TECTONIC SHIFT IN LENDING AHEAD

By Scott W. Johnson
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In 2016 bank regulators drew a line in the sand, and 86% of public companies surveyed may not meet new standards. Luckily, alternative debt financing is available.

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The regulatory agencies’ response to the 2008 financial crisis, coupled with the sudden decline in oil prices in 2014, has hastened significant regulatory changes in the oil and gas lending space. These will result in the need to refinance billions of dollars of existing bank loans and there will be a sharp reduction in future bank credit availability.

Many energy executives are well aware of this, but they may not be aware of the magnitude of the problem, or familiar with all the new options available to replace bank debt. Our survey of data from 150 public E&P companies shows that fully 86% of them do not pass the new regulatory standards on debt.

We fear some executives may underestimate the shifts that must occur in both the financial services and energy industries when a large number of companies are simultaneously trying to find new lending standards for E&P companies after the commodity price downturn in 2008. In late 2015, an annual review by regulatory examiners found that a high number of loans were incorrectly rated by the banks. They concluded that their analysis and rating should be based on whether a given company is able to repay all of its debt, not just its bank debt.

This was a sea change, for banks historically based their analysis and resultant credit ratings on whether a given company was able to repay all of its debt, not just its bank debt. Over time, it is logical to conclude that banks will hold pass loans and eliminate non-pass loans from their portfolios.

And while most banks have been relatively lenient through the worst part of the downturn, the March 2016 release of revised standards drew a line in the sand and forced banks to begin to act. Regulators have revised the standards dramatically.

The revised OCC guidelines were dramatically more stringent than in the past. While there are many facets, there was one key result: All E&P loans must be classified into one of five categories ranging from pass to loss, and a huge amount of existing bank debt does not pass, as seen in Figure 3.

What’s more, the OCC changed the standards as to what qualifies for each category, effectively reducing the amount of bank credit available to E&P companies. Each category other than pass results in increasing the amount of equity capital banks must hold in comparison to their loans outstanding. The weaker a loan’s credit rating, the more reserves a bank must set aside, making it more expensive, and less economic, to keep the loan on the books.

From the bank’s point of view, holding large percentages of equity capital against non-pass loans often makes it unprofitable to continue to hold these loans. It will become increasingly less attractive to hold non-conforming loans as compared to loans that pass the standard and require less equity capital on hold.

In addition to the tightening of numerical standards, three major changes in the OCC regulations affect how E&P loans are assessed and categorized:

1. All debt, not just bank debt, is included in the calculations.
2. Total committed amounts of reserve-based loans (RBLs) are tested, not just the outstanding amount.
3. Future net revenue (FNR) is calculated using strip pricing and unrisked reserves, so that bank-determined metrics have been removed, allowing banks much less discretion and increasing pressure.

The exact size of non-pass loans for all public, privately held, family-owned and private equity-owned businesses is unknown. However, information is readily available. The research studied cash flows and debt for the last 12 months through September 2016; oil and gas reserves at December 2015; and $204 billion in total debt in public companies, excluding the majors.

Of this amount, $92 billion is first-lien debt, meaning that the non-bank debt total is more than 120% of the bank debt amount.

Our results showed at least 129 companies, or 86% of the 150 total, do not pass the new regulatory standards. Total debt outstanding for these companies is $168 billion, and approximately $75 billion of bank debt is rated substandard or worse, as shown in Figure 3.

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The specific metrics for each regulatory classification are defined in Figure 2.

DEBT ALTERNATIVES

OCC’s 2016 Year in Review, “In June 2016, the Federal Deposit Insurance Corp. (FDIC) issued guidelines that are less specific but reinforce the OCC guidelines. The OCC regulations have become the de facto guiding principal for the entire industry.”

