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Capitalizing on the Distressed Oil & Gas Industry

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It came as no surprise to the restructuring community when Texas oil and exploration company Quicksilver Resources joined the growing ranks of troubled oil businesses by filing for Chapter 11 bankruptcy protection on March 17, 2015 (27 BBLR 410, 3/19/15). Quicksilver went public with its issues in September of 2014, stating that it could not meet certain debt obligations with cash on hand, financing or operational cash flow.[1] After a tough 4th quarter, its stock remained so depressed that on January 8, 2015, the Company was delisted from the NYSE.[2] Quicksilver missed its $13.6 million bond interest payment in February and filed for bankruptcy protection shortly thereafter as it continues to investigate options for restructuring.[3]

Quicksilver found a niche in the U.S. shale industry by focusing on unconventional reservoirs in challenging geological conditions. With around $1.2 billion in assets, however, Quicksilver was crushed under the weight of an immense debt level exceeding $2.3 billion.[4] Already hit by reduced income from low oil prices, the significant reduction in Quicksilver's global borrowing base near the end of 2014 was a knockout punch. Given the market environment, Quicksilver was not able to sell assets quickly enough to turn the company around.

While Quicksilver is unique in its drilling and business focus, the story is all too familiar across the entire U.S. shale industry. Highly leveraged oil companies are unable to procure further financing and sustained depressed oil prices are reducing revenues and limiting the ability to sell assets quickly. This creates a growing downward spiral that affects not only large and small oil companies but also all of the related suppliers, servicers, technology companies and infrastructure projects needed to support the U.S. shale industry.

High Yield Debt & Industry Wide Distress

One of the primary driving forces behind the U.S. shale boom was the increase in smaller and mid-sized companies coming to the table. With significantly less capital than the global giants, smaller companies were forced to take on large amounts of debt. Even the leading oil and gas companies more than doubled their debt over the past nine years from $981 million to $2.46 billion.[5]

Lenders were quick to deploy the requested capital. Loans to global and small companies were considered safe and secure since the assumption was that OPEC would sustain price levels and the increase in U.S. shale production wouldn't affect price stability. Despite significant industrywide leverage, debt levels were sustainable when oil prices exceeded $100 a barrel, but the leverage is crushing the industry with prices dropping to 40-50%. With OPEC's decision to continue high levels of production driving prices lower, U.S. oil companies of all sizes are at risk.

Adding to the complexity of market predictability is the variance in critical break-even pricing for U.S. shale. Companies operating in North Dakota and Texas

[1] Quicksilver Resources September 30, 2014 SEC Form 10-Q.

[2] Quicksilver Resources Press Release January 8, 2015.

[3] *Quicksilver Resources Announces Decision Not to Make Interest Payment*, February 17, 2105, Global Newswire.

[4] Quicksilver Resources September 30, 2014 SEC Form 10-Q.

[5] Townsend, Kevin, *Will Kodiak Oil & Gas Corp. Get Relief From Creditors To Cushion Oil Prices Drop*, December 8, 2014, InsideTrade.

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have break-even points around $55 a barrel or above.[6] More specifically, the Permian basin in Texas can withstand prices between $57 and $75 a barrel, with the Eagle Ford basin able to handle prices from $53 to $65 a barrel.[7] The North Dakota Bakken basin can remain economically viable between $61 and $75 a barrel.[8] But, the Texas Panhandle, Mississippi Lime, Tuscaloosa Marine and Scoop basins are only profitable above $80 a barrel.[9] The current prices in the $40 to $50 a barrel range will continue to strain over-leveraged U.S. shale companies that may be unable to restructure or shed existing obligations.

Given the disparity in break-even prices, losses and distress will be felt differently in the various regions. Newer basins requiring complicated methods of drilling have higher cost structures and will be more affected by the extended lower oil prices. Because a large number of U.S. oil companies operate in multiple basins, this regional cost-effect is somewhat spread out. However, the greater financial impact on the more expensive regions will be borne by the companies and boom towns supporting, servicing and supplying the oil companies in these regions.

Estimated 2015 Oil Prices & Investment Opportunities

The majority of average oil price predictions for 2015 remain in the $50 a barrel range with the lowest price estimated around $20 a barrel.[10] Absent a major shift in production from either OPEC or geopolitical forces, prices will likely remain below the break-even point for most U.S. shale related companies. In response to market forces and in order to attempt to balance their debt load, the majority of U.S. oil E&P companies as well as service companies have slashed 2015 capital expenditure budgets in half.[11] American shale extraction and offshore drilling permits tanked 40% in November and oil prices are expected to trim U.S. Shale output by 30% .[12]

The fallout is not coming, it is here. The recent Chapter 11 filings by Quicksilver, Cal Dive and WBH Energy Partners are just the beginning (27 BBLR 335, 3/5/15). Already, Hercules Offshore has been downgraded to zero, Goodrich Petroleum stock has lost 86% of its value and Halcon Resources bonds are not only trading at 70 cents on the dollar, but the CEO has hinted that the company could be up for sale.[13] These deeply indebted U.S. shale oil companies are unlikely to survive sustained price cuts without an influx of cash or restructuring.

The distressed investment community, bloated with stockpiled capital, is rushing in like ants at a picnic. While investors scurry to acquire companies and purchase solid assets at fire sale prices, industry experts recognize that investors should be thinking long-term to maximize returns from the current situation. The biggest winners will be those investors that employ an in-depth methodology to analyze financial information and fulcrum investment opportunities, in addition to looking at the unique characteristics of a particular company. With a diverse spectrum of available opportunities, investors can use multiple comparative ratios to determine the best potential targets given an investor's unique investment strategy.

The U.S. oil and gas industry will produce a plethora of distressed opportunities for investors throughout 2015, with the diverse community of companies and industries tied to oil and gas allowing for investment all along the supply chain. But don't be caught waiting and wanting, investors that are interested in capitalizing on the distressed oil and gas industry should look at possible targets now in order to maximize investment potential.

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[6] Gold, Russell, Ailworth, Erin, Faucon, Benoit, *Energy Boom Can Withstand Steeper Oil-Price Drop, Some Smaller U.S. Producers are Likely to Face Pinch from a More-modest Decline*, October 29, 2014, Wall Street Journal.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] Fahey, Jonathan, *US Running Out of Room to Store Oil; Price Collapse Next*, Associated Press, March 3, 2015; Friedman, Nicole, *Oil Glut Sparks Latest Dilemma: Where to Put It All*,

[11] Intel, Isa, *Oil Bear Market to Eviscerate the American Frack Boom?* October 11, 2014, Wolf Street.

[12] *Ten Reasons Why a Severe Drop in Oil Prices is a Problem*, December 7, 2014, Our Finite World; Mufson, *As Oil Prices Plunge, Wide- Ranging Effects for Consumers and the Global Economy*, December 1, 2014; *Here Are the Big Winners and Losers of Low Oil Prices*, October 26, 2014.

[13] Dicker, Daniel, *Shale Oil Bust Enters Phase Two, Led by Hercules and SandRidge*, March 3, 2015, The Street; Dicker, Daniel, *Which Oil Producer Is Next to Fall After SandRidge Energy Downgrade*? March 5, 2015, The Street.

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