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Liquidity Woes

Preparing Oil Companies for Ongoing Turbulence

by Julie Schaeffer

Oil prices don't appear poised to rise anytime soon and, until they do, oil companies and their capital providers must decide if they can survive and, if so, how.

"Most companies have a significant ways to go in making structural cost improvements," says Dennis Ulak, a senior director at Huron Consulting Group. He says that the companies that make the appropriate adjustments will likely be the leaders when the cycle finally returns to the growth phase.

Freeport-McMoran is well acquainted with the challenge. The minerals producer aggressively diversified into the oil and gas business in 2012 with two acquisitions focused on offshore production in the Gulf of Mexico: Plains Exploration and McMoran Exploration. Now the company, which paid \$9 billion through a combination of cash and shares for the acquisitions, is completely restructuring those businesses and is looking to monetize the assets.

The decline in oil prices began in July 2014, and with oil now hovering around \$40 per barrel, the drop is the most precipitous in 35 years. The number of active drill rigs is one measure of just how dire the situation is. After reaching a recent high of 1,931 during September 2014, the U.S. active rig count plummeted to 619 in January 2016 – a decrease of nearly 70 percent.

In this environment, many exploration and production (E&P) companies are tightening their purses to ensure that they have enough liquidity to stay within their financial covenant ratios, service debt now, and survive until prices recover, however long that takes.

"The usual playbook has been to cut vendors, squeezing them to the lowest possible marginal cost, then cut staff," Ulak says. "There are efficiency gains elsewhere in the supply production stream, but those are the two easiest cuts."

Freeport, for example, is firing its top oil and gas executives and is undertaking a near-term deferral of exploration and development activities by idling the three deep-water drill ships it has under contract.

And, in March, the Canadian Association of Petroleum Producers (CAPP) issued a news release that made international headlines: Capital investment by the group's members would be only \$31 billion in 2016, down from \$81 billion in 2014 and the largest reduction in CAPP's history of data collection, dating back to 1947.

But such cost-cutting measures may not be enough to ensure the survival of E&P companies. Freeport, in mothballing its drill ships, expects to incur idle rig costs of \$600 million in 2016 and another \$400 million in 2017.

"Better surviving companies will adopt best practices in terms of how they create structural alignments and standardize their operations," says Ulak.

One option he proposes is selling underperforming or non-core properties. "It's very much part of the playbook to add liquidity," he says, "both from the direct proceeds of the sale and from the lowered costs due to the new operating footprint. The challenge is that valuations are very low because we're in the lowest part of the cycle. People have been holding off in sales, widening the bid-ask."

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Lowering the unit cost of remaining production is also important, Ulak says. “Unfortunately, the easiest way to do so is to increase volume so you have more throughput through fixed-cost facilities. Since that’s not viable right now given a decrease in drilling, E&P companies will want to look at lowering lease operating expenses and general and administrative costs.

“There are industry metrics as to what they should be per flowing barrel; just make sure you’re examining all the cost components of each of those so you’re in line with industry peers,” he adds.

Another tip: E&P companies can improve capital productivity by improving drilling and completion costs, which account for a significant part of a company’s budget during the growth part of the cycle. Ulak points to the use of new technologies pad drilling, or drilling multiple wells from one location, which substantially cuts the time it takes to drill and cost. It also allows for batch bidding. “You can drill and hold off completion until you have 10 or 20 wells ready to go, then

bid in bulk,” he says. “That allows for a much more competitive price because the cost of the completions vendor is lowered.”

Finally, E&P companies (as well as oilfield service companies, which provide products and services for E&P companies) can explore the possibility of negotiating a restructuring with their capital providers. Indeed, Houston financial restructuring firm HSSK reports that a poll of more than two dozen bankruptcy attorneys in seven Texas cities shows that those attorneys expect business bankruptcy filings and restructurings to increase 30 percent this year, with oil being a main driver.

When it comes to restructurings, Ulak says total debt and debt service must be reduced to the new price and activity realities. But companies have to determine if they’re simply gaining near-term liquidity or if they’re making significant changes. “I recommend they make structural changes first to de-lever and either lower debt or give up equity, such that when they complete the restructuring they have fixed the problem and not just pushed it down the road,” he says.

Ulak also predicts that consensus is

building that oil prices bottomed in the high twenties and the market is on the rebound. “If we see that firming in the next six months, we’ll likely see a correction in the supply-demand imbalance in the fourth quarter of this year or first quarter of next year,” he says.

But Ulak believes the industry landscape will look different, with less competition. “I think there will be a lot of competition removed in the smaller and middle end of the spectrum among oilfield service companies and for some time into the next cycle.”

“We’ll probably see 25 to 35 percent fewer E&P companies for a while, but they’ll come back faster due to the enormous amount of capital on the sidelines.” □

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