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FIGURE 3: TOTAL DEBT

<table>
<thead>
<tr>
<th>Total Debt ($204B)</th>
<th>Total Substandard Debt by # of Violations</th>
</tr>
</thead>
<tbody>
<tr>
<td>$171.5 billion</td>
<td>$65.4 billion</td>
</tr>
<tr>
<td>$14.2 billion</td>
<td>1 Violation</td>
</tr>
<tr>
<td>$16.0 billion</td>
<td>2 Violations</td>
</tr>
<tr>
<td>$18.0 billion</td>
<td>3 Violations</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Bank Debt ($92B)</th>
<th>Total Substandard Bank Debt by # of Violations</th>
</tr>
</thead>
<tbody>
<tr>
<td>$8.6 billion</td>
<td>1 Violation</td>
</tr>
<tr>
<td>$19.0 billion</td>
<td>2 Violations</td>
</tr>
<tr>
<td>$23.0 billion</td>
<td>3 Violations</td>
</tr>
</tbody>
</table>

It is important to note that these numbers are estimates. Companies that have filed bankruptcy or are no longer operating were removed, and private companies are not counted. The repayment test was omitted due to lack of necessary information. Had this information been available, the repayment test would likely have resulted in more non-pass debt. On the other hand, rising commodity prices and additional debt restructuring will likely reduce the non-pass total over time.

Options and alternatives

Timing for the new regulatory guidelines was not ideal. Debt capacity took a double hit from the commodity price cycle and the new regulatory guidelines at the same time. So far, banks have in many cases moved relatively slowly in forcing refinancing or debt restructuring, which can be labeled either as patience or as “kicking the can down the road” to avoid or defer write-downs. It is likely that the adjustments in bank credits would not continue to play the sizeable role the E&P industry has relied on, operators do have alternatives. Some companies may choose to sell some assets, especially noncore assets, to reduce debt, but often that option is either not economically attractive or will not make a large enough positive impact on the balance sheet.

Other companies will raise common equity capital sufficient to retain some bank financing, some- times in connection with acquisitions, but with the amount of outstanding non-bank debt in public companies totaling more than their bank debt, it is likely that the amount of common equity that would be required is large enough and would be dilutive enough that this course alone will not be enough for a good many companies. Some E&Ps may continue to restrain capital expenditures, even as commodity prices strengthen, in order to pay down debt.

For larger investment-grade companies, refinanc- ing in the public debt markets will continue to be attractive. Public debt offerings are likely to be a sizeable part of the response to a reduced role for the banks. Of the $75 billion in bank debt that is substandard under the OCC guidelines, $27 billion is issued by investment grade public companies. Much of this bank credit may be replaced with publicly traded debt.

Some, but probably a smaller portion of the other $48 billion in non-complying debt, with debt ratings below investment grade (BBB), may also be refinanced in public high-yield debt, though a large portion of this amount will look to the private market.

The responses will be as numerous as the number of companies pursuing them, but it is likely that non-bank alternative debt will need to fill a large portion of the gap. Many companies that do not pass the standards will need to leave the banks, and time is running out. Companies are better off proactively seeking new debt sources before their banks and their regulators run out of patience, because short deadlines result in fewer and less attrac- tive alternatives.

Alternative debt

The current bank regulatory environment has expanded opportunities for alternative capital sources. For many of the private E&P companies and quite possibly a significant number of public ones, alternative debt providers will be the main source of replacement capital.

Alternative debt sources provide capital that is significantly more expensive than the banks, but they are also more aggressive with their advance rates, more flexible with their loan structures and repayment terms, and more supportive of drilling programs that can give companies a way to grow again. These capital product choices will allow companies to recapitalize their balance sheets with an appropriate, sustainable capital structure for the future.

The alternative debt market is large and growing as increasing amounts of investor money are allocated to the space. As a result, the coming demand will require that it gets even larger.

This capital is invested from funds sourced primarily from institutional investors such as public and private pension funds, endowments, founda- tions and sovereign wealth funds, but also from family offices and high net worth individuals. Some are pure debt funds (sometimes called credit funds) and some offer equity as well as debt capital. Re- cently, a number of established private-equity fund managers have added credit funds. Some of these funds may be linked to new oil and gas investments; others invest in multiple industries.

