

# The convergence of capital

## Market changes in private debt capital markets for upstream oil and gas

**Buddy Clark**

*Haynes and Boone LLP  
Houston*

Over the last two years the energy capital markets have seen commercial banks making mezzanine loans, mezzanine lenders making equity investments, and private equity funds leading syndicated senior and subordinated loan facilities. Traditional bankers are getting into the hedging business, and hedge funds are getting into the energy lending business.

There are more than 200 private capital providers focused on the upstream oil and gas industry: commercial banks, mezzanine lenders, equity funds, hedge funds, and investment bankers. Over 30 of these capital providers were formed, or rolled out new funds last year alone.

Anyone who has been in the energy business long enough is well aware of the industry's boom-to-bust commodity price cycles and its impact on capital availability. And while a good number of the established capital providers are also aware of the commodity price cycles, many of the new market entrants have yet to experience this first hand. Ironically, with their seemingly unlimited access to cheap investor capital and strong desire to put their investors' money to work, many of these new funds are influencing, if not leading, current trends in pricing and structuring of energy loans.

In order to compete and maintain market share, commercial lenders and traditional private equity funds have had to adjust their business models and underwriting criteria for middle market oil and gas lending. This convergence has blurred the lines that traditionally distinguished different capital providers into segregated and distinct markets.

The last downturns in the mid-'80s with the failure and

takeover of a number of prominent energy banks like Penn Square and Continental Bank, and again, near the end of the '90s when the world caught the "Asian Flu" and commodity prices suffered causing a number of highly leveraged energy companies to seek protection of the bankruptcy courts, are but a vague memory to today's capital providers.

Today's competition is bringing pricing down on all levels. Financial performance covenants and borrowing base formulas are being relaxed. Recent financing trends bode well for the oil

and gas borrower, but point to assumption of increased risk of overall lower returns for capital providers. So long as commodity prices remain strong, this move towards a more competitive and aggressive underwriting strategy is likely to continue to gain currency in energy debt markets.

The paradigms for underwriting middle market reserve-based debt financings in the range of \$10 million to \$150 million and higher are in a state of flux. Until the new capital providers turn to greener pastures or the commodity price

cycle heads south, it is not possible to say with any authority where the "market" is as it continues to adjust at an accelerating pace.

Capital can come in many shapes and sizes depending on an oil and gas producer's needs, asset base, and the lender's perception of the potential risk and rewards. Attempts to pigeonhole capital providers in the market are risky due to the overlapping products offered by the providers, but in broad terms capital can be divided among bank financing, mezzanine capital (debt or equity), and private equity capital.

While a sharp delineation of the current market is not possible, looking back on how the market has evolved over the last 25 years is helpful to put into perspective the pic-



**With oil and gas prices at record highs, producers are having little difficulty in finding financing to help grow their business through conventional bank debt and other means. This pumping unit is on a stripper well operated by Cano Petroleum in Nowata County, Okla.**

*Photo courtesy of Cano Petroleum*

ture, albeit blurry, of current capital markets and the credit options for oil and gas companies looking for capital.

## Conventional bank debt

Since at least the 1970s, reserve-based bank debt has been the traditional structure for secured oil and gas loans. The amount of funds available on a revolving basis under these loans is based principally on the collateral value of the borrower's proven oil and gas reserves (the "borrowing base"). Loans are made and secured against a borrowing base comprised as a percentage of the borrower's proved developed reserves, which are re-evaluated under semi-annually prepared reserve valuation reports.

Notwithstanding the stated maturity of these facilities (typically 3 to 5 years), this periodic review allows lenders to successfully manage risks on a 6-month time horizon. Any reduction in the borrowing base can trigger a mandatory repayment to the extent borrowings exceed the redetermined amount.

Because the lender's risk horizon is significantly constrained, this type of loan structure can be the least expensive form of debt financing. Currently, senior debt secured with a first priority lien on the borrower's oil and gas property is usually priced within less than one to two percent above current LIBOR or prime rate and some facilities are priced at or below prime.

Mindful of risks associate with fluctuating commodity prices, lenders historically would only advance against the borrower's proved developed producing reserves (PDPs). While the parameters of advance rates for setting the borrowing base varied among lending institutions, generally borrowers were not given more than 65% of the present discounted value of PDP and only a small, if any, percentage of proved developed non-producing (PDNP). Rarely would any collateral value be given for proved undeveloped acreage (PUD).

