

Financial Strategies For Oil And Gas Cos. During The Slump

By **Marc Zenner, Frank Schneider and Allie Schwartz** (June 2, 2020, 5:17 PM EDT)

The boom-and-bust cycle epitomizes the oil and gas industry. Even so, the oil price decline in the first few months of 2020 is one for the record books.

The historic collapse in demand due to COVID-19 restrictions on travel and the general decline in economic activity, on the heels of a price war between Russia and Saudi Arabia, and the ensuing price declines that included the much-publicized negative prices in the market for near-term delivery of West Texas Intermediate, or WTI, has shocked an industry that has shocks in its DNA.

A number of questions arise from this most recent episode. Will this shock lead to paradigm shifts in the oil and gas industry, or will this, with the benefit of hindsight, look like one of the many shocks the industry has experienced before?

What aspects of financial management will change as a result of the pandemic-induced volatility? Will capital markets shut down for an industry already exposed to high volatility and shocks before the pandemic?

Finally, how will industry participants and investors address a lack of liquidity, higher costs of capital, valuation challenges, increasing financial distress and potential bankruptcies, and the prospect of contract disputes? The discussion below begins to shed some light on these issues.

A Historic Collapse in Demand

To put it mildly, 2020 has been volatile for the oil and gas sector. Between the beginning of the year and March 8, oil prices had declined by roughly 33%. Then, on March 8, Saudi Arabia and Russia engaged in a price war, which was triggered by a breakdown in dialogue between OPEC and Russia.[1]

In the meantime, COVID-19 caused a historic, and highly uncertain, drop in demand, given the global shutdown of economic activity in many sectors and the resulting decline in travel, changes in consumer behavior, and spike in unemployment.

The combination of a price war and the economic shutdown due to COVID-19 contributed to an



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additional 18% decline in oil prices between March 8 and May 20, or a 45% decline from the beginning of the year to May 20 — and a 69% drop from the peak in the summer of 2014.[2]

These drops incorporate a large rebound in prices since April 21, without which declines would have been even more dramatic. This only further highlights the volatility of oil prices.

WTI spot prices declined to as low as \$8.91 per barrel in April, a level not seen since at least 1986.[3] More remarkably, many producers are getting even less for their barrels in the shale — and, in some cases, will have to pay somebody to take the oil they produced.[4] Needless to say, the current price environment is creating issues that challenge even the most prepared.

The oil and gas sector is not a newcomer to price volatility. It has experienced episodes of large price declines in the past: Oil prices have declined 40% or more 10 times since 1983.[5] In other words, since 1983, there has been a price decline of at least 40% roughly every four years.

As a result, many companies in the sector have been capitalized accordingly. However, certain aspects of this most recent episode of oil price decline are different. It has been swift, unforeseen by forecasters, and while there was an initial threat of increased supply, there has also been a rapid and deep contraction in demand, resulting in an unprecedented reduction in global consumption.[6]

Nowhere was the decline in oil prices more evident than in the futures market. Because of the shortage in storage space, the May WTI futures contract briefly dropped to a daily settlement price of -\$37.63 on April 20, an unprecedented low.[7]

Essentially, in the near-term futures market, owners of the physical commodity agreed to pay a counterparty more than \$37 per barrel to take delivery of their oil. Whereas producers of excess tulips in the Netherlands can dump the excess product in the compost bin, no such option exists for excess oil production that needs to find appropriate storage.

The Effect on the Oil and Gas Industry

Publicly traded oil and gas companies had suffered large stock price declines since the 2008 financial crisis, and following a major downward shock in oil prices in 2014-2015. From the troughs of the financial crisis in March 2009 to the end of this January, the S&P 500 returned 498%, whereas the SPDR S&P Oil & Gas Exploration & Production ETF, a major energy exchange-traded fund often referred to by its ticker symbol XOP, returned -17% over the same period, on a total return basis.[8]

After several short rebounds since the 2014-2015 downturn, 2019 was another weak year for the oil and gas sector. Even before COVID-19, the XOP declined 13% in 2019, whereas the S&P 500 returned 31%.[9] At the end of 2019, there were already predictions of potential problems, including higher defaults in the oil and gas sector.[10]

While it remains to be seen how deeply the current crisis will affect the oil and gas sector, based on past history, financial performance within the sector will depend in part on companies' preexisting capital structure and ability to access liquidity. While each case is different and individual circumstances matter, in past episodes of oil price drops, companies' capital structure and balance sheets have played an important role in their ability to weather shocks.[11]

In light of lower oil prices and demand, revenues will likely contract meaningfully, at least in the short

and medium term. Given this swift and deep contraction, companies with higher amounts of leverage and less access to liquidity will likely have a harder time covering costs, including their interest payments.

