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ENERGY

Structuring Private Funds to Profit from the Oil Price Decline: Due Diligence, Liquidity Management and Investment Options

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Energy companies directly or indirectly reliant on reserve based lending and public equity markets are feeling pressure as markets have tightened, as evidenced by recent significant stock declines, IPO delays, dividend and distribution cuts and missed interest payments leading to bankruptcy filings. If lower prices are sustained, this financial pressure will continue over time as reserves are increasingly valued at lower prices, interest rates move upward and poorly hedged E&P companies and counterparties face unfavorable positions. In such a market, leveraged and shale focused high-yield exploration and production (HY E&P) companies, shale-reliant and undiversified oil field services companies and small- to medium-sized financial institutions with significant exposure to such companies and the boom oil patch areas generally will present distressed investors with plenty of opportunities to extract value from current market conditions. Along with the financial considerations, investment funds looking to take advantage of distressed energy opportunities will have to consider various legal matters including structuring the investments, due diligence and dealing with potentially illiquid positions.

What Oil Companies Are Facing

During the run-up in oil prices and sustained low interest rate market, many HY E&P companies, particularly those exploring higher break-even shale plays, financed their high cost and ambitious drilling programs by taking on significant debt and frequently accessing public markets. The continued profitability of these companies will depend on whether or not oil prices recover to the higher levels seen over the last year. Many HY E&P companies likely do not have a capital structure that will allow them to withstand sustained low oil prices. Historically, HY E&P companies have escaped defaulting in bad economic times due to on-hand collateral and the cyclical nature of their business. However, the rapidity of oil's price decrease, coupled with fears that this price shift signals a fundamental change in the price of oil, may put many HY E&P companies into distress due to the borrowing base constraints and other financial and operational covenants of their credit facilities and indentures as well as general declines and tightening of public and private capital sources for these companies.

HY E&P companies with large capital expenditure needs driven by significant contractual drilling or production obligations, high utilization of reserve based credit facilities and reliance on public markets, are especially likely to feel the effects of sustained low oil prices. In recent years, lenders have been readily willing to provide credit to these companies with a borrowing base tied to higher prices and companies have been able to supplement their credit facilities by raising additional capital from a market eager to get into energy. Furthermore, companies found success in convincing lenders to give value to their proved undeveloped (PUD) reserves in addition to the traditionally considered proved developed producing (PDP) and proved developed non-producing (PDNP) reserves. Thus, with high oil prices and inflated reserves, HY E&P companies were able to fund operations with leverage and financing that was barely sustainable at $80 to $100/bbl, much less at or below $50/bbl.

However, lenders were certainly not going maintain borrowing bases pegged to higher oil prices for long. Companies are beginning to see a retrenchment in value given to their reserves as evidenced by the Macquarie Tristone Q1 2015 Energy Lender Price Survey, which reports an approximately 37.7% decrease in West Texas Intermediate (WTI) lender base case front-year pricing since its Q3 2014 survey and this trend appears likely to continue as front year WTI discount averages are near 100% compared to the 72% to 86% averages seen over the past five years. HY E&P companies are beginning to face scheduled redeterminations of their borrowing bases and as trailing average prices continue to decline, particularly price sensitive and leveraged companies (such as those focused on the more expensive shale plays) will face increasingly lowered borrowing bases and the greater costs and lesser flexibility that comes with higher utilization rates. As such, and without the public markets providing ready relief, these companies will likely need to consider capital restructuring and seek alternative financing arrangements such as second lien and mezzanine loans and preferred equity. A sustained price drop and rising interest rates would likely exacerbate this issue for such companies and cause a number of HY E&P players to fall into the distressed category and/or to seek consolidation or other M&A maneuvers to monetize assets, diversify or lessen exposure to their less profitable plays.

With the pressure on E&P companies, low oil prices are also putting stress on oil field services firms as their customers scale back and reassess projects in the new low oil price environment. These delays, and possibly cancellations, of projects will particularly strain smaller oil field services firms, who are often not well diversified and are dependent on consistent cash flow from a small roster of key customers, and many will likely struggle to make up for the revenue gaps and keep up with increasingly large and diversified competitors (as evidenced by the Halliburton-Baker Hughes and C&J Energy Services-Nabors merger announcements). Moreover, massive labor force reductions by key companies in the industry (industry leader Schlumberger has announced 9,000 layoffs alone among the more than 100,000 in global oil layoffs reported by Bloomberg) indicate that smaller oil field services companies will soon face similarly tough decisions regarding their workforces and ability to operate generally. Thus, in the face of these headwinds, many of these companies will feel significant financial pressure and need to consider alternative financing arrangements or seek their own consolidation in order to increase efficiencies, market share and pricing power.

