THE BUSINESS PUBLICATION FOR THE OIL AND GAS EXECUTIVE

OIL&GAS FINANCIAL JOURNAL®

PennWell®

December 2017

BUDDY CLARK TALKS ENERGY CAPITAL EVOLUTION

SPECIAL FOCUS:

2018 OUTLOOK

Farm-out agreements in bankruptcy

Energy insurance market

Mexico's financial restructuring system

OIL&GAS FINANCIAL JOURNAL®

INTERVIEW WITH BUDDY CLARK, PARTNER, HAYNES AND BOONE, LLP

Energy capital evolution

ENERGY LAWYER BUDDY CLARK TALKS ABOUT THE YEAR AND WHAT WE MAY SEE IN 2018

MIKAILA ADAMS, EDITOR, OGFJ
PHOTOS BY SYLVESTER GARZA

Editor's Note: Bernard "Buddy" Clark is the co-chair of the energy practice group and member of the Board of Haynes and Boone, LLP. He represents clients in the oil and gas industry, including producers and their capital providers, banks, mezzanine lenders, and equity providers in oil and gas acquisitions, production and development agreements, midstream acquisitions, and energy related litigation and bankruptcies. In June 2016, Clark published *Oil Capital: The History of American Oil, Wildcatters, Independents and Their Bankers*. I sat down with Clark, at a rustic desk of his own creation in his Houston office, to talk about the year and what we may see going forward.

OGFJ: You're well-known in the industry, but I like to start with an introduction. Can you share a bit about your background, your connection to the oil and gas industry, and your role at Haynes and Boone?

Buddy Clark: My connection to the industry begins a few months before I was born. My father came to Houston in the summer of 1956 to interview with a company called Christie, Mitchell & Mitchell and moved the family from New Orleans to Houston; I was born the following December. He continued to work for Mitchell Energy for 45 years until he retired as Vice Chairman in 2002. It's fair to say I grew up in the industry.

I graduated from law school in the early 1980s and joined Butler, Binion, Rice, Cook & Knapp in 1982, a long-time oil and gas law firm. I have been representing producers and lenders ever since. Butler & Binion wound down in 1999, and I joined Haynes and Boone's Houston office along with a dozen other corporate energy attorneys from my old firm. Haynes and Boone already had a great energy practice and we integrated quickly combining our energy clients with the firm's existing base. Since 2000 the firm's energy practice has grown in national prominence. Today I co-chair the energy practice with Jeff Nichols. We have over 100 energy attorneys and a land department with three full time landmen representing all facets of the industry with energy team members in Houston, Denver, Dallas, Fort Worth, Austin, New York, Mexico City, Orange County, San Antonio and DC. We've gone where our energy clients are, where the work is, responding to our clients' needs.

The firm is organized differently from most other law firms. It's client-focused, driven to putting the client first. Compensation drives culture and our firm compensates lawyers for teamwork, not necessarily individual success. Haynes and Boone was founded in the 1970s by Dick Haynes and Mike Boone, but the focus was not on them, from day one their focus was on their clients. As the firm's clients succeed, so does the firm and its lawyers.

OGFJ: How has the work you do changed, or has it, over the past few years as the industry has struggled with low oil prices?

Clark: The nature of the work changed from capital raising to capital restructuring. Beginning my practice in the early '80s I worked through a couple of cycles. This latest downturn is much like the '80s decade of destruction. But the impact overall has not been as severe – notwithstanding the "lower for longer" mantra, the industry has held its own on balance much better than in the late '80s. Following the Thanksgiving surprise OPEC served up in 2014, the work has changed. We're still dealing with financial agreements between producers and their capital providers but now we're looking at different sections of the agreements. Instead of looking at the requirements for the ability to borrow, we're looking at events of default and remedies. For the most part, in the last 36 months, there have been a lot of clients calling saying "Let's get the agreements out and finally read what they say and what we can do."

Generally, the banks and the producers, while not exactly

on the same team, have the same goal—to minimize loss and find a way to make things work. And when you think about the fact that prices dropped from over $100 per barrel to below $30, I think they've been successful. There were a lot of bankruptcies for sure, but when you think about how many producers are out there, the vast majority of companies survived. And now, with the market turning around, many of them have been able to capitalize on the opportunity. The creative destruction of capitalism has been amply demonstrated through this whole process. US producers have increased domestic production to levels not seen since before the '80s crash. You have to imagine OPEC members kicking themselves one hundred times over after thinking they were going to wipe out the US producers by dropping prices. It's amazing to me that OPEC has such a fundamental misunderstanding about the US market. Here, it's about private ownership of minerals, thousands of independent producers and the fact that you have landowners and companies incentivized to get hydrocarbons out of their property to make money.

