Greater capital discipline benefits lenders and borrowers alike

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While the world economy runs on oil, the oil industry runs on capital which has become more difficult to source during the current industry downturn.

The oil and gas sector has experienced one of the most precipitous declines in oil prices from US$100 per barrel in 2014 to as low as US$27 per barrel in 2016. The escalation of oil prices from 2009-2014 and the massive investment in the sector has resulted in a supply bubble that has forced the industry to recalibrate the fundamentals. We have seen a slow but deliberate recovery over the past few months putting the current price in the very approximate range of US$40-50 per barrel. However, is this a sustainable recovery?

First, we need to examine the question of how did we get to this point? Since the financial crisis of 2008, central banks around the globe have increased the supply of money, artificially kept interest rates at historically low levels, and devalued currencies. This surge in financial liquidity along with new discoveries like US shale, cutting edge technological advancements that allowed us to extract previously inaccessible reserves and insatiable demand for oil in the emerging markets fuelled the dramatic growth in production and the rise in oil prices in excess of US$100 per barrel. It also led to investments in the energy sector which were neither accretive nor economically sustainable along with an out of control cost base. Producers of every size globally had access to capital from banks, the capital markets, and private equity. This easy access to capital resulted in a significant expansion in the supply of oil which eventually out-paced the global demand.

As after all great boom periods, the fall is usually swift and dramatic. By the end of 2014, the oil and gas industry, despite high prices, had sowed the seeds of the largest cyclical downturn since the mid-1980s. In October 2014 OPEC, led by Saudi Arabia, refused to cut production to bolster falling prices sending a clear signal to the market. At the same time, demand in the emerging markets and China began to stagnate, accentuating the price drop. The industry reaction has been swift and painful. Producers were forced to cut capital expenditures, sell marginal assets, reduce staffing and restrict dividends to preserve cash flow. Since the end of 2014, the industry has reduced capital expenditure plans by US$370 billion through 2017, and US$620 billion through 2020. It is estimated that the industry will spend US$1 trillion less on finding and developing reserves between 2015-20, stoking fears about potentially tight supplies in the coming years.

The falling price environment has significantly restricted the availability of capital for the industry. The banking market has experienced a growing level of troubled credits which has led to a significant increase in provisions and loan losses. We have seen stricter terms and conditions in the Reserves Based Lending (RBL) market, where the collateral is the oil or gas revenue stream. The bank market has been more conservative in its price decks for RBLs and banks have been pro-active in reducing availability (20-30 per cent lower) in the redetermination cycle. The banks are under increased pressure from regulators to reduce exposure to the commodity sector. Despite a significant increase in bankruptcies, the RBL market has once again demonstrated a resiliency due to the secured nature of the deals and the structural protection. Globally, we clearly see less appetite in the banking sector with banks focusing their capital on high quality borrowers and downstream business opportunities. The banks have significantly reduced their exposure to the oil field services sector which has once again been disproportionately hit in the down cycle.

Glimmer of hope

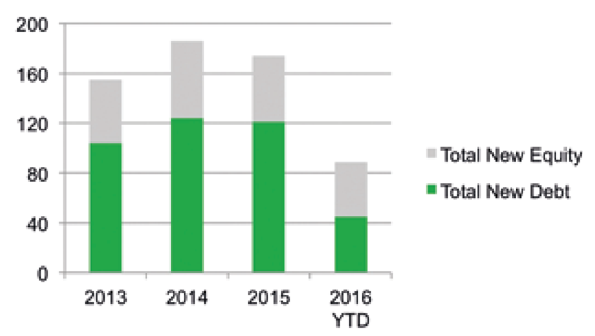
The high-yield and investment-grade debt market which had been the primary liquidity source for the industry from 2009-14 virtually shut down for 2015 and the first quarter of 2016. Investors and funds experienced a significant erosion in value as bond quality deteriorated. US E&P companies issued a paltry US$280 million in bonds during the first quarter 2016, the lowest level in more than a decade. There has been a glimmer of hope as oil prices have moved upward in the last few months. High yield volumes for the sector have increased over the past three months, easily exceeding the preceding 12 month period. This is a clear signal that investors are cautiously beginning to flow back to the sector.

The most encouraging market, and one that has virtually saved many players in the industry, has been the equity market. The equity market, especially in the US, has been more accessible to a diverse number of battered oil and gas companies. In 2016, oil and gas companies have issued US$9.2 billion in stock offerings, the single largest volume since 1999 for the sector. Issuers have included a wide variety of companies from Marathon Oil Corp to Weatherford International PLC. The equity market has been the primary liquidity source to fund the much reduced capital expenditure programmes in the sector. It also is a clear indication that investors have bought into the recovery story. The industry always says that the cure to low prices is low prices. The industry has responded and adjusted to the new realities of the cycle. Over the past few months, we have witnessed a slow but deliberate rise in prices towards the US$50 per barrel level. More importantly, it appears that industry has re-established the equilibrium between supply and demand which should continue the positive recovery

Nevertheless, the question remains of how quickly the debt markets will return to support the continued recovery. The financial community has historically short memories and tends to repeat the same boom and bust mistakes from one cycle to the next. However, I am expecting greater discipline amongst the banks and bond investors due to the depth of the downturn and financial losses realised over the past 2 years. The regulators have clearly highlighted the commodity sector from a risk perspective, and this will continue to challenge banks in growing exposure in the near term. Banks and bond investors will focus on high-quality players with a diverse portfolio of assets and a conservative balance sheet. The marginal players in the industry will continue to struggle to find new capital.

As a result, the industry will continue to run a cash deficit as prices recover. In order to maintain the momentum of the recovery, the industry will need to complete its divestment programmes in order to de-leverage and close the gap on cash flow deficits. Currently, there are over US$200 billion in global oil and gas assets identified for divestment. The two biggest challenges on divestments are closing the gap between the bid and offer spreads, and identifying new buyers. The current price recovery should assist in closing the price gap between buyers and sellers. However, finding new buyers/investors in the market poses a far greater challenge. The Chinese national oil companies who dominated the buyer market for the past five years have clearly backed off further international expansion focusing on internal governance issues. Private equity which maintain a sizeable war chest have focused more on midstream and downstream rather than upstream assets. The rest of the industry is focused on de-leveraging and cash conservation. Inheriting another player's problematic assets is no longer an exciting proposition. The industry will continue to struggle to complete the growing divestment goals. This will likely hamper the pace of the recovery and reinvestment in the sector.

Debt and Equity Issuance in the Oil & Gas Sector



Source: Bloomberg

Never as good, or bad, as it seems

Despite all of these challenges, I remain optimistic that we are entering a more positive phase in the industry. I agree with the adage that it is never as good as it seems and never as bad as it seems. In actuality, the oil and gas sector was not healthy at US$100 per barrel. The industry had become bloated with marginal projects, high costs, excessive leverage and a level of asset concentration that made it extremely vulnerable to a downturn.

It is critical that the industry does not cover up failures in strategy simply by enjoying the benefits of higher prices. The industry must become more introspective on its strategy and asset mix. The upstream sector must establish a more symbiotic relationship with the oil field services sector to control cost while reducing cyclical vulnerability to the service sector. I remain confident that capital will continue to flow at an increasing rate to this vital sector in the world economy. However, banks and financial investors need to be more disciplined in terms of whom they back and the structure of transactions. Private equity will continue to play a key role in supporting and backing new management teams and more innovative strategies. Perhaps we were complacent and forgot that the oil and gas industry is, and always will be, a cyclical sector. As such it requires investors who are experienced, have a longer-term perspective and can withstand the volatility.