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Drill they must

"I've run through a lot of industries as they've involuntarily entered my domain," the bankruptcy lawyer James H.M. Sprayregen, partner in Kirkland & Ellis LLP in Chicago and New York, explained to the *Grant's* faithful. Next up: the E&P segment of the energy business.

Over-leverage is spreading like an oil slick through the exploration and production industry, our speaker continued: "There are 500 public E&P companies out there, and there are thousands of private companies. Interestingly, and this is why I think we're in the early stages, the debt maturities for many don't ripen until 2016. There's not that many debt maturities in 2015. . . . Obviously, many of these companies have hedged themselves. But for the most part, these hedges are going to run off by the end of 2015."

Shale activity, driver of the American oil and gas boom, exhibits early step function declines in production, he said—a well's output can fall by more than half following the first year of operation. "What that basically means is that you have to keep drilling wells. And if you don't, there's a runoff in earnings very quickly—and a runoff in revenue, even."

It can't be said that the capital structure of the average E&P business affords much protection against the cyclical and geological elements. A relatively thin slice of equity, lots of bank debt, some project finance and high-yield bonds are par for the course. Banks lend against an estimated base of energy reserves, and these borrowing levels are adjusted—"redetermined," is the word—each spring and fall. The 2015 redetermination season is already underway.

"Between 2010 and 2013," said Sprayregen, "the majority of E&P financing stemmed from bank loans and bonds. Much of the debt issued in this period, when the price of WTI averaged just over $90 per barrel, is scheduled to mature in the short term, starting in 2016. If you look at the share of the high-yield market that the energy sector has become, it is about 15%. It has almost doubled in about five years. And E&P companies have been the largest issuers of high-yield debt in the energy industry; they're about half of the energy-related, high-yield debt"—$210 billion out of $1.4 trillion.

One-third of E&P-issued junk debt answers the functional definition of "distressed"—i.e., yielding 10 percentage points more than Treasurys. Distress is likely to deepen if, as expected, springtime redeterminations lead to reductions of bank lending on the order of 10% to 15%. What then? Less capital spending would seem the obvious course of action. The rub, as Sprayregen observed, is that you need to keep investing in new wells to compensate for the production declines in shale wells. The result? "You're kind of chasing your tail."

The E&P business is therefore betwixt and between. Cap-ex has indeed been slashed these past few months, but the impact has yet to be felt at the wellhead. Production continues to rise. "As a result," said Sprayregen, "you're seeing a delayed impact, like a slowly moving blob." Come the autumn, and the year's second round of redeterminations, the banks could once more reel in some liquidity—depending, of course, on where oil happens to be trading.

In closing, our speaker warned workout investors about the quirks and crotchets of state laws—even county laws—governing property rights and mineral rights. "Texas is different than Oklahoma and is different than Louisiana," he said. His advice?

"Get a good lawyer," counseled attorney Sprayregen.

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