In addition to direct plays in HY E&P and oil field services, financial institutions and funds with significant energy exposure in hedging and lending present opportunities for investment, either directly or by taking over their positions. Many of these institutions, particularly small- to mid-size institutions in Texas and other oil-heavy states with a memory of the impact the 1980s oil glut and seeing oil prices well below their sensitivity cases, may desire additional capital or to liquidate some of their riskier hedging and loan positions to lessen their overall exposure to the sector. This will likely present an opportunity to make value investments in otherwise strong financial institutions or to pick up mispriced or discounted hedging and loan positions.

Approaching the Opportunity

While investors interested in distressed energy plays have a multitude of options when it comes to structuring transactions, each presents unique risks and rewards that must be carefully weighed even though speed is a critical factor in maintaining maximum leverage in such negotiations.

Debt in particular is likely to be a preferred structure for funds under current market conditions, including taking positions in current first lien revolvers or senior notes or infusing new capital through second lien and mezzanine financing. Debt provides a flexible investment vehicle for an investor looking for exposure to a well-run company under a liquidity crunch or as a vehicle to eventually take control of a company if so desired. See "*From Lender to Shareholder: How to Make Your Equity Work Harder for You,*" The Hedge Fund Law Report, Vol. 3, No. 20 (May 21, 2010). In this regard, a debt investment will provide the investor with many options. First, a debt investment before bankruptcy will earn the investor a seat at the creditor's table if a bankruptcy is declared, giving the investor some comfort on receiving a return on the investment. Moreover, the investor may have leverage in any pre-bankruptcy negotiations with the company to gain favorable terms in any future restructuring. Further, a significant debt investment can give an investor some level of corporate control over the company if the investor feels that such control is necessary to safeguard the investment. Lastly, if the debt investor is interested in taking control of the company, such investor may use the bankruptcy proceedings as a way to trade its debt for equity in the plan of reorganization. See "*Liquidity for Post-Reorganization Securities Under Section 1145 of the Bankruptcy Code*," The Hedge Fund Law Report, Vol. 3, No. 26 (Jul. 1, 2010).

Like debt investments, equity transactions also come with their own unique risks and rewards which are often determined by whether the investment is in a preferred or common position, in the parent company or through a joint venture, and whether it is made pre-bankruptcy or during the bankruptcy proceeding. For example, in a pre-bankruptcy context, the investor can attempt to utilize its leverage to negotiate favorable terms such as price discounts, higher dividends in a preferred position, investment in the general partner of a master limited partnership and influence through approval rights and board observation rights or representation. A further potential benefit is that there may be fewer hurdles posed by existing credit and debt instruments to issuing equity (but possibly a need to amend governance documents) depending on how the investment is structured. However, if bankruptcy comes into the picture, a preferred investor would find itself ahead of common equity, but any favorable terms negotiated by the investor pre-bankruptcy could be wiped out.

A third general approach to distressed energy investing is through direct investment (particularly with respect to E&P properties), including farmout working interest arrangements, overriding royalty interests, volumetric production payments (VPPs) and "drill-to-earn" arrangements, amongst others. When properly structured, a direct investment can provide investors with a key advantage – bankruptcy protection. At the state level, such an investment generally takes the form of a real property interest which will not be considered part of the debtor's estate in bankruptcy and will also help protect the related production payments from being caught by the automatic stay (however, investors must be careful because results can differ state by state depending on the form of investment as, for example, overriding royalty interests and VPPs may not have this real property benefit in, notably, Kansas and Oklahoma). The federal Bankruptcy Code also produces similar results by way of a safe harbor which carves out both production payments and farmouts from the debtor's estate. These sorts of direct investments also allow funds to target particular assets that may be of interest without the potential drag posed by less attractive assets and may come with fewer obstacles from existing debt and equity instruments and stakeholders as compared to new debt or preferred equity. Moreover, companies may find direct investment advantageous given that it permits monetization of assets without dilution of equity or control while still allowing it to signal to the market that a "new partner" has validated the strength of its assets and management team.

