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RS Sector Outlook Series
Bringing industry challenges to the surface

Oil & Gas – Lower for Longer

April 2016

The price of oil halved in the second half of 2014, from over $100 to less than $50 a barrel (Figure 1), and by January 2015 participants in the restructuring market were busy scrutinising a string of unfamiliar credits in the Oil & Gas sector. Industry worries were compounded by announcements of **deep cuts in capital expenditure** plans by the major integrated oil companies.

Current price environment presents fundamental challenges throughout the O&G industry

The CEO of BP, Bob Dudley, told analysts that an "enormous rebasing of the industry" was underway and that he was intending to manage BP so that it could "balance its sources and uses of funds at $50 oil". Everyone started talking about whether individual companies' business plans were **"fit for $50"** and an industry whose costs had - by common consent - escalated quite rapidly on the back of several years of $100 oil, started cost cutting.

Yet the wave of restructurings didn't appear quite as anticipated. It transpired that many upstream groups had hedged a large proportion of their H1'15 production quite effectively, whilst their suppliers in the oilfield services chain were largely protected by a backlog of contracts at profitable rates. Only those unlucky enough to be unhedged, or forced to recontract in the spot market (certain owners of offshore supply vessels for example), had to face up to the immediate reality.

Many thought that the fall in the oil price was a blip, and that they could ride out the cycle with some prudent self-help (headcount reductions, overhead discipline) and avoid substantive change. Banks remained supportive, agreeing to **amend-and-extend deals** in return for margin increases and consent fees. Bondholders proved willing to consider exchange solicitations, supported by relatively modest contributions from equity in some cases. Anecdotal evidence suggests that the "technical" banks kept their price decks for reserve-based lending facilities high enough to avoid triggering nasty falls in companies' borrowing bases, thereby **avoiding liquidity shocks**.

Figure 1. Brent Crude per barrel, in US$, 2011 – 2016

(million barrels per day)

Source: Financial Times

The biggest challenges facing the sector through 2016 and 2017

Now in April 2016, even the most bullish industry players have been forced to admit **the oil price fall is unlikely to be a short-term blip**. Even though US onshore production is finally falling, worldwide supply has remained resilient and the re-entry of Iran into the market is expected to keep production volumes up.

The **global excess of supply over demand** (Figure 2), compounded by rises in inventories and intensifying concerns over the worldwide reverberations of a slowdown in Chinese growth on a wide range of commodities, has led analysts to talk of the end of the commodity supercycle. Citigroup warned that oil's previous low of $32 at the height of the 2008 financial crisis was now a "conceivable reality", and indeed spot prices fell below **$30**. This was driven by a wholescale reassessment of the supply-demand balance in the industry and fears that the oversupply position could get so great that US oil storage facilities might reach capacity, which would remove the short-term floor from prices.

Majors are cutting back investment and reprioritising many significant projects

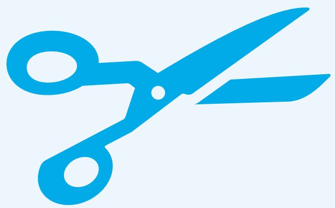
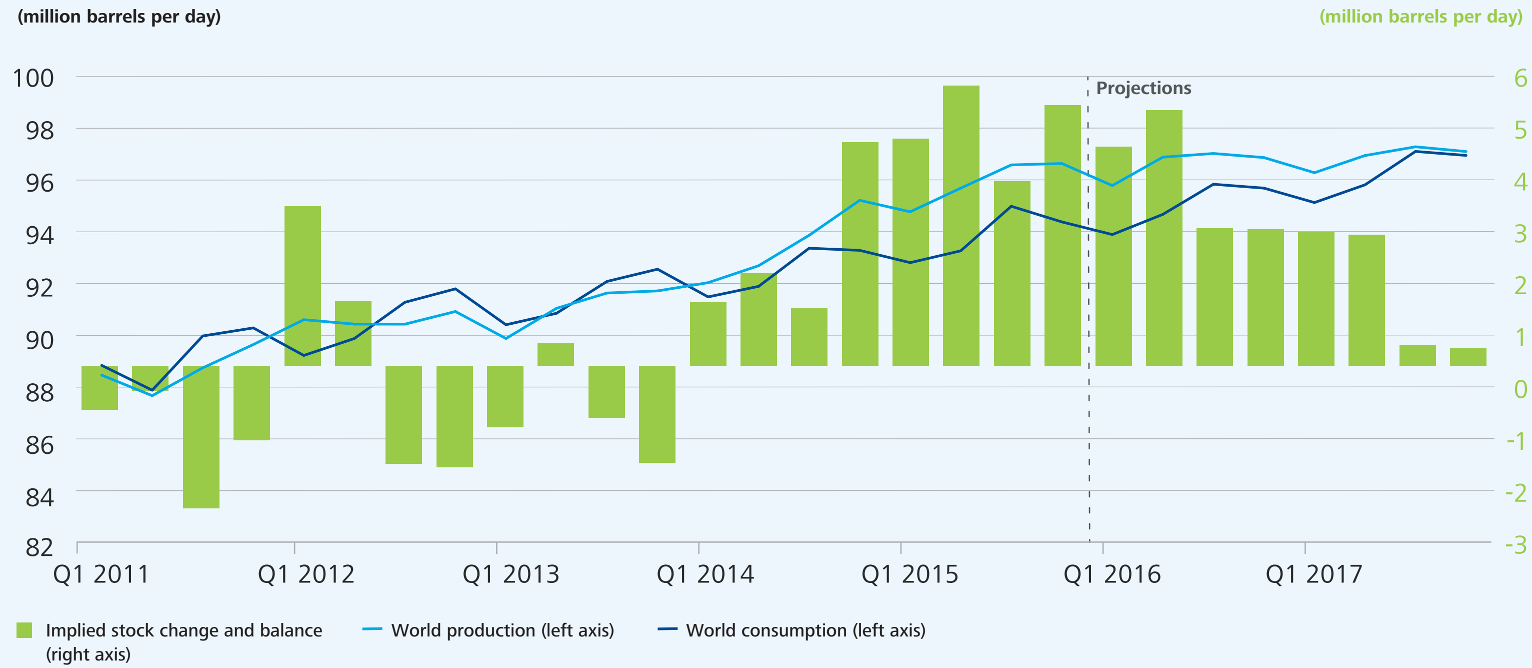