Data from the current episode show that while all energy companies are suffering, those with higher credit ratings[12] have seen relatively smaller declines in stock prices and lower credit spreads.[13] From the S&P 500 peak on Feb. 19 to the S&P trough on March 23, stock prices declined 55% for energy firms rated A- or better, whereas energy firms with below-investment-grade ratings dropped 68%.[14]

Companies with A- ratings or better tend to have a combination of less leverage, more scale, a more diverse asset base, and more access to liquidity and capital markets than those that are non-investment-grade — i.e., with ratings of BB+ or less.

A similar story is playing out in the bond market. Credit spreads — the difference between bond and Treasury yields — have widened for the energy sector since late March. Furthermore, consistent with the stock market, spreads of high-yield energy issuers widened much more compared to investment-grade issuers.[15]

Even more important than spreads is access to capital markets. Companies in the A or above ratings categories have been able to raise large amounts of debt capital over the last couple of months.[16] In contrast, companies with speculative debt ratings have not been able to access the debt markets as readily.[17]

When an industry is in distress, one of the issues with credit ratings is that credit and equity investors may not just look at what the ratings are today, but at what they may be in the near future. Not surprisingly, ratings agencies have downgraded many companies in the oil and gas space in 2020, and the high percentage of negative outlooks (75%) and watch negatives suggest that more downgrades may come.[18]

More than 76% of oil and gas companies experienced a negative rating action by S&P between the beginning of the year and May 20. Of those companies with negative rating actions, 72% saw downgrades and 56% saw negative outlook changes.[19]

The Crisis Playbook

Historically, companies have shored up their balance sheets and attempted to raise liquidity in times of oil price decline. The energy sector crisis playbook from 2001, 2008 and 2015 applies today as well: Cut costs, cut or defer capital expenditures, cut shareholder distributions, extend maturities, draw on bank lines, increase the size of existing bank lines, obtain covenant relief, manage accounts receivable and payables, sell assets, and equitize the balance sheet.[20]

The current downturn happened remarkably fast, yet energy companies have already started taking many of these measures. A number of companies have announced meaningful reductions in capital expenditures and large layoffs, and companies have also started to draw on their lines of credit to shore up liquidity.[21]

If history is a guide, companies with less need for — and better access to — capital and liquidity are likely to fare better. They are more likely to be able to draw on existing lines of credit, get additional credit lines and tap other sources of liquidity.

Only the largest and best capitalized companies can cut dividends or stop buybacks. Smaller and less well-capitalized companies likely did not have meaningful dividends or buyback programs to begin with.

Corporate Finance and Litigation Implications

Financial Distress, Bankruptcies, Restructurings

Bankruptcy filings are starting to emerge, and attorneys are predicting more bankruptcies among oil and gas companies.[22] Some companies will reorganize and reemerge with stronger balance sheets, whereas others may liquidate if the economic viability of some of the shale plays does not return soon.

Financing Under Duress

Many companies will raise crisis financing to fend off further value erosion or distress. This financing may come in the form of equity, convertible bonds or preferred stock with warrants.[23]

Client Credit Issues

Midstream companies that have agreements with producers to provide production and processing services in exchange for reserve rights must be mindful of the effect of producer financial distress or bankruptcies on their finances.

Some recent court decisions have allowed producers in bankruptcy to renegotiate these agreements.[24] Cases of contract disputes based on COVID-19 are starting to emerge.[25]

Lender Conflict

Some oil producers rely on reserve-based loans, in which the borrowing base is derived from the value of producers' reserves. The decline in oil prices, and accompanying reassessment of reserves, may lead to declines in producers' capacity to borrow, may provide grounds for conflicts with lenders, and could trigger litigation, distress or bankruptcies.[26]

Lease/Royalty Conflicts

Decisions to close wells and shut down facilities due to expected reductions in production may lead to litigation involving leasing contracts and royalties. This could involve further litigation if companies fail to make appropriate shutdown decisions.[27]

Valuation and M&A

Companies will try to become more efficient via mergers that increase scale, or will raise funds by selling assets. In both instances, it will be challenging to decide on appropriate valuation methods in M&A transactions. Some methodologies are very difficult to implement when there is very little visibility about the future.

