Expert Discussion

Hard Times for Oil & Gas

An interview with Baker Botts' John Kaercher. Mistakes made in the US shale revolution, rising interest in energy technology, governance issues with MLPs and the distress play in oil and gas.

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Privcap: Why are oil and gas stocks cratering right now?

John Kaercher, Baker Botts: It's almost a worstcase scenario. You couple supply shock with demand shock. Saudi Arabia was reaching out to extend the production cuts Russia said they were not going to go along this time. They were going to continue producing at a high rate. Now you've got everybody at full production because the agreement around production cuts fell apart.

On the demand side, you have COVID-19. And so on top of the market flooding with additional hydrocarbons, now you've got significant demand curtailment because nobody can travel. Airplanes are for the most part grounded. The fact that people are not out engaging in typical economic market activities, it's been, the worstcase scenario for oil and gas stocks.

Privcap: Keeping in mind that Warren Buffet said, one should be greedy when others are fearful and fearful when others are greedy, are you hearing from investors that now is the time to swoop in and start buying up oil and gas related assets?

Kaercher: I think people are still pretty cautious. ince the shale revolution, oil and gas companies have failed to prove that they can sustainably make money. They are very good at producing hydrocarbons but not necessarily good at ensuring that the hydrocarbons lead to cash to investors.

Privcap: Talk about the debt problem that many of these oil and gas companies have.

Kaercher: This isn't specific to oil and gas. The low interest rate environment since the global financial crisis in 2008 has made the cost of capital very cheap. You've got a lot of companies that have entirely too much debt. And with the market tanking their market cap has taken a huge hit. And so the market cap tends to be pretty significantly below their debt burden right nowhe debt burden is just too great for a lot of these companies.

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Privcap: Is there a lot of disappointment out there? The Permian Basin was supposed to make America the number one energy producer in the world. Certainly America can produce more hydrocarbons than anyone at this point. But it can't do it profitably.

Kaercher: As you rightly pointed out, the ability to produce from shale plays has made America the number one producer. The problem is, there was a lot of money flowing into that because of the promise. And unfortunately, the promise didn't hold up. The ability for the United States to be the number one producer and be energy independent is a great thingut you're not going to have the capital behind it to maintain that production unless they figure out how to make money. And I mean - let's be honest - at $20 a barrel, I don't think there's a single oil play in the world that makes money. It's not just a US problem right now.

Privcap: As you know there's still a ton of private capital that's looking for good investment opportunities. Where are they putting their capital if they are interested in the energy industry?

Kaercher: Right now a lot of people are saving their capital and sitting on the dry powder until they see how the broader market shakes out, given the impacts of COVID-19. As upstream producers go belly up or start to struggle, the midstream - the movers of the hydrocarbons - end up having issues as well.

I think one place where you'll see a lot more capital deployment going forward is on the energy technology side. That's both oil and gas energy tech and also broader energy tech like renewables or green hydrocarbons, or things of that nature. You're starting to see smart, young people who've been in the oil and gas industry for a decade now tend to be a little bit amazed by the lack of technology and the lack of modernization.

Privcap: When you say energy technology, how much of that is focused on improving the oil and gas industry and how much of that is focused on renewables?

Kaercher: The biggest piece of it is probably focused on next-generation energy, renewables - ways we can improve energy efficiencies. A big chunk of that is oil and gas, because as a lot of people know, sure, we all want to get away from using hydrocarbons. But hydrocarbons are used in so much more than just powering your car or flying your plane. Um, they go into pretty much everything you use on a day-to-day basis. It is important that oil and gas is the focus of developing technology.

Privcap: Talk about how these oil and gas companies have changed their approach to ESG - environmental, social and governance, including safety.

Kaercher: I think leading up to the global pandemic, people were making a pretty concerted effort to take ESG into account, not least because a lot of the large institutional investors have mandates to find investments where that is a critical piece. Governance has never been energy's strong suit. The downside is that, with the onset of COVID-19, that's taken a back seat because it is something that is difficult to deploy, to change your entire business model to try to accommodate ESG and ESG investors. People are focused on survival.

Privcap: You mentioned that many of these companies are being criticized around their governance practices, or rather perhaps lack of governance practices. Without necessarily naming names, can you give some examples of weaknesses that have led to problems?

Kaercher: The biggest example that people tend to focus on was always the MLP structure. The Master Limited Partnership is more used in the infrastructure space, just given the volatility in the upstream space. These are publicly traded partnerships, and as a partnership you don't have the same rules around fiduciary duties and obligations to shareholders that you do as a corporation.

Some people would say MLPs benefit sponsors more than they benefit the actual shareholders. That's been one place where you've seen a lot of activity. After the tax cuts in 2017, along with general market sentiment, people have started shifting from publicly traded partnerships back to corporations. That solved the problem a little bit.

The other issue that you'll see on the governance front is that there are a lot of public companies that file for bankruptcy and their management team makes significant amounts of money, even though they took the company into bankruptcy. People view that as potentially problematic. When times were good, you might have a couple of people in the cheap seats saying stuff about it. But as markets have suffered and individual employees of companies have suffered you'll start to hear more people raising their voices about how they don't think that's particularly fair.

I think that the people who pursue energy tech have for the most part been a little more in tune with the people that they're working for. Not just the board of directors and their investors, but their stakeholders, which includes employees.

And then obviously there's renewables, which was getting a lot of attention. It will continue to get a lot of attention, notwithstanding the current market environment. People recognize it needs to change. And there needs to be more of a drive towards improving the broader energy markets in the US, and not just such a focus on oil and gas.

Privcap: If there is a wave of bankruptcies and restructurings, private equity firms tend to be good at that. On the other hand, a lot of these companies are already owned by large private equity firms and it's going to be a huge issue for them. . .

Kaercher: A lot of the companies that are going bankrupt are

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already backed by private equity funds. There are some bigger, maybe more fiscally conservative funds out there that have been sitting around, waiting for these opportunities to try to snap up some assets at a really great value. I think you will see that. You might see some better positioned public companies using this opportunity to shore up their asset base. There's a lot of opportunity out there. And who takes advantage of it is going to be based on who was smart and cautious with their money in the boom times.

Privcap: What are the energy insiders saying about the big, key mistakes that were made during the boom times? Over-enthusiasm?

Kaercher: People were excited, especially back in 2014, before the initial oil price collapse. Oil was at $100 a barrel or more. Everybody thought that was a great opportunity to take out debt and go buy as much as you possibly could - to have a bigger company with better assets. Unfortunately, as is learned time and time again, oil and gas markets tend to be incredibly volatile. They came down and with it came down a lot of companies. And now here we are in a second shock, and I think the same thing might happen.

The other thing that happened is that shale plays were, in the grand scheme of things, relatively new. And so there were a lot of expectations about, for example, spacing, where you could drill parent-child wells really close to one another without a lot of degradation in the parent well. It turned out that just wasn't true. And you end up in a situation where your spacing had to be a lot larger than you would have otherwise guessed. It meant that you couldn't produce what you thought you were going to be able to produce.

That's the nature of any nascent technology. Shale certainly was a nascent technology. It's a little bit of trial and error. Unfortunately for oil and gas companies, it's on a little bit longer of a timelinend it involves a whole lot of capital. A you get a lot of people who spent a lot of money on something that maybe necessarily wasn't what they thought it was going to be. ■

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