The Deal

Covid, OPEC Deliver Shale a One-Two Punch EXCLUSIVE

Doomsday predictions for the oil and gas industry no longer need a crystal ball.

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In good times or bad, oil company executives and advisers hedge their predictions. But the latest industry woe would have thrown the best psychic medium for a loop.

"If we were sitting here a few months ago and you said to me the Masters would be canceled, March Madness would be canceled, Tom Brady would have left the [New England] Patriots and oil would be in the 20s, I would have taken that bet," SOLIC Capital Advisors LLC managing director Raoul Nowitz said. "Nobody has a crystal ball, but this is an unprecedented level of disruption."

Months before Covid-19 reached U.S. shores, deal activity in domestic shale had been slowed by drooping oil prices, and industry advisers already worried that a second wave of bankruptcy filings, possibly as large as the one following the 2014 commodity downturn, was on its way in 2020.

That wave is now a near certainty after West Texas Intermediate crude futures fell to $20.37 on March 18, their lowest level since 2002.

Doomsday predictions no longer require a crystal ball.

Some market watchers have gone so far as to predict U.S. crude will fall to $10 a barrel. Low-cost fossil fuel producers Saudi Arabia and Russia are pumping the market full of cheap, unnecessary crude just as around the world factories close, airplanes ground and people shelter in place, decimating crude and refined product consumption.

IHS Markit's Daniel Yergin has estimated that global demand for oil could fall by as much as 15% in the next one to two months, while fossil fuel-focused research firm Wood Mackenzie Ltd.'s Roy Martin estimated that oil producers may have to slash more than $75 billion in 2020 discretionary exploration and development investments and cut some $80 billion of shareholder distributions if global benchmark Brent crude oil averages $30 a barrel in 2020.

Brent traded hands at $28.65 a barrel at Thursday's close.

"Nothing in recent memory has been as traumatic and diabolical as this is right now," said Nowitz, who helps lead his boutique bank's restructuring and distressed asset support services groups. "I don't think anyone is immune."

Bankruptcy advisers were busy in 2019 and will be even more so in 2020.

Between the upstream oil industry and oilfield services providers, there were around 50 bankruptcy filings in 2019. Nowitz expects that number to easily surge past 60 in 2020 if current commodity prices persist for much of the year.

Many companies were already hurting before the latest turn in the market. Chesapeake Energy Corp. (CHK), Gulfport Energy Corp. (GPOR), Antero Resources Corp. (AR) and Whiting Petroleum Corp. (WLL) are all considered likely restructuring candidates by industry watchers and advisers — Chesapeake reportedly tapped advisers on March 17 as it was struggling to service its $9 billion in debt before talks between Russia and Saudi Arabia broke down.

Even healthier companies may be pushed to near collapse, because fast approaching is spring redetermination season, when banks reassess the value of oil producers' reserves to determine whether they will raise or lower the borrowing base on their revolving credit facilities.

Banks have been pressured over the past several years to reduce their exposure to oil and gas, and with that pressure unlikely to be eased during the current environment, borrowing bases are largely in question.

Siebert Williams Shank & Co. LLC upstream oil analyst Gabriele Sorbara is concerned redeterminations will cut some producers' revolvers by as much as 50%. One name on his coverage list that he is particularly worried over is Callon Petroleum Co. (CPE), which he said has $1.3 billion drawn on its $2 billion revolver.

"A lot of upstream companies out there may have 50% or 75% drawn on their revolver and could find themselves to be overdrawn in a few weeks," Skadden, Arps, Slate, Meagher & Flom LLP Eric Otness said in a mid-March interview with The Deal. "You said crippling, I don't disagree. Certainly for a lot of companies this upcoming reset is going to be critical and require them to look at all options carefully."

While there is no debate as to how dire the situation is, aside from bankruptcies, there is nothing but uncertainty regarding what comes next.

Sorbara is not alone in his expectation that the oil industry, particularly independent U.S. producers and oilfield services companies, will need a federal bailout to survive the double whammy of an OPEC-Russia price war and the Covid-19 pandemic. But where the oil industry falls on the expansive list of desperate industries in need of aid is unclear.

As part of the $2 trillion stimulus package passed by U.S. Senate on Wednesday, the Trump administration has access to $500 billion to aid distressed companies, but there will be oversight on how the president can spend those funds.

The oil industry was a major ally in electing Donald Trump to the presidency in 2016. Some major supporters, including Continental Resources Inc. (CLR) leader Harold Hamm, who has seen his company's market capitalization fall from $13 billion to $3.7 billion since the start of 2020, have directly called on the president's aid.

Drilling activity in the U.S. is expected to screech to a halt if oil prices continue at this level for much of this year, and some believe the financial effects will be far more drastic than the 2015-2016 commodity downturn. Stephens Inc. analyst Gail Nicholson expects U.S. oil producers to cut capital expenditures by 40% and drilling rigs to fall by 40% to 415 from 683 rigs.

It's unclear how many jobs may be affected by this decline in drilling activity, but PGIM Fixed Income chief economist Nathan Sheets told CNBC on March 17 that employment fell by one third during the 2015-2016 commodity downturn and a similar situation could cost the U.S. oil sector between 50,000 and 75,000 jobs.

Yet there are reasons why the industry should not be first in line at the Treasury's soup kitchen.

About 500,000 restaurant workers were expected to lose their jobs by the end of March in New York City alone, and the National Restaurant Association anticipates losing at least $225 billion and five to seven million jobs across the U.S. over the next three months due to the coronavirus.

Meanwhile, there are more than 3 million jobs vulnerable to layoffs within the travel industry, where airlines have asked for almost $60 billion in bailout funds.

Beyond direct loans to distressed businesses, Sorbara suggests the federal government also could persuade lenders to relax debt covenants so that oil producers have more time to avoid loan defaults.

Ultimately what forces oil producers to refrain from taking even more drastic, albeit necessary, cuts to drilling and employment numbers is having to service debt covenants. They pump oil because it's too expensive not to.

Nowitz said the Covid-19 pandemic may have created a scenario in which the government can offer assistance to U.S. oil producers and services companies that would have not been available if the industry were only facing a price war. He expects the government to work with banks to create liquidity in the system, thereby indirectly benefiting oil companies.

One small silver lining is the likelihood that activism will be reduced to near nothing in the oil and gas industry.

Illiquid markets do not attract activists.

"Liquidity is scarce (likely the new norm), thus without a strong balance sheet, scale and/or a premier asset base survivability in the current environment seems bleak," Stephens' Nicholson wrote in a recent note to clients. "While bankruptcies may take time, sadly we believe a large majority of the group equity valuations likely do not recover."

In the years following the 2014 downturn, the oil industry realized a vastly reduced investor base that had not fully recovered in time for the latest rout.

Those that did remain became increasingly critical of companies, many times on a public scale. But with the majority of independent producers once considered mid- or large-caps knocked down several pegs, many to micro-cap status, Sorbara expects activists to take aim in industries with greater liquidity and more prospective upside.

So while industry watchers like Nicholson expect many within the oil industry to suffer a "slow death," at least they may be spared the sounds of agitated shareholders screaming at them as they die.

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