Nevertheless, direct investment comes with its own pitfalls. Significantly, a direct investment comes with additional risks and concerns that an investor will need to plan for and monitor including direct commodity price risk, reserve and operational risks, marketing of production received in-kind and, depending on the investment structure, potential environmental and plugging and abandonment liabilities. These sorts of risks and the peculiarities of the industry may mean the need to hire or engage oil and gas specialists and to consider extra hedging and insurance actions to better protect the investment. Some forms of direct investment may also come with the need to fund additional costs or involve actual operating interests, which may not fit well with the funding or structure of the fund. In addition, not all of the oil and gas tax deductions apply to all forms of direct investment. For example, the deduction for intangible drilling and development costs and the deduction for depletion are not available if the direct investment is structured as a VPP. Further, in the context of foreign investors, certain additional U.S. taxes related to the Foreign Investment in Real Property Tax Act (FIRPTA) may apply and would need to be monitored.

Speed vs. Diligence

While speed is a key factor in distressed investment in order to maintain maximum leverage, investors should at least be sure to undertake a careful baseline due diligence process to identify key issues facing the investment. This will help funds see roadblocks that may stand in the way of the preferred investment strategy and avoid future issues and reduced returns that may arise from structural problems and undiscovered liabilities. Such a process would include a detailed review of existing capital arrangements, such as credit agreements, indentures and preferred shares, along with diligence on the existing creditors and shareholders to determine the existing stakeholders' level of resistance to (or interest in joining) a new investment. Failure to do so may result in a fund expending efforts towards a type of investment that is not workable under existing arrangements, being mired in long and arduous negotiations with existing stakeholders or could even lead the company into default, thereby giving existing stakeholders even more influence over the company at the expense of the new investor.

Whether debt, equity or direct, a baseline level of diligence is paramount in evaluating any investment; however the need for speed in these sorts of investments means that a more fulsome diligence process cannot always be undertaken. One option funds can consider to mitigate the downside risk in such a situation would be by securing representation and warranty insurance. By focusing on key due diligence matters, investors can ensure that any major issues are discovered through their internal due diligence processes and the risk of more remote liabilities can be passed on to a third party by obtaining such insurance.

Fund Structuring Considerations

In addition to transaction level considerations, investment funds should keep several things in mind when structuring funds for distressed energy investments – efficiency of fund formation, tax considerations and handling illiquid investments. As discussed above, speed is one of the most important considerations in distressed investing. With borrowing base redeterminations and capital expenditure shortfalls looming and no significant increase in the price of oil predicted, viable energy company targets will be foremost on distressed investor's minds. Therefore, creating a sophisticated, tailor-made fund should be a key consideration for any fund manager looking to take advantage of the opportunities outlined above. Tax considerations also need to be on managers' minds, especially those looking at master limited partnerships or direct investments, which can create operating, reporting and pass-through issues for the fund and both foreign and domestic investors. See "*Tax and Structuring Considerations for Funds Organized to Invest in Master Limited Partnerships*," The Hedge Fund Law Report, Vol. 6, No. 30 (Aug. 1, 2013).

Lastly, fund managers need to consider how to handle potentially illiquid positions that may come from investing in distressed companies, which implicates issues often seen with hybrid funds. Oftentimes during bankruptcy, the securities of the bankrupt company will become illiquid due to the automatic stay and fraudulent transfer concerns, amongst others. The complexity of dealing with illiquid investments can create issues at the fund level as investor funds move in and out. Thus, utilizing side pockets for distressed energy investments can be helpful to ensure that investor redemption requests do not cause stress during the bankruptcy proceeding or the fund manager's investment strategies. On hybrid funds, side pockets and redemption management mechanisms generally, see "*Structures and Characteristics of Activist Alternative Investment Funds*," The Hedge Fund Law Report, Vol. 8, No. 10 (Mar. 12, 2015).

In addition, even when a fund is focused on a liquid investment strategy in the energy industry, such as investing in publicly-traded debt of distressed energy companies, it may take a fund manager time to identify investment opportunities in the space. Thus, a manager may wish to consider a fund with a short draw-down period rather than requiring the investors to contribute all capital up front, as is typically the case with funds that pursue a liquid investment strategy.

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