Surviving Industry Turbulence:

Know your Capital Options

By MARK E. CHESEN, SSG Capital Advisors
JAY KRASOFF, Chiron Financial Group Inc.

Companies across the oil and gas industry are facing major financing challenges. The current financing environment stands in stark contrast to that of the 2008-2013 period when there was a large inflow of capital into the energy sector, which helped spur major investment across the oil and gas industry. As oil prices plummeted between the summer of 2014 and the spring of 2015, lenders began to reduce credit lines, enforce covenants and require more collateral from borrowers to protect against defaults and mitigate the risk of loan losses. What's more, recent pressure on banks from federal regulators increased, which resulted in some lenders jettisoning into space. Alternative capital providers have stepped in to fill the void. This new reality requires sector participants to adopt new capital strategies.

What happened?

As oil prices fell, upstream companies rapidly reduced their costs and their production activity. For example, rig counts have been halved. The exploration and production (E&P) companies adapted their business models to be more flexible and significantly reduced their cost structures. They right-sized their business costs and assets, consolidated vendors and leveraged fixed costs through greater efficiency.

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Meanwhile, oilfield services were left reeling from cutbacks in drilling and spending by E&P companies and their revenues and margins declined.

Many E&P companies had access to inexpensive bank lines of credit, which they locked into prior to the collapse in oil prices. This access to credit, coupled with their crude oil and natural gas price hedging strategies, allowed E&P companies to weather the drop in oil prices to date. However, many of the hedges are set to expire in late 2015 and 2016. Also, E&P companies are bracing for a recalculation of their bank borrowing bases, which are typically calculated every six months and are based on the value of their reserves. The last borrowing base recalculation occurred in the spring of 2015. The next recalculation of borrowing bases will occur in the fall of 2015, which may result in consolidations, restructurings and even some bankruptcy filings of E&P companies. Any negative financial impact on E&P companies will have a ripple effect on oilfield service providers.

The changing industry dynamics of lower oil prices has escalated interest in the oil and gas industry by alternative lenders and investors. The upside for capital providers with longer term investment horizons include: predictions by experts for oil demand to grow over the next decade, scenarios where oil prices return to equilibrium between \$65 and \$85 a barrel, and expected consolidation which would alleviate

some of the pricing pressure on oil and gas companies. Right now, alternative capital providers and investors are quickly evaluating opportunities across the various oil and gas industry segments, with E&P and oilfield services attracting strong interest.

Options for Oilfield Service Companies

Alternative capital providers to oilfield service companies include hedge funds and alternative asset investors, private equity firms and non-bank lenders. They typically have experience dealing with complex, distressed and special situations transactions and have expertise working with management teams as they restructure, turnaround, reorganize or liquidate non-performing or non-core business units and/or assets. Some providers are solely focused on the energy sector or a certain geographic region, while others are industry and region agnostic.

Alternative lenders and investors bring different products and capabilities to bear, and as such, management must determine which capital provider best meets the oilfield services company's current and future needs. Owners and management teams need to realize that the more financially challenged the business, the fewer their options. Exploring possibilities and making hard decisions early will preserve more options. Oilfield service companies should explore the full range of capital options available to them and understand the benefits and drawbacks of each.

Capital providers favor working with management teams who have a track record of success and have led a company through a prior downturn. In addition, the management team should have a strong knowledge of industry dynamics and their competitors, as well as have good financial and accounting systems in place. Good recordkeeping is essential for the due diligence and ongoing reporting required by capital providers.

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Hedge Funds—While some hedge funds are exiting their energy positions after suffering losses, others are looking to increase their energy holdings and focusing on companies that can survive and be profitable in the current environment. Hedge funds are actively looking to purchase energy-related debt from banks at a discount. In addition, some energy companies represent an attractive direct investment, or in some cases co-investment opportunity alongside private equity, for funds that can leverage their deep industry relationships and professionals with energy expertise. Hedge funds typically actively manage their investments and can provide much needed capital to the cash-constrained energy sector. In addition, hedge funds with a long-term investment horizon can wait more patiently for companies to realize desired results.

Private Equity—The energy industry remains an attractive sector for private equity firms which have invested heavily across the entire oil and gas value chain, from upstream to midstream to oilfield service companies. The year 2014 saw record levels of fundraising for energy funds. Private equity firms with an energy or special situations focus recognize that the values of all energy companies and their assets have been painted with a broad brush and adjusted downward indiscriminately. With the right capital structure in place and access to reliable capital, these companies will be poised to grow through acquisitions and as a result of expected consolidation in the industry. In addition, private equity professionals will work alongside management to right-size the business, negotiate better terms with lenders and creditors, and implement cost control initiatives.

Equity infusions by investors are generally viewed as positive events by lenders and creditors. The infusion provides a cushion of capital subordinate to the bank's interest and provides the company the working capital it requires to prove their viability on a longer-term basis. In addition, creditors view the positive cash flow as additional security that they will be paid in a timely manner and in full.

Additional Non-bank Lenders—As access to capital through traditional banks and the capital markets has become increasingly restricted for oilfield service companies, many businesses have turned to non-bank lenders including asset based lenders, mezzanine lenders and factoring companies. Asset based lending provides liquidity based on the value of a company's assets, not its earnings, and often provides more liquidity than traditional bank financing. In addition, asset based lending typically has fewer covenants surrounding financial performance which gives management teams more flexibility in operating or restructuring a business. Mezzanine or second lien debt may also be appropriate for some oilfield service companies, such as drillers, which are capital intensive and require long-term financing for assets. It is also appropriate for companies looking to grow through acquisitions. Mezzanine debt sits in between the senior debt and equity on the balance sheet and generally does not require the sale of equity ownership in the company and does not give control of the company to the capital provider. Some mezzanine debt providers do offer equity co-investments and/or require a board seat with their investment.

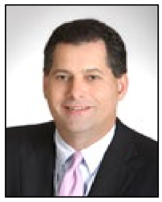
For equipment providers to the oil and gas industry with a global customer base, Ex-Im Bank provides exporters with products including loan guarantees, direct loans and finance lease guarantees. Ex-Im Bank will work with a company's existing lender to unlock cash flow for a business and allow it to take on new business abroad. As of this writing, Ex-Im Bank's authority has lapsed and they are unable to process applications for new business. It is expected that this authority will be reinstated when Congress reconvenes after its August recess. There are other government or quasi-government loan guarantee programs available to oil and gas companies through the USDA and SBA, allowing private lenders to extend more credit than they would typically be able to.

Conclusion

Alternative capital providers are a good source of financing for oilfield service companies and equipment providers to the industry. It is imperative that companies understand the options available to them as well as their respective pros and cons. Companies should engage financial advisors and investment banking professionals who can devise a capital structure that is appropriate for the business and that aligns with the short-term and long-term goals of the company, who have relationships with capital providers and who know how to structure complex transactions.

***ABOUT THE AUTHORS**: 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



Jay Krasoff

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.