Critical Decisions When the Clock is Ticking

Deep industry experience, planning, and analytics tools are necessary when decision-making and execution determine an E&P company's survival

By: Dennis Ulak and Michael Manes

The oil and gas industry is dealing with an unexpectedly high degree of change over the last 14 months. The world is shifting after years of constrained supply, high demand, and relatively stable prices. Low prices, oversupply, and heightened volatility are the catch-phrases of the current paradigm.

Among the hardest hit are U.S. exploration and production (E&P) companies that relied heavily on debt financing over the last seven years. As the fourth quarter of 2015 approaches, many of these companies are faced with extremely difficult choices. Some will be able to fund their capital expenditures and service their debt while staying within their financial ratio covenants, as well as other stakeholder agreements, and EPS targets. Others, however, will not; many will require a financial and operating plan that includes extreme precision, speed, agility, and flexibility. Without such a plan and seamless execution, survival is by no means guaranteed.

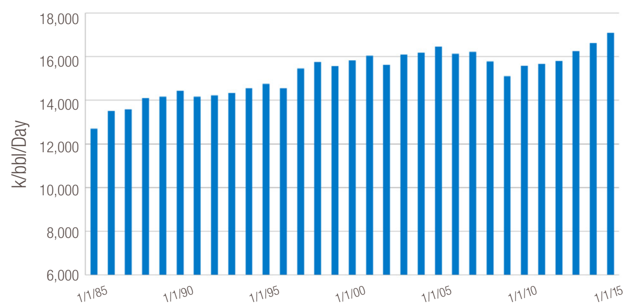
The following profile provides an example of how industry experience and deep capabilities in planning and analytics can be combined to avert a liquidity wall and provide a pathway to survival and then growth. While the company is not real, the situation is similar to several companies Huron's Business Advisory and Enterprise Performance Management and Analytics practices have seen.

Border Energy is a U.S.-based E&P company with an enterprise value of approximately $425 million. Its production is predominately in the Texas Gulf Coast and the Mid-Continent regions.

Historic WTI (Spot) Prices

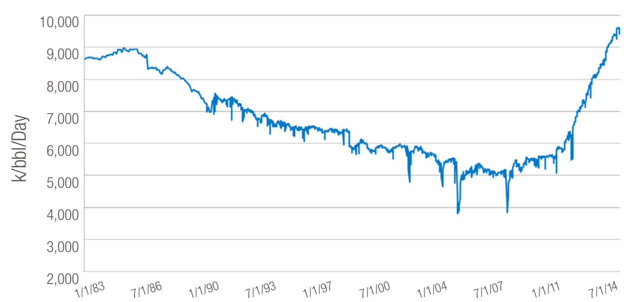
Source: EIA

U.S. Oil Demand



Source: EIA

U.S. Field Production



Source: EIA

Like many of its North American peers, Border relies heavily on debt financing to fund its growth through aggressive drilling campaigns. As long as oil and gas prices remained relatively high and debt capital was priced at historically low rates and readily available, Border's approach to funding growth through debt was sustainable.

The precipitous drop in oil prices over the past year has severely contracted Border's cash flow and contributed to the company being out of compliance with several typical financial ratio covenants contained in its loan agreements.

As prices tumbled more than 50 percent in fewer than six months, Border's capacity to hedge production in 2016 and 2017 at prices that could sustain operating expenses and debt service evaporated.

Border is now in a liquidity crisis. The company has some options, but it must act quickly to asses a wide array of scenarios and fluctuating variables.

As a result, Border has entered into a very demanding forbearance agreement with its creditors. As a condition of the forbearance, Border has been required to retain an advisor to assist in preparing both near-term and intermediate-term cash flow and liquidity projections, assessing recapitalization options, and reviewing asset sales options.

Let's Examine the "Facts":

- Border was formed in 2008 and now produces 3,500 bbls of oil and 45 mmcf of gas per day.
- Border has $175 million of senior secured bank debt and it has second lien debt in the amount of $150 million.
- Border entered into a third tier of debt, a mezzanine loan agreement in the amount of $85 million in 2014, immediately prior to the drop in oil and gas prices last October.
- Border is in the process of executing a large capital project and has $47 million in past due accounts receivable as a result of that project's timing in this sudden downturn. The capital project's completion is at least six months away.

The banks in the senior group are subject to federal oversight and Border's loan has been placed in a high risk category. These senior banks are being forced to increase loan reserves or exit the credit. As a result, these banks have used the forbearance agreement to set a one month deadline for Border to obtain a binding agreement from bona fide new lenders to replace or "take them out."

Ticking Clock

In the next four weeks, Border must assess an array of options with its three tranches of current lenders, prospective lenders, and its equity sponsors. It must find an outcome where it can bridge its liquidity gap until additional revenue is generated from the large capital project it is attempting to execute and bring online.

The only way to fill this six-month gap is an infusion of one or more forms of capital. The possible sources of capital are:

– More equity

– A larger borrowing base in a new senior secured facility

– An increase in the loan amount for its second lien facility or mezzanine facility

– The sale of assets

– A structured drilling program that provides non-recourse financing

Each option impacts the existing stakeholder groups, and the current loan agreements effectively prohibit any action without renegotiation with all parties. Failing to find a solution, all of the stakeholders will be in a worse position – some substantially worse – and Border may be forced into bankruptcy.

Creating Transparent Model

Border must immediately build an accurate, transparent, and dynamic model that is fully capable of running each of the scenarios in front of it and also running them under varying price and production rate sensitivities. The model and output must be credible and transparent, as all stakeholders will be requested to compromise and restructure their existing agreements. This cannot be achieved unless everyone is operating on the same set of modeled outcomes.

Building a similar model typically requires 12–14 weeks using software and/or proprietary knowledge as the foundation of the model. The process consists of the following phases: scoping, design, build, test, and first use. However, a company like Border needs to begin making critical decisions immediately and then continuously tweak, shape, and modify those decisions until the critical issues are fully resolved.

Huron Business Advisory is able to use its oil and gas experience to create and implement bridge tools that are responsive to a highly compressed timeframe, and permit early decision-making and an acceleration of the full dynamic model's creation and roll-out.

The scoping phase can be compressed in time due to sector-specific knowledge and the business process knowledge.

The design phase can also be compressed for the same reasons, and the design outcomes can be improved due to the sector knowledge and benchmarking. Specifically, the company's end-needs are shaped and identified faster, and better KPIs are created.

While the build phase is underway, a "bridge" model is created, and serves to allow the company to being making decisions. The bridge model also helps to shape the iterative build process, accelerates the test/training phase, and accelerates first use capabilities.

While every company's situation is different, the ability to accelerate the adoption of a strategic and tactical model can be invaluable to an E&P company working through this difficult scenario, as well as the company's stakeholders. Utilizing a strong advisory practice that has the organizational benchmarking, process, and implementation history can be vital.

About the Authors

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Dennis has more than 35 years of experience organizing and leading teams to invest and manage upstream and midstream, oil field services and related infrastructure investments. His extensive operating experience in the U.S. as well as Asia, Africa, and Europe has led to solid relationships in the energy community where he advises on oil and gas markets, acquisitions and restructurings of energy assets, market conditions and the structured financing of large and complex energy projects. Prior to joining Huron, Dennis served as the CEO and president of the international subsidiary of one of the largest independent oil and natural gas companies in the United States. Dennis can be reached at 713-229-5824 and dulak@huronconsultinggroup.com.

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