Unpredictability

Companies will be challenged to provide guidance to investors given the magnitude of uncertainties in the sector.

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[1] "Saudi Arabia Launches Oil Price War after Russia Deal Collapse," Financial Times, March 8, 2020, <https://www.ft.com/content/d700b71a-6122-11ea-b3f3-fe4680ea68b5>.

[2] Refinitiv.

[3] WTI closing spot price for April 21, 2020, from Refinitiv.

[4] "Oil Prices Dip below Zero as Producers Forced to Pay to Dispose of Excess," The Guardian, April 20, 2020, <https://www.theguardian.com/world/2020/apr/20/oil-prices-sink-to-20-year-low-as-un-sounds-alarm-on-to-covid-19-relief-fund>.

[5] Refinitiv.

[6] "Short-Term Energy Outlook (STEO)," U.S. Energy Information Administration, February 2020, <https://www.eia.gov/outlooks/steo/archives/feb20.pdf>; "Short-Term Energy Outlook (STEO)," U.S. Energy Information Administration, April 2020, <https://www.eia.gov/outlooks/steo/archives/apr20.pdf>.

[7] WTI futures contracts are settled by physical delivery of WTI crude oil in Cushing, Oklahoma. Therefore, a buyer of these futures contracts needs to take physical delivery of the oil. Buyers include refineries and airlines. Since these buyers were faced with full storage tanks and low demand due to COVID-19, this led to an unprecedented scenario where sellers had to pay buyers to store the oil, and hence the May WTI contract briefly went negative the day before the near-term contract was set to mature.

[8] Refinitiv.

[9] Refinitiv.

[10] "Energy Defaults Are on the Rise Again, Clouded Economic Outlook Calls for a Higher US Speculative-Grade Default Rate," Moody's, Oct. 31, 2019, https://www.moody's.com/research/Moodys-Energy-defaults-are-on-the-rise-again-clouded-economic--PBC_1201342.

[11] "Here We Go Again ... Financial Policies in Volatile Environments: Lessons for and from Energy Firms," JP Morgan, February 2015, <https://www.jpmorgan.com/jpmpdf/1320693987524.pdf>.

[12] A credit rating represents a rating agency's opinion regarding the borrower's ability to repay a particular debt or financial obligation. Higher ratings are associated with higher creditworthiness.

[13] A credit spread is the difference in yield or rate of return between bonds of different credit quality and is a measure of the additional yield required by investors to hold the riskier bond.

[14] Refinitiv. Median figures based on all U.S. Oil and Gas companies with available S&P Long-Term Issuer Level rating.

[15] Refinitiv.

[16] "BP Racks Up \$6 Billion in New Debt in Three Months Amid Pandemic," Wall Street Journal, April 28, 2020, <https://www.wsj.com/articles/bp-posts-loss-maintains-dividend-amid-pandemic-and-oil-rout-11588068555>; "Exxon Raises \$9.5 Billion to Load Up on Cash While Debt Market Still Open to New Deals," Reuters, April 13, 2020, <https://www.reuters.com/article/us-exxon-mobil-debt/exxon-raises-9-5-billion-to-load-up-on-cash-while-debt-market-still-open-to-new-deals-idUSKCN21V269>.

[17] "US Oil Companies Race to Restructure Debt," Financial Times, March 19, 2020, <https://www.ft.com/content/c1be5ca0-695a-11ea-800d-da70cff6e4d3>; "American Oil Drillers Were Hanging On by a Thread. Then Came the Virus." New York Times, March 20, 2020, <https://www.nytimes.com/2020/03/20/business/energy-environment/coronavirus-oil-companies-debt.html>.

[18] Refinitiv.

[19] Refinitiv. Percentages calculated based on all U.S. Oil and Gas companies with available S&P Long-Term Issuer Level rating. Some companies experienced both downgrades and negative outlook changes.

[20] "Here We Go Again...Financial Policies in Volatile Environments: Lessons for and from Energy Firms," JP Morgan, February 2015, <https://www.jpmorgan.com/jpmpdf/1320693987524.pdf>.

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