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Asset-Based Lenders and The Big Chill:
The Collapse of Energy Prices

BY HUGH C. LARRATT-SMITH

From Texas wildcatters to Oklahoma riots, the energy business has a colorful and lucrative history reaching back 100 years. Today the rise and fall of energy prices has a global impact. Hugh Larratt-Smith speaks with ABL lenders from the U.S. and abroad to provide a perspective on how ABLs will fare as market volatility continues.

HUGH C. LARRATT-SMITH
Managing Director,
Trimingham Inc.

H.L. (Boy) Hunt had two formidable talents: playing cards and completing swift and complex mental arithmetic. He had a stout appearance with a trademark string tie and straw boater. In 1920, he opened a gambling hall in the oil boom town of El Dorado, AR. When the Ku Klux Klan threatened to fire-bomb it, Hunt switched to oil.

In 1930, backed by an El Dorado men's clothing store owner, Hunt paid $30,000 upfront to oil wildcatter "Dad" Joiner for a stake in The Black Giant drilling site in East Texas. (Joiner was later nicknamed "Dad" because he was the "father" of The Black Giant.) This would turn out to be one of the largest discoveries in America. Joiner and his crew had already drilled for three years, beginning in 1927, with rusted third-hand equipment. At one point, a Texaco geologist came by their site and joked, "I'll drink every barrel of oil you get out of that hole."

Hunt paid the balance of the purchase price to Joiner — $1 million — out of future production.

In 1926, oil prices had peaked at $1.85 a barrel. By the time Hunt purchased Joiner's stake, the price of oil was in free fall. By 1931, with the flood of oil coming from The Black Giant, a barrel sold for as little as 10 cents. The pricing regime was complicated by the tsunami of production coming from a large group of independents producing at breakneck speed to outmaneuver the majors. By August 1931, Oklahoma Governor "Alfalfa Bill" Murray proclaimed a state of emergency, declared martial law and ordered the state militia to take control of the Oklahoma oil fields.

Fast forward to 2016. Oil prices have plummeted from a peak of $140 per barrel in 2009 to a low of $27 per barrel in February 2016. This rapid descent caught some ABL players off-guard.

No Skid Marks at the Edge of the Cliff

As the shale industry exploded with growth, many owner/managers of middle market companies in the oil and gas sector drove their companies with their foot to the floor. They never saw a piece of equipment they didn't want to buy or a lease that wasn't a sure winner. Like the drillers in Boy Hunt's time, they operated at breakneck speed. Added to the mix were ABL players competing in a crowded marketplace, looking for yield and attracted to good collateral. High commodity prices were the coup de grâce to create the resulting overleverage.

"For those of us who didn't live through the painful 80s, but saw the scars of those who did, avoiding deep exposure to asset classes that collect dust and rust is crucial," says Dan Karas, Triumph Business Credit EVP and chief lending officer. "That said, driving growth in an overheated competitive environment takes creativity, at least as an alternative to abandoning both yield and structure discipline."

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For the most part, senior secured loans on oil and gas reserves are not at significant risk of loss. Many borrowers hedged their future revenue streams, locking in prices at the high water mark. The standard practice was senior secured loans based on their conservative pricing (~80% of NYMEX) and advancing 60% to 70%

1930 photo showing "Dad" Joiner (third from left) shaking hands with A.D. (Doc) Lloyd in front of the The Black Giant well. Lloyd was responsible for convincing Joiner to drill in East Texas, on the Daisy Bradford farm, eight miles west of Henderson. Third from right is oilman H.L. Hunt, who bought out Joiner and became one of the richest men in the world. The well is still producing oil today.

of the lender's calculated proved reserve value while limiting proved undeveloped reserves to +/-20%. This conservative underwriting practice served the banks well in previous downturns, historically resulting in minimal losses on reserve-based loans.

Michael Haddad, Sterling Bank Asset-Based Lending president, cautions with a favorite quote: "The closer to the wellhead, the higher risk of default, regardless of what they do."

"Notwithstanding an overall decline in value of over 60% in almost all oil and gas related asset classes in the last 24 months, most of our ABL clients' energy portfolios should perform well given the appropriate structures around eligibility and advance rates that will protect lenders against energy price unpredictability and volatility," notes Tom Greco, Hilco Global CEO of Valuation and Industrial Service. "That said, the strongest overall recoveries will come when senior, second lien and mezzanine lenders band together to monetize assets as opposed to breaking apart asset pools in an attempt to independently cut losses."

