Alternative Capital Providers
to Oilfield Service Companies

By MARK E. CHESEN
SSG Capital Advisors, LLC

Jay Krasoff, Managing Director of Chiron Financial Group, Inc. and an SSG Capital Advisors strategic partner for the energy sector, and colleagues discuss capital options for oilfield service companies.

The participants in the following roundtable discussion represent a broad cross-section of alternative capital providers with a long history of lending to and investing in companies in the oil and gas sector. The participants include David Hull, managing partner, Renovo Capital, LLC; Preston L. Massey, co-founder and managing member, Congruent Investment Partners, LLC; Todd M. Tomlin, co-founder and partner, Turnbridge Capital, LLC; and Greg White, vice president, Arena Investors, LP.

Jay: Where do you see the market for 2016 and will the senior lending banks stay in this market or exit?

Greg: It's going to be very difficult for commercial banks to provide additional financing in this sector. In conversations with a lot of commercial banks, there's really no appetite to provide the capital despite there being high quality deals that are very financeable from a senior lender's perspective. It looks like they are looking to unwind or lower their exposure. That creates opportunities for us when there are high quality management teams sourcing acquisition opportunities or bolt-ons but they just can't find capital. So they will have to go to the non-bank market to find financing and that's the market we serve, the $5 to $20 million lower middle market segment.

Todd: I agree with Greg. It's going to be a difficult year for the E&P universe, and upstream spending is going to be down. Thus, those businesses in the services and equipment space which benefited from working capital contraction this year won't have that benefit next year. So there's definitely a contraction of capital. We see the traditional lenders who understand this market as remaining very committed, but looking to manage exposure where they can, which will make it really hard for companies to do new or incremental things. I think there's a lot of dislocation from some of the non-traditional lenders that are not energy focused and have been in this sector for less than five years. I believe they will be exiting next year. I think it's going to be a pretty chaotic market for transactions and financing.

We see the traditional lenders who understand this market as remaining very committed, but looking to manage exposure where they can.

Preston: In the middle market we see regional banks feeling more pressure on the services side. There's been more publicity and market scrutiny on the E&P side, but most of that pain is being felt in the high-yield energy bond market as opposed to the traditional bank market. So in terms of capital available for middle market services companies, banks that have been the primary funding source are pulling back and will likely be realizing more losses in 2016, which will further restrict their ability to provide new capital. Meanwhile the biggest alternative capital providers in the middle market have been business development companies (BDCs), many of which are facing financial problems of their own and will not be able to make new loans. That will further restrict capital availability in the middle market.

David: The rig count decline has definitely decelerated and we are seeing that manifesting itself into flattening fourth quarter 2015 results. We are assuming Q4 2015 is a pretty good proxy for what to expect throughout 2016 and we are advising operators to be sizing operations and capital planning at these Q4 levels. These levels are painful; we are seeing the typical oilfield services company with $15 million EBITDA in 2014, $7 million LTM Q3 2015 and run rate of $2 million in Q4. Using the current run-rate EBITDA numbers as an indication of near-term values for these companies, they are fundamentally non-financeable. Those companies are not going to access the capital markets outside of equity raises and we expect that given the significance of the decline, once banks are able to digest the Q4 results and implied run rates, operators are going to be challenged by these lenders to get leverage in-line with this near-term profitability profile.

Jay: What alternatives do oilfield service companies have to raise capital today?

David: Options will unfortunately be very limited. We see asset values being massively depressed.

Alternative lenders can do aggressive, loan minded investments which are entirely equity or equity-like in terms of their risk and return profile.

The ability to get any kind of replacement financing on the back of your assets is almost impossible because you can't discern current liquidation value. Further, E&P companies cannot give oilfield services operators any definitive view into 2016 pipelines, so the ability to put out credible budget for 2016 is a real challenge.

Todd: Revenue for the industry is going to be down year over year, I agree with David. The fourth quarter of 2015 is the new normal operating environment for these companies and the industry as a whole is losing money. It's not sustainable and some of these businesses are not going to make it to the other side. There's too much capacity of people and equipment in some of these sub-verticals, and overall, it's going to be a very difficult 2016. Some of the companies that made it through 2015 did so because the balance sheet contraction covered their fixed payments and that will not assist in year two. It will require alternative lenders to partner with these companies. Alternative lenders can do aggressive, loan minded investments which are entirely equity or equity-like in terms of their risk and return profile. I think it needs to be dominated by people who understand the industry. Since there's a lot of rationalization occurring in this business, it's going to last for a while, and many times business models and management teams will continue to benefit from a real strategic capital partnership, not just a loan.

