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Emerging Capital Sources and Opportunities in the Oil and Gas Space

The 2008 economic downturn coupled with the sharp decline in oil prices from their 2014 levels has significantly disrupted the oil and gas capital markets. Because of economic and regulatory changes, traditional sources of capital are not as readily accessible for many E&P companies. Banks have grown reluctant to extend credit to energy borrowers that are not large-cap, investment grade businesses. Private equity has emerged as the primary source of capital for small and middle-market energy producers, and alternative sources of capital are becoming increasingly popular in the oil and gas space. Below is an overview of these recent changes in the energy capital markets along with projections about what trends we can expect to see in the near term.

Retreat of Traditional Capital Sources

E&P companies traditionally financed their operations through secured and unsecured loans from banks. The most common loan structure offered by these conventional lenders was a type of senior secured revolver known as a reserve-based loan (RBL). During 2015 and 2016, however, oil prices plummeted which resulted in E&P companies being unable to cure borrowing base deficiencies under their RBL facilities. As energy companies' cash flows dwindled, default rates on RBL facilities skyrocketed and more than 90 energy companies filed for bankruptcy in 2015 and 2016. In response to this, many of the large banks amended their credit agreements with oil and gas companies to make their covenants more robust. A number of banks added minimum liquidity requirements and anti-hoarding provisions which were aimed at protecting banks from lenders who drew down their lines of credit and then filed for bankruptcy. Banks also began increasing their collateral protection by requiring that borrowers enter into deposit account control agreements and that borrowers house their cash inside the lenders' bank group.

The slump in oil prices also caused the Office of the Comptroller of the Currency (OCC) to undertake a review of the RBL lending process and the credit risks presented thereby. This review lead to the OCC issuing new and more rigorous rating and reporting standards that lenders to the oil and gas industry were forced to follow. The most notable of these new guidelines forced banks to make their risk rating determinations based upon a borrower's ability to repay all of its secured debt, rather than just the debt being provided by the applicable bank. This heighted risk analysis lead to a significant increase in interest rates for RBL facilities and caused RBL lenders to add more robust covenants to their loan documents and, perhaps more significantly, curtail their overall lending to energy companies.

Furthermore, well before the 2014 collapse in oil prices, the heightened Basel III capital and liquidity standards imposed on banks in response to the 2008 financial crisis had already reduced banks' appetite for riskier, commodity-linked investments. Likewise, Dodd-Frank and the Volker Rule created a regulatory catch-22 — these regulations made increasingly difficult for E&P producers to hedge their operations, but as a result of increased regulatory scrutiny many banks were actually requiring E&P companies to hedge their production in order to receive financing. As a result of this heightened regulatory environment, traditional capital providers to the oil and gas industry scaled back extending credit to all but the most financially secure borrowers.

The cumulative effect of these economic and regulatory headwinds can be seen in the high-yield debt markets for E&P companies. In 2013 there were 808 high-yield debt issuances by E&P companies but by 2016, that number had plummeted to roughly 450 issuances. Although the high-yield market has seen a slight uptick in 2017, high-yield issuances are still only generally available if the deal size is in excess of $200 million. The result is that many smaller and mid-size E&P companies have been locked out of traditional capital sources and have had to look to alternative capital providers as a means of financing their operations.

The Emergence of Alternative Capital

Private Equity

Private equity firms have filled the oil and gas capital-providing void left by traditional lenders. In the past three years alone, energy-focused private equity funds have raised more than $100 billion. Although some of this money is dry powder that has not yet been deployed, many funds have begun using their capital reserves to offer flexible debt products to small and middle-market E&P, midstream and oilfield service companies that cannot acquire traditional financing. These flexible debt products often have fewer covenants than more conventional oil and gas loans but typically have an equity component, such as a warrant and/or equity kicker, that would not be seen in a more conventional loan. In many cases the interest rates on these alternative investment vehicles are significantly higher that than which would be charged by a traditional lender. The typical debt investment size for these funds ranges from $25 million to roughly $200 million, and such investments are usually structured as first or second lien credit facilities, unsecured debt, net profits interests or other mezzanine structures.