Figure 2. World Liquid Fuels Production and Consumption Balance



Source: Short-Term Energy Outlook, March 2016

The biggest challenges facing the sector through 2016 and 2017

Our expectations for 2016-17 are that the **oil price will remain depressed for 18-24 months** whilst the market rebalances, absent a change in Saudi/OPEC policy or a major security event which affects the global supply/demand imbalance. This price scenario sets out a **number of challenges** to the industry.

Overall, most companies in this sector are reporting **shrinking covenant headroom** as the benefit of earlier quarters in happier times begin to fall out of LTM covenant calculations. Others with more debt are coming under **liquidity pressure**, but as share prices have fallen, equity raising at this stage in the cycle is – at best – highly dilutive, and for some companies is frankly unrealistic. This is compounded by the unwillingness of a handful of management teams to provide the market with guidance or share forward looking forecasts with their key stakeholders due to **profound uncertainty around future financial performance.**

Taking each sub-segment in turn:

For the majors

The main impact of this price scenario is fundamentally to the dividend. Current IOC dividends yield around twice the market average, reflecting the risk that **dividends may need to be cut**. Yet to date, only ConocoPhillips has cut its dividend.

E&P companies

E&P companies with imminent debt maturity deadlines may struggle to achieve market based re-financings.

Smaller independent E&P groups

Particularly those in higher cost regions such as the North Sea or with major development projects still requiring funding – face more existential threats as historical hedges roll off and production is sold into the **spot market** or sold forward at much **lower rates**. At the time of writing the forward curve does not exceed $60, even out into the 2020s.

OFS companies

OFS companies exposed to the capex cycle (notably at the more discretionary end of the value chain, such as seismic & geophysical services) face deeply discounted day rates, whilst others face huge margin pressure as contracts come up for renewal in a new cost environment.

Possible solutions

What can companies do?

Many management teams are rapidly implementing **self-help measures** ranging from cost cutting, working capital optimisation and cash management to capex prioritisation. Analysts point to the success of a number of US shale companies which have demonstrated great skill in **reducing cost and enhancing productivity** to ensure that production remains profitable at lower price points.

In trickier situations, CFOs are seeking **solutions in conjunction with their stakeholders** to amend existing debt facilities, raise new money, and renegotiate/walk away from existing contracts with suppliers and counterparties.

Where the situation is sufficiently severe, astute boards are moving early to instigate **contingency plans**, which may include reviews of whether **targeted insolvencies** of certain business units would be required to save healthier parts of a group.

For some companies and shareholders, **M&A** is a potential source of salvation, and a number of teams are quietly investigating the possibilities around **monetisation of assets** via farm outs, joint ventures or full sale. Buyers are wary, however, and seeking bargains.

What can lenders do?

Credit committees are well aware of the macro outlook for the industry. It is clear that work out teams are increasingly being asked to **shadow relationship managers** more closely.

Where companies are seeking to amend or roll over existing facilities, lenders are **subjecting business plans to far greater test and challenge** than before. Resilience of business plans to quite severe **downside sensitivities** is increasingly fundamental to getting lenders comfortable with the idea of maintaining or increasing exposure to some situations.

Lenders need to form a clear view on how supportive they are willing to be for the sake of existing relationships. This can cause **considerable friction** internally between relationship managers and work out teams. For E&P companies with RBL facilities, additional tension can arise within the syndicate where different banks are beginning to take different views on where price decks should be set, a situation which ultimately forces a **majority lender vote** if the bankers cannot agree collaboratively.

The restructuring market is likely to be busy in 2016 as upstream hedges expire & service companies' contract backlog unwinds

Oil & Gas credentials

Ceona	Reef Subsea	Project Blaze
CEONA Financial Restructuring, Short Term Cash Review, Options Analysis, Contingency Planning	REEF SUBSEA Power & Umbilical Options Analysis Accelerated M&A	Turnkey Drilling Provider Short Term Cash Review Contingency Planning Managed Exit

Polarcus	Project Puffin	ATP
Polarcus Restructuring Turnaround Advisory	Listed North Sea E&P group Liquidity Management Strategic Options Review Financial Advice Contingency Planning	ATP OIL & GAS CORPORATION Corporate Finance Advice

"We have observed how quickly some parts of the O&G value chain – particularly in the offshore supply space – are now beginning to suffer as a result of industry-wide cost-cutting and the global reprioritisation of projects and investment strategies by the IOCs/NOCs.

There are over 400 companies active in the North Sea alone, many of whom are struggling to provide their lenders and shareholders with financial forecasts supported by any degree of confidence. This lack of visibility is proving challenging for boards, shareholders and lenders.

We are already busy in this sector and anticipate a wave of consolidation, recapitalisation and – for the less fortunate – significant operational and financial restructuring over the next 12 months."

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