Avoiding Rust and Dust

Suppliers who pressed the accelerator to the floor will feel the most pain. A lot of collateral will rust and catch dust. The ability of borrowers to rapidly drive down cost structures will determine the winners and losers.

One winner is a drilling rig fluid supplier in Aberdeen, Scotland. The company was able to reduce its inventory of consumables and headcount roughly in tandem with the slowing of the orders from its North Sea customers.

An equipment rental company near Williamsport, PA was not so lucky. The borrower has inventory, ranging from prefabricated housing to drilling trailers, that is going to waste.

Despite the recent rise in Brent crude to over $40 a barrel from a low of $27, E&P and oilfield-services companies may not be able to jumpstart drilling. Many independent companies released too many workers or idled too much equipment to ramp up immediately. To get back to drilling, these shale-only producers must first repair their balance sheets. That will curb any recovery. Close to 60% of U.S. fracking equipment has been idled during the downturn. One reason output remained robust last year was drilling and fracking wells became cheaper. Producers leaned on services companies to cut costs, and certain wells remained profitable even at lower prices. Now many companies have cut as much as possible.

Regulators now require senior lenders to grade risk on an enterprise basis, rather than solely on the senior loan. As a result, there is significant downward risk-grade migration, requiring the banks to hold additional risk-based capital vis-à-vis these loans.

Deploying the minimal dry hole risk theory, for the last five years lenders aggressively advanced against proven undeveloped reserves. The new reserve recognition rules — the SEC's five-year and reliable technology rules — spurred this lending practice. Unfortunately, at today's prices many of these reserves are uneconomic to drill and have been reclassified from proven to probable, which makes them ineligible collateral for borrowing base purposes.

Another thorny problem has surfaced. Until recently, lenders assigned risk grades based solely on senior debt, which they held without regard to second lien and sub debt in the capital structure. Regulators now require senior lenders to grade risk on an enterprise basis, rather than solely on the senior loan. As a result, there is significant downward risk-grade migration, requiring the banks to hold additional risk-based capital vis-à-vis these loans. > >

"Our approach is to identify if a client has a material weakness, which can be cash flow that is insufficient to service the junior debt on a post-block basis, even if the senior obligations can be covered. That would factor into our decision to downgrade the risk rating accordingly," notes Karas.

"One of the strengths of asset-based lending is that we focus on specific collateral and the value drivers of that collateral," says Jeffery Wacker, TD Bank managing director, head of U.S. ABL Business Development. "With a disciplined focus on eligible collateral, ABL players have an unvarnished perspective on how collateral will perform, which is crucial in addressing the impact of volatile energy prices. Also, in transactions which are very time-intensive, borrowers and their advisors appreciate the fact that legacy ABL players will typically have a working history of how collateral performs in most scenarios. Collectively, we have been through many credit cycles. We can provide important guidance on where we are in today's credit and economic cycles."

"CFA's cross-border lending events in New York and London provide a valuable education platform on intercreditor arrangements between asset-based lenders and direct lenders. This dialogue between collateral classes is a very important driver in the continued vitality of the ABL/direct lender marketplace."

— Jeremy Harrison, *SVP and senior BDO of Business Capital*, Bank of America Merrill Lynch

If You're Not at the Table, You're Probably on the Menu

From 2010 through 2015, lenders of all stripes booked $160 billion of alternative/second lien/sub-debt. With the energy price collapse, the value gap between collateral and loans has widened significantly for many borrowers.

In many industry sectors, distressed investors rush in to buy troubled loans from lenders. "When it comes to the energy sector, many special situation players are sitting on the sidelines these days," notes Kirkland & Ellis Partner Partha Kar. "No one is prepared to bet on where the bottom of asset values lies. There seems to be numerous geo-political forces at work in the energy sector which make the whole thing quite difficult to model."

"Enterprise valuation lending is *not* occurring now as there are *no* enterprises that can be relied on," Haddad adds.

"Making a call on the low water mark in energy prices is confounding most experts," cautions Kirkland & Ellis Partner Will Bos. "A lot of funds have already been burned by piling into distressed energy loans too quickly, only to watch them continue to deteriorate — some quite significantly." According to Credit Suisse, some lenders are already offloading energy-related debt, selling loans for as little as 10 cents on the dollar.

Strange Bedfellows

Until now, no disasters have occurred to illustrate how lenders in the capital structure will act. Now, a growing multitude of real life examples shed light on how parties will act and react.