Other energy PE funds have focused on acquiring distressed assets from E&P companies that either are short on cash or that have filed for bankruptcy protection. Much of the private-equity driven M&A activity in the middle and lower-middle market energy space has been centered the Permian Basin and the SCOOP and STACK plays in central Oklahoma, as private equity funds have begun focusing their investments in one or two locations, rather than having a geographically diverse investment portfolio. 2017 has proven to be an especially active year from energy-focused M&A activity. According to PwC's latest deal report, through the first two quarters of 2017, energy M&A deal value totaled $110 billion, which was the strongest first half of the year start to energy M&A activity in the past eight years. This uptick in investment activity is being driven principally by PE funds which have been aggressively looking for ways to deploy large amounts of capital that they have raised in recent years. Market watchers expect this trend to continue as E&P companies continue to be cash-strapped due to depressed oil prices and locked out of conventional financing.

Joint Ventures

In addition to debt and equity investments in energy companies being driven by PE funds, some funds are exploring alternative methods of deploying their capital such as forming joint ventures and partnerships with management teams and landowners. For example, the Carlyle Group, which recently raised it first energy fund, announced in March that it is forming a joint venture with US shale producer, EOG Resources. Carlyle has committed $400 million to a JV with EOG that will be used for drilling and land development by EOG. What makes this deal unique is that Carlyle has a direct interest in the wells being developed by EOG — most funds invest just at the corporate level of a management group, rather than directly in those assets that the management group is operating – and this interest will eventually revert to EOG after four years. Likewise, Blackstone recently formed a partnership with Jetta Permian LP to jointly invest in leasing acquisition, farm-in deals and other joint ventures and partnerships with existing management teams.

Resource Funds

Resource funds have also emerged as an alternative investment vehicle to traditional private equity funds. Like PE funds, resource funds raise capital from LPs, but resource funds employ their own management teams which eliminates one tier from the investment structure. This results in an overall reduction in management fees and gives LPs more direct exposure to the underlying investments. Resource funds also typically have a more conservative investment strategy and longer investment horizons than traditional energy PE funds. To increase returns and allow the funds to begin making payments to their investors early in the fund's life, resource funds will take on significant leverage. They borrow as if the funds themselves were the energy company operators and use as collateral all of the fund's assets. Traditional PE funds, by contrast, will typically finance each of their investments separately, which mitigates cross-collateralization risk and prevents bad investments from putting their good investments at risk. Many resource funds have, however, taken a significant hit with the downturn in oil prices. One of the most well-known resource funds, EnerVest Ltd., recently announced that one of its $2 billion funds is now virtually worthless as a result of the plunge in oil prices. In spite of this, industry observers expect that resource funds will continue to play an important, albeit small, role as a source of alternative capital for small and mid-cap energy companies in the years ahead.

Crowdfunding

Crowdfunding has also emerged as an alternative source of capital for small energy companies. In 2015, the SEC adopted rules that approved crowdfunding as a means of raising capital and selling securities. Since that time, the total amount of capital raised via crowdfunding has doubled year over year, and industry experts expect that by 2020 more than $90

billion per year will be raised via crowdfunding. Investing in the energy industry typically has high entry costs that can be incurred only by private equity funds, family offices and other large institutional investors. Crowdfunding, however, allows smaller investors to make direct investments in energy companies without the prohibitively high entry costs. For example, the crowdfunding platform EnergyFunders lets investors make direct investments in various oil and gas companies with a minimum investment of $5,000. Crowdfunding also allows energy companies easy access to capital without many of the administrative burdens that are typically associated with traditional forms of fundraising. Most of the of regulatory, legal, marketing and investor relations activities are managed by the crowdfunding platform, which frees up time and resources for the energy operators to focus on running their business. As a result, crowdfunding will likely continue to be a critical source of capital for smaller energy companies that are not able to secure traditional financing and do not have the means to engage with private equity funds.

Conclusion

Although oil prices have recently rebounded, and some traditional capital providers are beginning to re-enter the oil and gas markets, conventional financing is still remarkably inaccessible for most energy companies. Private equity and other alternative forms of capital have established themselves as the emerging source of capital for small and middle-market energy companies and this trend is likely to continue into the future.

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