Finding Value in a Difficult Energy Market

From the Privcap webinar "Energy, Volatility, and Valuations"

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How Volatility is **Changing Energy Valuations**

The prolonged period of low oil prices, with no recovery in sight, is making both GPs and LPs change how they look for deals and investments. And, in a downturn, not all parts of the production chain are created equal.

The Panelists

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Privcap: What do investors need to understand about the specific aspects of valuation as they affect energy assets, especially in today's volatile market?

Steve Sprenger, RSM: Obviously, whether we're talking uranium, coal, or oil and gas, current and future commodity prices are of extreme importance. But to that end, the question is what type of price deck do you use? Depending on the commodity you're producing, there may be something available from the futures contracts, but even then, you only have a few years out at best.

One of the advantages you have, depending on the type of energy asset, is the ability to shut down and wait till prices come back. But if we're talking oil and gas, at that point a lot of up-front costs were already committed, so other factors come into play. And one of the biggest issues, of course, is understanding the differences in resource certainty, understanding whether we're looking at proved reserves and what category "within" that.

And then you have to understand things like the type of adjustment factors that have been applied by the petroleum engineer. And if we're talking about producing assets or assets that are ready to produce, we have to understand what historical production looks like and what the decline curve is.

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> –Shaia Hosseinzadeh, WL Ross

There are two sides of the equation when we think about energy volatility and valuations. There's the private equity portfolio and then there's the the deal market. How has record volatility over the past 18 months impacted valuations and M&A activity?

Shaia Hosseinzadeh, WL Ross: People can adapt their valuation approach to high prices. They can adapt it to low prices. What's quite difficult is to adapt any kind of valuation method to prices that are indeterminate. If you look at consensus estimates for oil, the dispersion of views is remarkable. On the low end you have estimates as low as $20. On the high end, in the short term, we've seen estimates as high as $80. That's a difficult environment in which sellers and buyers can transact and that's been a driving factor for why M&A volumes are down so markedly. 2015 ended with something like 60 percent reduction in M&A volumes.

Today we're in a much different place. We've been through two redetermination cycles. Coming into this year's redetermination cycle, we're going to see a much greater need for either collateral replacement or revolver paydowns. And there will be three categories of people. People who can raise equity to pay that down, which is a very small portion of the market. People who will have to sell assets, maybe at prices they don't like, but have no other way to pay down their RBLs or at least shore up liquidity. The third category, which seems to be getting bigger by the day, is this cohort of companies that can neither issue equity nor can responsibly sell assets without meeting the fiduciary that they have to the various stakeholders. For those companies it's going to be a mixture of in-court and out-of-court restructuring. That's really going to be the next leg of this M&A cycle.

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What kinds of conversations are happening now between GPs and their LPs with regard to the valuation of energy investments?

Jim Gasperoni, Aberdeen: The frequency and veracity of the conversations have increased. If you look at the strategies that most LPs gravitate toward, is there some kind of value-add component that you're able to execute on at the asset level? Given the gap between capital expenditure programs and cash flow from operations, particularly in a reduced commodity price environment, we already saw some downward pressure on the ability to execute using your own income stream, which was historically the way that most of our managers would fund the increase of production—by drilling new wells, etc. So we already felt some of the downward pressure there as part of the go-forward market expectations among limited partners. When you think about setting aside long-term, patient capital—while interim valuations are helpful—when you think about what you bought the asset for and how you're managing it and, ultimately, what type of liquidity you're going to get in the back-end, folks are still taking a breath. Most general partners today are being far more aggressive in terms of their conversations with their investors. And we're probably going to see more aggressive writedowns, even if those writedowns are only temporary.

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Aberdeen Asset Management

Getting back to the M&A market, what does the lending market look like for deals in the energy sector?

Hosseinzadeh: The short answer is that capital markets are highly dysfunctional, starting with the banks, which are critical to the energy sector. Banks are retrenching in a significant way. There is curtailed appetite for risk across the bank balance sheets, which means that dealer inventories in the high-yield market are considerably lower, which in turn puts pressure on secondary spreads. And that leads to more expensive new issuances. A large number of bonds are lagging down 5, 10, 15 points, not necessarily for fundamental reasons but because people need to offload supply. Second, as a result of the shared national credit review, many reserve base lending facilities are going to be curtailed going into the balance of this year. And that's quite meaningful when you consider that for some companies that's almost 50 percent of their cap structure. As if the first two are not bad enough, oil is now down to a level where 90 percent of the U.S. [production] doesn't make money. So if you're sitting at the bank and arguing for a client, unless you're prepared to argue for an oil price near-term strip that's at a material increase, that makes for a very difficult conversation with the risk committee of the bank.

What tools can a manager use to mitigate the falling value of commodities?