"What could be problematic is a lack of history between reserve based-lenders and distressed investors. Reserve-based lending by commercial banks in the U.S. is likely the last vestige of relationship lending. Distressed investing most assuredly is not," notes Bos.

"The typical tensions now arising between in-the-money ABLs and junior creditors on oil and gas credits may not be ideally regulated in European transactions by legacy intercreditor agreements that do not always have a truly split collateral package, fulsome collateral valuation and/or release provisions," says Paul Hastings Partner Karl Clowry. "If an intercreditor or agreement among lenders is not fully tailored to an energy/field services related transaction, it may take longer to recover value once they seek to move against the debtor's assets."

Squire Patton Boggs Partner Susan Kelly notes, "In the UK, schemes of arrangement are unlikely to be the ideal answer for a struggling oil company as many of the contracts on which the businesses are built will likely terminate. Administration brings with it potentially disastrous environmental risks. Stakeholders will need each other and company management to put shoulders to the wheel. The key document is the intercreditor agreement, and while funds and ABLs may not have a long history in work out, the fact is that the intercreditor agreement will govern the initial engagement and the scorched earth around the oil companies will provide whatever encouragement may be necessary for the stakeholders to work together to make the best of what is likely to be a not very flattering haircut."

Evan Cobb, partner at Norton Rose Fulbright Canada, says, "When prices of outputs are subject to rapid and significant change, the conflict intensifies between senior secured lenders, who prefer a quick and certain sale or liquidation for immediate cash, and subordinate creditors, who would favor providing the troubled debtor with interim financing in hopes of increased recoveries if commodity prices rebound. In Canada, the process of insolvency and restructuring is quite flexible, and courts have a very important and challenging balancing role to play."

Path of No Return

"In the U.S., the process of bankruptcy reorganization, preserving the business in a more viable form, is well established, generally has a clear structure and pace and usually has a predictable outcome. In Europe, a company that's in early decline can be pushed down a path of no-return relatively easily unless it examines its options and engages with stakeholders quickly. Lenders are likely to want time to stabilize and re-organize the company

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outside of a formal process (unless the board has no other choice), and won't want the ABL player to poke a stick in the spokes of the bicycle's wheels," says Kar.

"The growing European chapter of the CFA is providing a valuable forum for the ABLs and alternative/direct lenders to get to know each other before challenging situations arise," says Jeremy Harrison, Bank of America Merrill Lynch SVP and senior BDO of Business Capital. "CFA's cross-border lending events in New York and London provide a valuable education platform on intercreditor arrangements between asset-based lenders and direct lenders. This dialogue between collateral classes is a very important driver in the continued vitality of the ABL/direct lender marketplace."

Clowry concurs, "Real efforts have been made in Europe in the last three years to incorporate U.S. style unitranche with key ABL products, requiring market participants to adapt credit structures and documents to properly address the drivers and concerns of different lender groups against Europe's multi-jurisdiction legal backdrop. Everyone wants to see proper pricing of risk and reward and not to be T-boned by some arcane intercreditor legal argument, which can be unexpectedly good or bad for seniors and juniors alike."

Fears of energy sector bankruptcies weigh heavily on the U.S. banking sector, which financed the decade-long expansion of the shale industry.

Kelly says, "European Banks are generally playing down their exposure to the energy sector. BNP Paribas projects overall losses of around $6.7 billion against a total sector debt of $455 billion. If the Basel Committee prevails with a more standard approach to risk measurement, it's likely the European banking sector will come under intensified pressure — again."

In Canada, regulators are urging major banks to review accounting practices to ensure sufficient reserves as the commodity-price collapse takes a toll on the economy.

Where is this headed? Haddad observes, "All three rings of the circus are full. The animals are dancing and the clowns are trying to get anybody's attention."

How did the 20th century oil glut pan out? Hunt ultimately secured title to much of the East Texas Oil Field, one of the world's largest oil deposits. From The Black Giant and his other acquisitions, he amassed a fortune. Hunt reputedly had the highest individual net worth in the world when he died. His personal life, which featured 15 children by three wives, was the main inspiration for the *Dallas* TV series. The J.R. Ewing character was based on popular perceptions of Hunt. In 1980, Hunt's sons, Bunker and Herbert, tried to corner the world silver market, which triggered a global collapse in silver prices. abfj

HUGH LARRATT-SMITH is a managing director at Trimingham and is on the Advisory Board of the Commercial Finance Association Education Foundation.

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