In addition, reserve valuations were run on present value calculations based upon the bank's internal price forecasts, which are more conservative than current market prices. Depending on the risk rating and a banker's comfort level with the loan, in the 1970s and '80s these loans were tightly structured with a lockbox for proceeds from the sale of production to control all funds flowing in and out of the company.

As the market for this type of loan has matured, and certainly for larger borrowers, the facilities were less tightly controlled and financial covenants relaxed to permit the borrower greater autonomy and control over its own capital management.

In order to remain competitive with other capital providers in today's market, bankers are giving greater credit for PDNP and PUD reserves but still imposing some cap as to total reserve values attributable to non-PDP reserves. Additionally, while oil and gas price decks for commercial banks remain

well below the current historically high prices, banks have been able to boost borrowing base levels by factoring in a borrower's current hedge position into the bank's projections. But even with these concessions to competitive markets, there remains a substantial collateral cushion for the banks to fall back on in the event of a material adverse change in commodity prices or the borrower's financial condition.

## Stretch conventional financing (A-B loans)

With the increased competition from mezzanine lenders (described below), many of the leading energy banks responded in the mid-90s by adding a second tranche of debt (the B Loan), which was typically a term loan contractually subordinated in payment to the senior revolver facility (the A Loan). The B Loan was underwritten with a higher advance rate against PDP and a larger portion of PDNP reserves. This stretch portion had higher pricing but, when blended with the A Loan, provided as much capital as the mezzanine lenders with a lower cost of funds.

The B Loans were typically tied to low-risk capital development projects such as in-fill drilling or step-out exploration. While structured with a longer maturity than the A tranche, the expectation was that with the capital provided under the B Loan upon successful efforts increasing PDP reserves, the conforming borrowing base for the A Loan would increase sufficiently to enable the borrower, with the lender's consent, to retire the B Loan prior to its maturity. For so long as the B Loan lender group was composed of the same lenders as the A Loan group, there was basically no difference in the way the A-B Loan was documented from the traditional single tranche revolver borrowing base loan. These loans were structured so that the same bank, or group of banks, held equal portions of both the A Loan and the B Loan. This commonality of interest facilitated administration of the loans and avoided inter-creditor issues that can arise under the senior/subordinated loan structure with different lender groups for each facility as can occur with mezzanine debt financing described below.

## Mezzanine debt financing

The A-B Loan structure was in part a response to growing competition in the early '90s from mezzanine capital providers who saw an opportunity between the traditional secured bank loans and private equity capital providers. The original pioneers in this area in the '80s, such as Resource Investors Management Company (RIMCO) and Trust Company of the West, were later joined by Enron Capital and Trade Finance Group and MG Trade and Finance in the early '90s.

These mezzanine lenders were able to tap into the "collateral cushion" left behind by more conservative bank underwriting. The substantial advantages under bankruptcy statutes for secured creditors made this portion of the

borrower's assets attractive even for the mezzanine lenders who contractually waited in line for payment behind the senior secured bank lenders.

In the later '90s other capital providers, including investment arms of some of the major oil and merchant energy companies, increased access to mezzanine capital. This original field of providers contracted considerably with

holder; 3) agreement not to challenge the liens or priorities of the first liens; and 4) waivers or limitations on the second lien holder's rights to exercise or take actions in bankruptcy proceedings of the borrower.

Early mezzanine lenders were looking for returns in excess of 20%. Today, given the competition, internal rate of return targets are more in the low teens. The market for sub debt

*Today's competition is bringing pricing down on all levels. Financial performance covenants and borrowing base formulas are being relaxed. Recent financing trends bode well for the oil and gas borrower, but point to assumption of increased risk of overall lower returns for capital providers. – Buddy Clark, co-leader of the energy and power practice group for Haynes and Boone LLP*



the fallout from the '97-'98 commodity price collapse and subsequent merchant power collapse following Enron's bankruptcy.

RIMCO, Shell Capital, Duke, Mirant, Enron, Cambrian, and Aquila have all closed their doors and sold off their portfolios. Notwithstanding the apparent mass exodus, there are many more mez capital providers today than in the late '90s. Today over three dozen mezzanine finance companies have their doors open ready to lend to the energy markets. This number does not include the hedge funds and private equity funds and some commercial banks that have also entered the mezzanine capital market.