OGFJ: In your 2016 book you talk about the enduring relationship of oil and gas producers and oil and gas bankers in the context of the evolution of the two industries. You've noted that this most recent cycle was caused by a flood of capital chasing technological innovation. Can you explain?

Clark: I think the Shale Revolution, which was begun by Mitchell Energy's Barnett shale experiment, created a real land rush for non-producing acreage. The rush for acreage fed on itself and prices were bid up rapidly. But the problem with non-producing acreage is that it doesn't throw off any cash flow. In order to amass acreage positions, a lot of companies went heavily in debt—and not just debt on bank financing, but unsecured bonds and all other levels of debt, which made sense at the high commodity prices people were seeing. Since the early 2000's, excluding the financial crisis years, oil and gas prices showed a fairly steady increase. Producers and capital providers on either side of the equation could see that the land rush made sense assuming that prices would continue to increase. Of course in hindsight that was the fallacy because prices didn't continue to increase. But during that period, if you wanted to compete and see your stock trade at a premium you had to add acreage even though it wasn't really producing yet.

There's one other element that occurred, and that was the real estate and financial crisis that wiped out a lot of capital in 2008 and 2009 when the oil and gas industry was seeing prices continue to rise. Following the financial crisis, for those institutions and private equity firms that still had access to capital, if you were looking for a place to invest, oil and gas was a good place. You had producers with all this need for capital, and you had capital providers looking to find a home to invest their money. These elements fed on each other. Private capital was competing with other private capital to place money into the market, bankers were happy to permit their borrowers lever up on second liens and unsecured debt because they could see that money behind them—as an equity cushion. And as for producers, you'll never meet a producer who'd say "I don't need any more money." All that led to excess debt, over-levered companies, and very complicated financial structures. It wasn't just one banker and one producer, you had the producer, with his lead banker, the bank group, the second lien lenders, the bondholders, the preferred equity holders, and the private equity bankers. It was quite a complicated structure when prices collapsed. Something had to give.

The market adjusted and people retrenched. A lot of the capital providers exchanged debt for equity and banks were willing to give waivers and forbearances on exercising remedies because the expectation, at least early on, was that it was just another commodity price cycle and we'd bounce right back. If you remember, in March of 2015, prices came up a little bit and a number of companies went to the public markets and added even more debt. That turned out to be a bad idea because prices then dropped even lower. The 'lower for longer' reality kicked in and people have adjusted for that. I think we are seeing the beginning of a slow recovery for the industry – barring any unforeseen black swan event, of course.

OGFJ: I read an article you penned about the destruction of capital with this latest downturn and the ways in which companies have adjusted. Where are we in the process and what does an evolved E&P company look like? What about capital providers?

Clark: I think the market has adjusted in that that people are able to operate in a $50 price environment. There's been a lot of pain distributed throughout the capital structure, but the brunt of it has been foisted on the backs of the oilfield services companies. That should be one of the bigger concerns if and when prices start to rebound. Will there be oilfield services companies available to help drill up the properties?

As far as companies that went through bankruptcy…the fulcrum debt was not the secured lenders, not the commercial banks, but the bondholders. Commercial banks, as the senior secured creditors, came away unscathed for the most part. However, the second lien lenders and unsecured bondholders either lost a ton of money or they lost a little bit of money, but they were the ones calling the shots through the bankruptcy process and exchanging their debt for equity. They layered on some exit financing from a bank facility with the hope, I think, that when prices rebounded they'd be able to get out of the oil and gas business. Most of the unsecured bondholders that converted their debt into ownership of the oil companies are bond traders, not oilmen. You see some of that going on right now. Many are looking to liquidate their positions, a good example is the recent announcement by Sandridge Energy that it is acquiring Bonanza Creek, a merger of two post-bankrupt producers, or Talos Energy's announcement that it is acquiring Stone Energy which emerged from bankruptcy earlier this year. For the companies still standing—and that's most of them—the goal is to live much more within cash flow. Leverage ratios have been reduced in response to bank regulators' demands. You don't see the producers, or the market being receptive to, layering on a bunch of additional debt.

Before the downturn, banks had first lien security positions, mezzanine lenders came in and put second liens on, and then you had the unsecured bondholders. The mezzanine second lien market is nowhere near as robust as it used to be. There is probably more bond debt still than second lien facilities. With first lien, I think banks are being more conservative with respect to financial covenants, pricing and collateral coverage. Haynes and Boone recently published our borrowing base survey. The survey confirmed that people expected this fall borrowing bases may go up or down about 10%, but that's going to be it for the most part. I think that's reflective of the fact that the market has adjusted.

