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RESTRUCTURINGS IN LAND DRILLING EVALUATING FRACKING SUPPLIERS & PROVIDERS

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Evidence shows onshore drilling activity in the U.S. is not sustainable, given the current state of oil prices and issues facing producers. Joseph R. D'Angelo, partner at Carl Marks Advisors, looks at restructuring issues facing fracking suppliers and providers, and advises steps to take when ABLs are hit with vulnerable credits.

Prospects for middle market fracking suppliers and service providers — companies that support producers in the field, manufacture or distribute equipment, or provide labor and equipment as a solution to oil and gas onshore drilling operators — can be gauged by rig counts. Currently, rig counts are down by 31% from a year ago, and fell below 1,000 for the first time since 2011. Oil patch companies laid off more than 20,000 employees in January, compared to 14,000 in all of 2014, reflecting the cutbacks in exploration and development projects.

This situation is partially caused by the price of oil dropping by 40% to 50%, although most companies in the oil patch are more directly affected by the resulting drop in activity.

Producers and RBL Facilities

The price of oil affects producers, who must plan their capital expenditures for increased and new production accordingly. Producers rely on reserve-based revolving credit facilities, or RBL facilities, which are based on the collateral value of proven energy reserves. The borrowing availability under these facilities is usually re-determined twice per year: in the spring and the fall based on a pricing deck that forecasts the forward price of oil. Many producers may find reduced availability under their RBL facility as a result of falling oil prices, which will decrease the amount of capex available for new projects and negatively affect suppliers and service providers.

Typically, middle market suppliers and service providers companies do not own reserves or drilling rights; their assets include: equipment, vehicles, people, customer relationships and sometimes intellectual property. These companies typically use working capital to prepare for new project commitments. The collection cycle could extend cash conversion to more than 120 days. When utilization rates decrease, companies suffer the liquidity risks of stranded working capital in the form of having to pay employees (who cannot be invoiced and collected); training expenses; raw materials and product costs; opportunity costs and retention costs, among others.

Well-capitalized companies can usually make quick adjustments and ride through the cycle. However, the current price disruptions and lower land drilling activity are being caused by multiple competing variables.

50% Rule

Predicting this cycle looks like unchartered ground. For example, research analysts discuss production-level changes from Libya and Iraq while Saudi production increases to defend market share against the rapidly increasing supply of oil from U.S. land drilling, all against potentially flattening global demand. On the other hand, industry operators explain that the price of oil should be driven by the marginal cost of producing the next barrel. Production costs include: exploration, drilling, pumping and transportation costs, not the cost of making oil on an active rig tomorrow. The lack of predictive information and foresight on the current cycle is a problem if you are a lender with a default or are expecting one.

When asset-based lenders are unsure about the timing of the cycle, and their instincts tell them to expect a negative event/default, you sometimes hear the "50% Rule," which assumes that EBITDA will be 50% of projections, and the collateral is worth 50% of the previously appraised value. That might be about right for a number of middle market businesses that ramped up for new drilling projects, especially in regions with higher production and transportation costs. However, those companies that recently incurred debt supportable based on high asset utilization rates will be the most vulnerable.

So what do you do if this sounds like some of your credits? What can companies do to work through their issues, or keep the situation from getting worse? And what are key considerations for a restructuring or sale transaction, or when looking to maximize recovery in an orderly liquidation?

Restructuring Plan

Urgency in three particular areas can increase liquidity, stabilize the situation and provide time to figure out the restructuring options. The first order of business is to address the current liquidity. In many instances, the weekly cash-flow is driven by recurring revenue and expenses of existing contracts and spending on resources to fulfill new or pending contracts and orders. Therefore, if you review the most significant customers and contracts, and the fully allocated expenses and profitability of a majority of the revenue, you can determine if the business is making money on the precious revenue it has.

At the same time, you are developing the template for scrutinizing all pending and forecasted opportunities to make sure that new revenue will be profitable. Expenses that are not directly attributable or necessary to support the expected revenue must be challenged. As much as travel and entertainment turns out to be necessary in the oil patch, there is always some spending that is

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excessive and doesn't pass the cost/benefit test. Savings and soft benefits also come from making sure there aren't too many individual contributors and not enough managers making decisions. Some middle market companies lack the basic organizational, business process and fiscal discipline to figure out the necessary changes to increase liquidity.