The mezzanine loan is structurally junior in payment and lien priority to the senior secured facility. Broadly speaking, the mezzanine lender will only get paid back after the senior lenders have been paid in full, including post default interest. As a secured creditor however, the mezzanine lender will rank ahead of the trade and other general unsecured creditors and ahead of equity holders in the event of bankruptcy and liquidation.

Consistent with the greater repayment risk, these subordinated loans are priced higher than first lien debt. In addition to carrying a higher coupon, these loans traditionally included an equity kicker in the form of overriding royalties or warrants that, if successful, greatly increase the lender's return. In order to obtain the senior lender's consent to "share" in the borrower's collateral, an inter-creditor agreement is negotiated between the lender groups that strictly limits the mezzanine lender's rights as a secured creditor in exercising control over the borrower's collateral especially in the event of a default or insolvency.

Customary second lien inter-creditor agreements have four primary elements: 1) prohibitions on right to take action to enforce the second liens for some period of time (standstill or blockage period); 2) agreement not to challenge enforcement or foreclosure actions by the first lien

has shifted with the demands and expectations of new market entrants which include private equity groups, leveraged public funds, commercial banks, and investment banks with dedicated mezzanine funds in addition to the more traditional sources, including insurance companies, endowments, and pension funds.

Perhaps the most visible and active participant to arrive in the last 12 to 18 months has been the hedge funds. Current estimates of assets under management in hedge funds are over \$1 trillion as of the end of 2005, according to Hedge Fund Research.

The private equity markets have also grown substantially, raising more than \$172 billion in 2005, according to Standard & Poor's. Hedge funds are not constrained to any one market or investment strategy. Unregulated by the statutory investment constraints imposed on commercial banks, these funds are able to use opportunistic investment strategies to meet their investors' expectation for deployment of and return on capital.

As many traditional hedge fund strategies have become crowded in the last few years, managers are seeking to invest in new arenas where they can generate returns. They are finding the capital-intensive energy industry an attractive arena.

The impact of this shift in market players is magnified by the shift in the market's demand for capital. Most companies with a large percentage of PDP reserves are not looking to add debt but instead are reaping the benefit of higher commodity prices and paying down outstanding indebtedness. Companies with a greater proportion of PUD drilling prospects compared to PDP reserves lack the collateral attractive for conventional senior secured financing. With assets weighted more heavily towards sub-debt, this is providing the mezzanine lenders greater say in the

terms of the secured financings.

Accordingly, the market for subordinate debt has become more aggressive, competing with the traditional senior lenders (commercial banks) to provide secured capital to oil and gas companies. This shift in the market is changing the dynamics between the senior and subordinated mezzanine lenders. The old generalizations about what is “market” under inter-creditor agreements between the two groups no longer holds and makes current “market terms” impossible to pinpoint.

In order to get even greater advances against existing reserves and often to provide drilling capital to access proven undeveloped reserves, borrowers have been looking to private capital lenders to provide a junior debt tranche to their existing senior secured facilities. Some of these “secondary lien” lenders are taking a more active role by arranging to refinance the borrower’s entire existing senior debt and adding a layer of second lien debt underneath.

Borrowers are benefiting directly from this increase capital availability in that deals that two or three years ago would have commanded an equity kicker to get traction in the market are now priced 400 to 800 basis points above the senior facility without any kicker at all.

The current frothy market for capital in the energy

industry is causing market players to morph into one another. Commercial bankers are taking pieces of mezzanine debt, hedge fund managers converge with private equity lenders to agent and syndicate along side commercial banks first and second lien secured loans.

As with any evolutionary process, there will be winners and losers. Seeing clearly who is the winner and who is the loser may not be possible until there is a change in the economic climate of the industry. Perhaps the sea change will be brought on by a natural storm in the form of a hurricane or a figurative storm brought on by political disruption. Until then, for the oil and gas executive looking for some cheap capital, there is no better time to get out and ride the wave. **OGFJ**

*The author*

*Buddy Clark, [buddy.clark@haynesboone.com] co-leader of the energy and power practice group for Haynes and Boone LLP, has represented energy companies on matters ranging from credit transactions to royalty disputes and environmental law related to exploration and production. He has also served as special counsel to the executive director for the US Emergency Oil & Gas Loan Guaranty Board to review and advise on emergency loans to oil and gas producers.*

haynesboone  
Setting precedent.