"Seventy percent of the activity in the industry today is private equity driven. Ten years ago it would have been considerably less, and 20 years ago it would have been zero. I don't know if it's a good transformation long-term or bad. Private equity may like oil and gas today, but they may not like it tomorrow."

OGFJ: Do you see a change happening with regard to reserve-based loans? We ran an article recently about loan values that weren't reduced in 2015, 2016, or 2017 despite a 75% contraction in oil prices from 2014 to 2016. Are we witnessing an evolution in the financing?

Clark: You'll never get a bank to put in black and white its borrowing base formula because there's a little bit of art with the science. It's not a linear equation of 75% of PDP plus 20% of PUD value. There are other variables that go into a bank's calculation of how much it is comfortable lending to any given producer. The formula is a black box and it enables the banks flexibility in either direction, but, more often than not, the banks are going to stretch rather than contract.

I think the study you are referring to reflects the reality that banks faced in 2015-2016. Prices contracted severely, but borrowing bases did not follow in lock-step. Reducing a company's borrowing base below its outstanding borrowings triggers a repayment of principal. In a low price environment, that can be a death spiral. The more cash a producer uses to repay its bankers, the less it can reinvest in its properties to maintain cash flows, the lower the borrowing base, etc. So unless the bankers wanted to force their borrower into a fire sale or bankruptcy, they were slow to reduce borrowing bases below outstanding borrowings.

As prices recover and producers regain their financial health, I predict you will see more 'conforming' borrowing base determinations. I think we are already seeing that with the fall 2017 redeterminations.

OGFJ: Will West Texas continue as the news-maker in 2018?

Clark: There's so much momentum there. Everybody has acquired this acreage that they're going to need to drill, produce, and build out infrastructure and pipelines. I think the Permian is an incredible story. If you read the history of the industry, while it didn't exactly begin there, the Permian is where a lot of the big oil companies got their start. It's part of the romance of this industry, that the Permian is back. OPEC's actions in late 2014 hurt them more than the US producers. What they did was help drive more inventions and technology that have driven a phenomenal increase in production. That's the spirit that made our industry the engine that has enabled the United States to dominate the world in energy…and at the same time made it so interesting...the boom and bust, and the characters and activity around the industry.

OGFJ: Haynes and Boone publishes a report on bankruptcies in the sector. What does the recent report show in comparison to the firm's previous report?

Clark: Our most recent Oil PatchBankruptcy Monitor Report

is showing that the wave of bankruptcies is subsiding. It's still an incredible number, around 133 total bankruptcies as of October 2017 for producers now with a few more in the works. When we first started tracking oil and gas bankruptcies in January 2015, I thought 150 would be the number we'd hit. I'd be glad to be wrong. The larger bankruptcies early on, the blockbuster, billion dollar bankruptcies…I don't think we will see too many more of those. Of course, that's not taking into account oilfield services side. I don't know if we've seen the end of oilfield services bankruptcies.

One question folks ask is if some of these companies will file a "Chapter 22," that is, will they file Chapter 11 twice? A couple of companies have so far. Some of the earlier bankruptcy exits occurred when many thought prices would rebound faster. Exiting bankruptcy, they left more debt on the companies and they're struggling right now. The story is not over, but we're closer to the end of the book than the first chapters.

Bankruptcy for the individual company and its employees can be very tragic, but for the industry as a whole it's positive. There are a number of zombie companies still out there. If they were not still limping along, it would be better for the industry long-term. In Texas in the 1980s we had a lot of real estate companies that couldn't get anywhere and the whole real estate market suffered for a decade. Texas had to get rid of all that raw land inventory, but once you got rid of it, there was more activity. I think it's the same thing in the oil and gas industry. I don't want to say all zombie companies should go through bankruptcy, but I think even those companies recognize there needs to be a resolution. The sooner the resolution, the stonger the recovery. But for any individual company that is still struggling, their thought is 'I don't want to resolve it today, because I can get more money if I wait.' I think there are a number of companies that aren't doing anything with their assets because they can't afford to, but the assets, in the right hands, are valuable.

OGFJ: We've seen some oil and natural gas E&P companies emerge from bankruptcy with equity swapped to eliminate large debt loads. Why do some emerge then hire investment bankers for a review over Section 363 sales during Chapter 11?

Clark: I think they imagine they're going to get a higher return on their investment. In a forced bankruptcy sale auction process, usually it's a structured event with a stalking horse bidder. For any competitive bid to come in, it has to beat the stalking horse by 5% or some clearing price. More often than, not the stalking horse purchaser ends up with the properties. There have been some competitive auctions in a bankruptcy court in front of a judge, but for the most part sales in bankruptcy auctions were disappointing for the company and its creditors. I don't think people believe 363 sales are as successful as reorganizing, cleaning up the properties, investing capital as needed, and selling in a negotiated process outside of bankruptcy. In this downturn we've seen companies going into bankruptcies, much more organized. They're usually pre-packaged, or at least pre-agreed, with a restructuring agreement put in place—usually including debtor in possession financing. If you have a freefall bankruptcy without advance agreements, you end up with different constituent groups fighting among themselves, and then the only answer may be to sell.