We are looking for teams that are proven operators and sound business people who think like investors in terms of deploying capital and generating returns on invested capital.

Jay: In 2015, there were a lot of failed M&A transactions due to a wide valuation gap between buyers and sellers, along with other factors. Do you think there will be an increase in M&A and restructuring activity in 2016?

Preston: Most likely there will be an increase in distressed M&A transactions but I would qualify that by saying there's still a tremendous amount of attempting to kick the can down the road, whether it's the legacy equity holders, the operator, or the banks that are impaired. We continue to see a tremendous number of paralyzed situations where nothing is getting invested in the business, it's just dangling by a thread but the banks don't want to force the borrowers' hands, so the operators are going to hang on as long as they can. Until you see that capitulation, there is not likely to be an uptick in M&A activity.

Greg: I think you're going to see a lot of bankruptcies and liquidations. The M&A activity will be around those who end up acquiring ABC company out of bankruptcy, or what company ends up acquiring an equipment division or asset package from some of these wind-downs. I don't see a lot of capital coming out to finance rollups.

Jay: What qualities or capabilities are you looking for in the management teams, or in a balance sheet?

Greg: We are looking at track record, cash flows and skin in the game.

Preston: We are looking for teams that are proven operators and sound business people who think like investors in terms of deploying capital and generating returns on invested capital. Alignment of interest is also extremely important. Management needs to have skin in the game and be properly incentivized with our common goals.

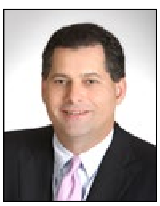
David: Alignment is number one. You can weather a lot of storms, and you can manage to a lot of less-than-optimal situations where the company might have positioned itself from a market or capability perspective over the last couple years, if you have good alignment. For us that mostly manifest itself into a very realistic perspective on the near term operating environment where we can collaboratively reduce operating costs and reduce footprint, down to a level that keeps the company operating cash flow positive through 2016. Also, it is finding people we feel have shown an ability to perform at a very high level through at least the last cycle, if not the last two cycles.

Todd: We care about the sector and its importance to the industry over the long term, and we focus deeply on their customers, to whom the company has been and continues to sell. We think there's a lot of relative differentiation among the quality of E&P companies and how they'll behave over the next year or two. Lastly, especially now that we are a full year into this, we care about assessing that the management team has been proactive already in reacting to an altered industry backdrop.

ABOUT THE AUTHOR*: Mark E. Chesen is a founding partner and managing director of SSG Capital Advisors. He has completed over 100 investment banking transactions involving the sale, private placement or financial restructuring of middle market companies in North America and Europe.*

Mark Chesen

ABOUT THE ROUNDTABLE PARTICIPANTS*: Jay Krasoff is a managing director of Chiron Financial Group, Inc., a Houston-based investment bank and SSG Capital Advisors strategic partner for the energy sector. He has over 30 years of investment banking experience and has spent most of his career advising clients in the energy industry on mergers, acquisitions, divestitures, restructurings and capital raises.*



Jay Krasoff

David Hull is managing partner for Renovo Capital, LLC, a special situations investments firm based in Dallas. Renovo Capital provides control or non-control equity positions in businesses and have invested approximately $2 billion in the energy sector, up and down the sector.

David Hull

Preston L. Massey is co-founder and managing member of Congruent Investment Partners, LLC, a private investment firm based in Dallas. Congruent Investment Partners invests up and down the capital structure including unitranche debt, mezzanine debt and structured equity. They are focused predominantly on the production and maintenance side of the oilfield services sector.

Preston Massey

Todd M. Tomlin is co-founder and partner of Turnbridge Capital, LLC, which has offices in Dallas and Houston. Turnbridge Capital provides control equity positions in middle market service providers and equipment manufacturers that sell not only into the upstream business, but also into the midstream, downstream, and other infrastructure sectors.

Todd Tomlin

Greg White is vice president of Arena Investors, LP, which is based in New York, with offices in Canada and San Francisco. Arena Investors is a credit-oriented finance company. As it relates to the E&P or the energy sector, they invest across the capital structure and in the ground, and have looked at both service companies and working interest transactions with an emphasis on private lending, whether first lien or second lien, and secondary markets.

Greg White