Gasperoni: One of the benefits of owning the asset in the wellhead rather than buying the commodity pure is that you can work both sides of the ledger. You can control the flow, you can produce or not produce. And you can manage the cost side. We've talked about the fact that breakeven costs are actually a variable depending on A, where you are and B, how well you can manage the role of the producer versus the service provider. My expectation in this environment is that managers are using all the levers within their control to manage their way through this.
One of the skills a manager needs to have in this market price environment is the ability to manage

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the LP base and to collaborate, be constructive and, to the degree that you think there's going to be some stress on an asset level or a portfolio level, to be able to talk with your limited partners and find a way to manage through this in some way that doesn't cause permanent impairment either to that asset or to the fund itself.

Where in the value chain are you looking to invest during this downturn?

Hosseinzadeh: Upstream is a much more attractive place to be. The midstream sector has been quite problematic because there has been this perception in the marketplace that upstream can reduce volumes substantially and midstream is protected by the contracts. So midstream has the potential to be interesting, but it's probably not quite there yet. Services is a difficult sector to invest in until you start to get some visibility around oil prices. And not all segments of services are created equal. Some will be in secular oversupply because of productivity gains. There's a megatrend of doing more with less and you don't want to be on the wrong side of that. And then there is an underlying secular trend, which is higher cap ex intensity per well. At some point services does become interesting, but right now these companies don't throw off cash flow and there is not a lot of terminal value unless you can put your finger on what EBITDA is and the multiple is.

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What about the upstream oil field services industry? How will it evolve over time in light of low oil prices? Consolidation? Bankruptcies?

Sprenger: At $28 oil, we're not looking at a recovery anytime soon, so there's been a substantial decrease in oilfield services company market caps. Demand for drilling and other services has dropped substantially. There's a good degree of debt financing on that end too. Oilfield service companies are certainly feeling the pinch. A lot of them are highly levered. The EBITDA's not where it was. So we're going to see more bankruptcies there. We're going to see a lot more consolidation. Companies becoming more savvy, more nimble, finding ways to produce at lower prices—we can expect that down the road.

Hosseinzadeh: We were running something like 1,100 horizontal rigs before this downturn. Today we're running around 400. It's a very negative picture and there will be bankruptcies. That could lead to another round of expensive education for distressed invetors who don't have energy capability. Some generelist firms might that look at these companies on a multiple of prior cash flow or on liquidation value of equipment and decide to buy the bonds or the bank debt. The only way to make money in the oil field services sector is either to bet on a big recovery—which is, for most of us in private equity, not a very attractive business model—or to find a very defensive niche with barriers to entry and buy right. And today that's very difficult to find in the oil field services sector. So we're going to see a wave of bankruptcies and new lows for valuation and new lows for liquidation on equipment that has not been tested before. ■

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Assessing the Debt Opportunity in Energy

As oil prices continue to drop, the energy debt market is extremely volatile. Melissa Brady, a director at RSM US LLP, discusses where opportunities lie, and the impact of the illiquidity in the market.

Melissa Brady
RSM US LLP

Privcap: How do you value leveraged loans—those in the oil and gas sector in particular?

Melissa Brady, RSM: What we're looking at are loans that, in a nutshell, are already 1,000 basis points above Treasuries. I would argue that there's a lot less issues with interest rate risk and more on credit risk. One way to look at credit risk is by fundamental credit ratio. But it's limited, right? So there are a lot of more qualitative considerations to keep in mind, like the diversity of the cash flows. We want to argue that not all E&P companies are alike. There's going to be a big difference on break-even prices based on geography.

When we look at debt, we don't want to just focus on current ratios and current financials, but what are the capital expenditure requirements going forward? What are the break-even prices to know whether this company going to be able to sustain profitability? Looking at liquidity and its access to capital in order to understand—will it be able to weather the storm?

Is there a particular part of the space where you see more opportunity?

Brady: The Tier 1s are going to be your bigger conglomerates—the Permian Basin operators. Their loans are trading around 80, 90 [percent of par]. The Tier 2—they have sufficient liquidity. They're not in a dire distress situation. Loans are trading around 40, 80. They're the preferred targets. And then [with] Tier 3, unfortunately, there are major liquidity constrains. They need more capital just to survive, and they probably won't.

How efficient do you find the energy debt market now?

Brady: The debt markets are not as efficient as we would like them to be. There are few players that really get involved, and you have to remember, the loans that we look at are privately held, illiquid. So for those that are [involved], there's also not as much fluid information as you would find with the high-yield bond markets. And with regulatory changes, with the Dodd Frank and Volker rule, banks cannot service that intermediary anymore for other, more traded loans space. So that's also causing more illiquidity in the high-yield bond market as well as the traded loan space

What impact does this relative illiquidity have on pricing?

Brady: Not many people want to hear this, but there is that herd effect where a lot of investors in the debt space, they may get fearful and act at the same time. So we may see a major exodus. We have seen this before, and prices are going to have to really come down to find a suitable buyer. It depends on the appetite of the investor, but we should see more opportunities in 2016. ■

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