OGFJ: Recent industry events have hosted natural gas weighted companies with an overall outlook trending positively as exports continue to grow. What could we possibly see in terms of an outlook for natural gas in 2018?

Clark: I can't predict natural gas prices, but I do think it's another result, perhaps an unintended consequence, of OPEC actions. Shale production of natural gas and associated gas is so prolific that there's not enough demand domestically to absorb it so we have to go international. Cheniere turned an LNG import facility into an export facility. Now there are dozens of LNG export projects under construction or permitted for construction. It's another fascinating aspect of our industry—how shale production has changed not just global markets but that the world balance of power has changed because of US shale production.

OGFJ: What about crude oil?

Clark: If you exclude unforeseeable disruptive events, it seems to me that the market is nearly balanced. There's sufficient domestic demand growth to absorb the increases in domestic production. Overall, prices, having stayed within a tight price band around $50 barrel for some time, which seems to indicate

a supply and demand balance. I don't know what future market conditions will bring, but there are a lot of smart people out there looking at that, and if they saw an opportunity they'd be bidding up the price or undercutting the price, and it doesn't seem that's happening.

OGFJ: Looking back at 2017, what are some of the things that stand out in your mind?

Clark: Recovery. Innovation and technological improvements across the board. At Haynes and Boone, what we saw was a structural transformation in the capital debt and equity markets. The traditional model for almost a century used to be that the independent producer borrowed money from friends and family, drilled a few wells, built things up slowly and steadily, and created a company. Since the economic downturn of '08-'09, the model has been different. Private equity has money to put to work and if they can find a good management team, they will back the management team with hundreds of millions of dollars to acquire production and become an instant company. In our borrowing base survey for the fall of 2017 we asked how many of the new loans booked in 2017 were private equity backed management teams. The responses were consistent with what we've seen…70% of the activity in the industry today is private equity driven. Ten years ago it would have been considerably less, and 20 years ago it would have been zero. I don't know if it's a good transformation long-term or bad. Private equity may like oil and gas today, but they may not like it tomorrow. Private equity has more of a buy and flip mentality. They want to get in and get out, not build a company for 20 years. Their investors are looking for a return on investment within five years. It seems to me that would increase volatility in the industry. Volatility can be good or bad. I don't have a crystal ball, but that's what stands out for me at this point.

OGFJ: Do you see private equity continuing in the space in 2018?

Clark: Definitely. Unless private equity finds a better place for its investment, it will remain the principal capital provider to the industry in 2018. It used to be that the banks could dictate terms of credit agreements, but we've seen situations where private equity has gone to a bank and said, "we'll let you loan money to our management teams, but here's the credit agreement you're going to use." You would have thought that after the crash in commodity prices that the private equity sponsors would not have been as aggressive, but it really hasn't slowed down their view of the world. That's an over generalization, of course, but they command a large piece of the market.

OGFJ: What else should we look for going into 2018?

Clark: I think technological advancements are guaranteed. Probably more so if prices stay low than if prices go up because when prices are low you have to find a new way to pinch pennies and make money. I think there'll be more consolidation in oilfield services. Many of the Mom and Pops can't continue to operate on a loss. Going forward, from a capital perspective, you see the same financial products with a new name trotted out every five years or 10 years. For example, in the 1980s there were MLPs, blind drilling funds and conventional farmouts. Today we're seeing MLPs, SPACs, and DrillCos. To me it's the same product in a new wrapper. The close relationship between the producer and the capital provider started in this industry Day One. It continues to this day because you can't drill wells without men, rigs, pipe, …and capital. You've always had to have capital. While things have changed, in many ways they'll remain the same.

OGFJ: Any final thoughts for our readers?

Clark: Former Saudi oil minister Sheikh Ahmed Zaki Yamani's comment that we didn't exit the Stone Age because we ran out of stones comes to mind. We're not going to exit the Hydrocarbon Age because we run out of hydrocarbons. There's going to be a lot left in the ground. What's going to replace it? When is it going to happen? If you look back at history, we're seeing innovations occur at a more rapid pace. Where is technology going to take us? I don't know the "how" and "when," but I know based on this industry and its history, it will be a very interesting ride.

OGFJ: It's been a pleasure. Thank you very much for your time.

Electronic and single printed copies for distribution with permission to Haynes and Boone, LLP from *Oil & Gas Financial Journal*
December © 2017 PennWell Corporation

haynes*boone*