new automatic normal – that there is real upside here for prices to jump closer to where they were several years ago.

It's also dependent on where the assets are. It's clear that certain locations are still ripe for investments. People believe in the Permian, for example – they're willing to put money there. And it could be that some of the broader plays that own acreage all over might be a little more hesitant. But if it's in their area, they should be more tailored to location.

Paul Jansen: To an extent, I think there's investor fatigue in relation to E&P entities for two main reasons. The first is a disconnect of the historical correlation between oil prices and stock price performance of E&P companies. In recent months E&P companies have underperformed the price of oil. Secondly, there appears to be a "show me" mentality from investors. Investors want E&P companies to focus on being profitable instead of growing the company. This is leading to more diligence and discipline regarding capital allocation.

In my view, if you look at 2018, there's a risk sharing going on between various E&P entities. I think this year will be focused on improving cash flows instead of increasing the drilling inventory or growing reserves.

Debtwire: Reserve-based lenders saw their positions threatened in the latest wave of reorganizations via significant pre-petition drawdowns and questions over the collateral packages that secured their loans. What do you see as the key lessons learned in the revolving loan space?

Emanuel Grillo: Exactly that – we've seen anti-hoarding positions in loan agreements. Once the Linn Energy drawdown took place, I think everyone went back and checked their collateral packages. Historically, I think people had given time to get mortgages filed, because it takes some time to be able to do that. But people realized there was no time like the present, and if you perfect your collateral, you shorten the windows. There were 60- and 90-day windows on a lot of those – sometimes they put as much as 120 days for perfection purposes, because no one saw the market turning as quickly as it did.

I think everyone has learned their lesson, and between the timeline for perfection as well as the anti-hoarding provisions, people aren't just drawing down the funds without a particular purpose. In my view, those are the key lessons that have been taken from all of this.

Josh Friedman: And I think the lenders have already learned their lessons. Since mid-2016, I don't think we've seen RBLs drawn down all the way right before a filing. I don't think we've seen any RBL lenders' collaterals challenged in any meaningful way that led to worse recoveries as a result of that challenge. It didn't take long for the RBL lenders to see the lessons learned. It was these two issues that came up hot and fast when all these E&P companies were filing all at once. And now it seems to have resolved itself, from their perspective.

Emanuel Grillo: There are still companies that have undrawn revolvers, but nobody has gone to precipitously draw and file in a major way. They still have availability, though. I think everyone has basically addressed the perfection issues, but the drawdowns are subject to some of the anti-hoarding provisions.

I think lenders are going to think twice about funding, and they've put in some protections. They've also reduced commitments. The lenders used the opportunities for waivers and amendments to reduce the overall commitments consistent with the companies' affordable borrowing capacity.

Paul Jansen: I think there are really four lessons if you look at the reserve-based loan space. For one, I think a major factor is that the value of the reserves can go down much faster than what was estimated based on reserve reports. The steep and prolonged decrease in commodity prices left some lenders under-secured. Lenders have addressed this risk by reducing their loan-to-asset ratios.

Second, banks typically will not consider acreage value in determining the size of the reserve based loan. However, acreage value has helped improve lenders' collateral package and provided banks a cushion in shortfall situations.

Third, banks have increased their focus on second lien and subordinated debt. This heightened scrutiny is partially due to changes in regulations and partially due to lessons learned in the recent wave of E&P bankruptcies. Any debt subordinated to a first lien reserve based loan is impacting cash available to service debt and the collateral package. Also, additional tranches of debt can add complexity in a restructuring scenario.

Finally, banks have included scrutiny of anti-hoarding provisions and control agreements.

Debtwire: What part of the oil and gas area do you see continuing to need significant restructurings? Is it just further waves of additional exploration and production bankruptcies? Does the midstream follow-up ever come? What about servicers or offshore operators?

Emanuel Grillo: I think some people are still focused on the servicing companies, since the servicers have been on this model still built on higher volumes. And with the big contraction in offshore activity, they haven't made that back up. The question is, where are gross revenues in that part of the market? And if they're still down, do people need to take another step or do a little more in order to make that work? That's where the people I know have been putting their attention.

Josh Friedman: To me it almost seems like more of the same, which is interesting. It'd be interesting if some of the same E&Ps that left that on their balance sheet come back because nothing, or little, has changed. In the offshore space, the big players that people were talking and thinking about have all filed. So the question is, who's next? Six months to a year from now, if prices are the same, what offshore operators might look to the US or to foreign jurisdictions to get things recognized in the US? It doesn't seem like the midstream fall is coming. That much seems fairly certain.

Paul Jansen: I think 2018 will continue to be a challenging environment for the offshore space. I expect more restructurings will happen to E&P companies, drillers and other service providers who are primarily offshore focused.

I don't really see a big wave in midstream companies happening. I think there is a risk that onshore companies that restructured early on but remained highly leveraged need to take action. If you compare commodity levels needed to service their debt versus the forward curve, I think you might see some of those companies forced to restructure a second time.