Sales Pipeline

Getting a handle on the sales organization and the sales pipeline is critical to being able to make quick and consequential changes. Assess the performance and contribution of the sales representatives to weed out the underperformers and recognize/reward/retain the high performers. Make sure there aren't too many sales support positions, and question the ROI of all replacement and new hires. Identify customer trends for products and solutions to make sure sales representatives are pitching the right value proposition. Review the asset inventory and utilization by region and make sure that sales efforts prioritize idle equipment that is locally available. If a new contract is signed that requires relocating equipment from another region, the transportation cost could be more than the contract is worth.

Another important way to stop stranding working capital is to hold sales representatives accountable for pipeline forecasts, and to perform constant and continuous inspection on new project opportunities to make spending decisions based on achieving selling stages. For example, defining and enforcing selling stages could include identifying the project (land lease and drilling operator), confirming the budget (in the capex plan or discretionary); and validating the contract authority, calendar schedule for rigging up, signed contract, etc. It is important to know which producers are under the most pressure to cut new drilling products, and evaluate your borrower's current revenue and pipeline exposure to these producers.

Liquidation Analysis

Concurrently with evaluating liquidity and the pipeline, you should prepare a liquidation analysis to show the low end of potential recoveries. The liquidation value of the assets will obviously influence the restructuring options, constituents' decisions and recovery outcomes; everyone knows the assets are usually worth more if the going concern can be preserved. If the business has enough critical mass to preserve the going concern, then a combination with a strategic buyer may be the best option. However, buyers may require bankruptcy §363 sales to avoid certain liabilities. Sometimes, buyers will acquire assets out of court, even from the lenders through Article 9 foreclosures or a sale of the debt. If it looks like the business can't be turned around, an orderly liquidation may be the inevitable objective.

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Wind Down

In this scenario, there are still things you can do to ensure an orderly liquidation versus a fire sale, and improve the liquidated recovery. Talk to the field managers to see if it is feasible to try to sell equipment operating in place to competitors on common customer sites. Typically, a buyer will pay more for the equipment in place if the revenue goes with it. You will need management's cooperation to figure out the optimal approaches. A skeleton team of the best managers is usually identified as the wind down team. Getting involved early and being onsite help control the situation and manage toward tight deadlines.

Getting your hands on the equipment lists, and understanding the asset management process is critical for preparing the liquidator and compressing timeframes. The equipment list should track every piece of equipment being used on a job or in inventory. The only way to make sure the equipment list is accurate and reliable is to vet it by visiting customer locations and equipment yards where idle equipment is stored and refurbished. The equipment lists can be very detailed and contain information on the age and maintenance records. The liquidator will need this list to provide liquidation estimates, and should be able to determine if it is better to sell the equipment at regional yards or bring the equipment to one central place.

When time is running out, you have to make sure that the assets can be seized and not locked up on a drilling site. The wind down team may need to take the equipment off of a customer location to avoid issues with recovering the equipment later. Also, make sure the assets aren't combined with other assets that are leased from another lien holder. For example, mobile solutions may have equipment mounted on a truck; and it turns out that the equipment is in the borrowing base, but the truck is leased with another lender. You need to get the equipment off of the truck before it is repossessed with your equipment on it. You may need to keep a welder and a mechanic on the wind down team.

Prioritizing Credits

We expect middle market fracking suppliers and service providers to be among the early victims of decreased onshore drilling activity in the U.S. Many companies lack the critical mass to get through this cycle alone and should look to consolidate with competitors to increase scale and diversify customers. Some companies will lack strong management necessary to make adjustments and restructure operations. Other companies simply aren't capitalized to withstand this cycle or the business plan is flawed at lower oil prices and drilling activity. If you are an asset-based lender with numerous credits involved in onshore drilling, you will want to sort the portfolio in a similar way and prioritize your time and resources on the credits with a higher probability of surviving this cycle.