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Q&A Bank Leeway, Hedges Give Energy Companies Breathing Room: Schulte's Karp, Chin

Photo: *Schulte Roth*
David Karp

Photo: *Schulte Roth*
Kirby Chin

The impact of falling oil prices, and hence the opportunities for distressed investing, differs so widely from company to company that it's hard to generalize, say **David Karp** and **Kirby Chin**, partners at **Schulte Roth & Zabel LLP** who specialize in advising distressed investors. The fallout will extend beyond energy companies to banks and real estate investors in production areas, they told Bloomberg Brief reporter Hema Parmar. Their comments have been edited and condensed.

Q: What themes are you noticing in the energy M&A space?

Karp: If there is a theme, it's that there is not a theme. The theme is that you have players with very different experiences. You have players with very different types of capital. Players that are interested in different parts of the oil and gas value chain.

From the company side, you have different shale plays and different productions, different price points where they're profitable. You have individual capital structures that determine whether or not someone will survive or whether they will fail.

Q: How might mergers in the energy sector be financed?

Chin: Because of the uncertainty in the oil and gas markets and declining prices, many acquisitions for assets appear to be done on a non-cash basis, in other words, stock-for-stock transactions.

Q: What spaces within energy are seeing distress that have fallen under the radar?

Karp: Especially in the Bakken, there has been a significant increase in housing costs and a number of private equity funds have invested significantly in home developments with capital from both local and national banks. Those projects are being slowed down. That is something that you're going to see in a lot of the large shale plays. You'll see that in Williamsport in Pennsylvania with the Marcellus. You're going to see that in North Dakota with the Bakken, and in different parts of Texas. You're really going to see local banks with exposure to projects — whether it's real estate projects or service-provider projects that are dependent on the E&P's moving those projects — start to pull back. You'll have some defaults, and I'm sure you'll have a fall in real estate prices.

Q: What kind of activity are you seeing in the distressed energy sector?

Karp: We're focused on investors in the credit space. We're seeing a lot of investors going into either high-yield or leveraged loans to start getting information from companies, evaluating the capital structures with the potential for down the road restructurings. Many companies are well hedged, well capitalized, through 2015.

Right now what you're seeing is a lot of opportunistic distressed investors, as opposed to energy investors, coming in and getting to know the space.

Chin: My impression is everyone is looking. Some are opportunistic who are trying to get to know the space by perhaps making smaller investments. The bigger, larger investments have not yet come to pass just yet. I think people are sniffing around.

Q: What will it take for buyers to act?

Chin: My guess is a lot of players are waiting for the bottom. My impression is that there is sufficient uncertainty as to how long this is really going to last, which is making people pause a little bit to figure out what they want to do. The other thing is that for the players that are already distressed, they're in the cycle, they're in the bankruptcy, and they're selling off assets. But what I have heard from some business people is a lot of other companies are managing their risk. Some are flush for cash, and some were smart enough to put hedges in place to help them continue to moderate the decline in oil prices this year and into part of next year.

I think a lot of banks and lenders have been taking a softer approach in terms of how hard they're going to ratchet down borrowing bases, reserve-based borrowing bases in particular, which has bought some companies more breathing room in terms of what they can do and how much runway they had.

Karp: The one thing we do know is that there are many, many high-yield issuers that are hedged through 2015 and the hedges expire in 2016 and default rates may maintain themselves through 2015. But if oil prices stay at $50 a barrel through 2016, we're going to have more distress. So the one thing we're seeing is that every situation is unique and that's really how you have to play it.

Q: For companies that have asset-based loans and used their land as collateral, the drop in oil price means a drop in the value of their collateral. Do they need to put up more collateral?

Chin: It depends a bit. Typically what would happen is the companies will pledge their proved, developed, producing reserves as collateral in the asset-based lending loan. It used to be valued at $80 a barrel and now it's not. Now it's $50, if not lower, depending on the discounts that a bank would place on it. What this has done is there are some companies that have sufficient running room and, depending upon the type of valuations that the lenders are using, they have perhaps loosened their credit. So for example, they may have had a price cap last year, or the year before that, at $70 a barrel. Despite the fact that prices are at $90, they'll cap it at $70. Now, instead of reducing the price cap to what the actual price of oil is, they will lend up to the value of the oil and gas that's it trading at. So if oil today and gas is trading at say $50 a barrel, they will give full credit to it. That's what I've seen and heard some banks are doing in order to provide that soft landing.

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