Chiron Financial has recently conducted a survey of 30 larger funds with an interest in E&P invest- ments. Of these, 14 have provided specific invest- ment guidelines. They span a wide range in size, risk tolerance, targeted rates of return and form of investment, but some highlights are:

- Total assets managed of approximately $520 billion;
- Total debt investment funds of approximately $345 billion;
- Targeted E&P company debt investment funds of approximately $26 billion;
- Targeted individual company investment size ranges from $10 million to $1 billion or more, across a very broad risk spectrum;
- Interest coupon rates of 5% to 16%;
- Total cost of money, including fees and return “kickers,” if any, range from 5% to 25%;
- Type of investments: first-lien debt, second-lien debt, unsecured debt, preferred stock and working interests (i.e. joint ventures with re- versions); and
- Advance metrics range from near to bank terms to straight drilling deals with no proved devel- oped producing (PDP) reserves.

Although each provider has its own specific pref- erences, they may be roughly categorized in groups by total cost of capital as follows, with some funds providing terms that span more than one of the categories. (Figure 4.)

DEBT ALTERNATIVES

<table>
<thead>
<tr>
<th>Capital type</th>
<th>Bank-like</th>
<th>Stretch</th>
<th>Mezzanine/hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total cost</td>
<td>5%-8%</td>
<td>9%-13%</td>
<td>14%-22%</td>
</tr>
<tr>
<td>Use of proceeds</td>
<td>Purchase; modest development</td>
<td>Acquire &amp; develop</td>
<td>Aggressive development</td>
</tr>
<tr>
<td>Advance vs. PDP PV10</td>
<td>50%-100% of PDP PV10</td>
<td>70% to more than 100% of PDP</td>
<td>100% + of PDP to no PDP</td>
</tr>
<tr>
<td>Participating kickers</td>
<td>No</td>
<td>Not usually</td>
<td>Sometimes</td>
</tr>
</tbody>
</table>

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Not surprisingly, the lowest-cost capital shares some of the attributes of bank debt, generally including lower advance rates, a first lien and borrowing base reviews. Most of the providers seeking total returns below the mid-teens are not seeking any form of equity participation such as warrants or overriding royalties, while at least some of those seeking higher returns do seek some form of participation.

Cost of funds is lower when the advance is based predominantly on producing reserves (PDP), though for most of these providers the advance rate versus PDP and even vs. total proved reserves is substantially greater than in a bank credit.

Many providers are quite supportive of economic drilling programs, and will periodically expand credit advances as new production is brought on line. These increases will typically occur much more rapidly in response to additional production than is the case with a bank.

Conclusions

Even with continued oil and gas price recovery, there will be dramatically less bank credit available a year or two in the future as compared with today. As a result of regulatory guidelines, oil and gas producers will find it harder to obtain new bank financing, and current borrowers will find it harder to obtain amendments or extensions from their existing banks.

Given the size and duration of the crisis, banks have been remarkably patient so far, but regulators are engaged, and the numbers show a tectonic shift on the near horizon. Most banks appear to be beginning to respond more firmly under the regulatory pressure.

This piece is not written to cause alarm. Fortunately, public and private capital is plentiful and will fill any reduction in bank credit availability. The point is that E&P companies will be well served to recognize that a shift is occurring.

They need to take steps to adapt on their own initiative and timetable before being forced to react to the timetable of their banks and the bank regulators. Each E&P company should recognize the range of alternatives available and know where to look for the most attractive capital for its particular assets and opportunities. In many cases, an experienced investment bank can help identify and capture the best solution.

For the industry, the bad news is that capital will be more expensive, but much of the new capital will also support a wider range of activity and faster growth. Fortunately, these alternative capital providers are willing to assume more risk in return for the possibility of higher reward.

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