

# Capital Market Uncertainties Begin To Work Through The Upstream Sector

By Gregory DL Morris

Special Correspondent

Independent oil and gas producers are known for their ability to respond quickly to changing market conditions. Less anticipated, however, is how quickly capital market conditions have changed for independent producers.

A midsummer survey by *The American Oil & Gas Reporter* (July 2008, pg. 51) of upstream credit markets found independent producers were one of the few bright spots for lending in a financial sector that already was beginning to be roiled by the emerging subprime crisis.

"In June, energy was one of the last sectors where investors and lenders could find strong deal flow and attractive returns," affirms Peter Gaw, president of CIT Energy, the 100-year-old investment banking and commercial finance firm based in Houston. "But even then we began to see the signs that energy would not be immune to the credit crisis."

Since then the bust in the U.S. housing market has led to a complete collapse of the debt and derivative markets that backed mortgage lending. Several historical Wall Street firms have gone under or been purchased. By early October, stock markets around the world were in a steady retreat and credit was at a near standstill. More pointedly for the upstream, West Texas Intermediate had fallen from a record high of \$145 a barrel to close below \$80 on the New York Mercantile Exchange on Oct. 10, while spot natural gas at Henry Hub had tumbled to \$6.51 an MMBtu, down from twice that level at midyear.



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CIT Energy



“The difference between June and October is night and day,” says Gaw. “We are experiencing a severe dislocation in the financial markets, the likes of which I have not seen in 25 years. The lack of debt availability has hampered producers, especially smaller producers who need short-term credit for day-to-day operations.”

That said, Gaw stresses that some transactions, nevertheless are going forward. “We closed three exploration and production deals in September and have several more in various stages of completion,” he related in early October. “I could close 20 more deals this year if more capital was available. We have seen credit spreads gap out so much that the cost of borrowing has become prohibitive in some instances.”

Gaw notes that the great frustration—and irony—is that, “There is a substantial amount of equity capital available in hedge funds and private equity firms. Banks are hoarding cash as well. The credit markets are more or less shut down.”

He says those investors have been unwilling to get off the sidelines because of “the 50 percent drop in energy prices and the appearance of a global recession. Even at (early October) prices, the industry should continue to perform well. The challenge is the volatility and lack of liquidity.”

The immediate danger, Gaw states, is that the smaller companies, which he calls “the true entrepreneurs in this industry,” cannot develop their properties without available debt capacity. So, he concludes, “I continue to be bearish on prices and liquidity for the moment. I don’t expect anything to change until at

least the first or second quarter of 2009.”

#### **A Somber Mood**

“The mood today is much more somber than it was in the middle of summer, and the last few weeks have just been chaotic,” remarked Tod Benton of Houston in late September. Benton is managing director and head of energy and power in the United States for Toronto-based BMO Capital Markets.

“We are advising our clients to sit tight unless they really need to do something, such as tap an existing credit facility. There are many players now who are keeping to the sidelines,” he says.

The independent oil and gas sector has been mostly spared the worst of the credit crisis, Benton maintains. But a few problems have hit close to home. “There

was one work-out in the midstream sector that spooked a lot of people,” he articulates. “Nevertheless, many lenders are pulling back and being extra cautious.

“What we are seeing is the separation of the haves and the have-nots,” Benton continues. “There are about a half dozen banks in this market that still have capacity to put deals together; others are struggling.”

He also notes that equity in lieu of cash has become a more difficult proposition because stock prices have declined as the price of oil retreated from its mid-summer record.

“The fundamentals of the industry have not changed,” Benton stresses. “The problem really is a global capital issue, not a problem in the oil patch.”

That said, he comments that when banks stop lending to each other, it becomes difficult to get deals done even for highly rated operators.

“We have clients who view these conditions as a great opportunity to acquire assets or even whole operators at very favorable multiples,” Benton reveals. “The reality is that the high-yield and equity markets are shut. But there are guys who have been prudent and have kept their powder dry. There will be opportunities for them to buy on the cheap.”

Benton confirms that there has been some acquisition financing and even some underwriting of deals, but stresses that “the days of solo underwriting are over. Now if it is being done at all, it is on a club basis.”

Looking beyond the immediate financial crisis, he says BMO Capital Markets remains very bullish on the independent oil and gas industry. “We expect some

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**BILL WEIDNER**  
Managing Director  
The Rodman Energy Group of  
Rodman & Renshaw

further softening in the price of oil, given the outlook for the global economy,” Benton allows. “But we also believe there is some floor. We don’t know exactly where that is, but it certainly is not back where it was last year.”

Benton acknowledges more near-term weakness for natural gas. “We have a production phenomenon that is a short-term problem,” he ventures. “But the long-term outlook is still very bullish. The long-term dynamics in both oil and gas are very strong.”

### Half Speed Ahead

Bill Weidner, managing director of the Rodman Energy Group of Rodman & Renshaw in New York, confirms that deals indeed are going ahead, albeit at reduced sizes and speed. “The size of transactions is being reduced, mostly because bank groups are throttling back,” he says.

Weidner says that is partly because lenders cannot be sure of the external situation in the markets nor of the internal situation of their own institutions. He points toward the tug-of-war between Citigroup and Wells Fargo over Wachovia Bank, and notes that until the havoc of late September, Wachovia was a very big player in the upstream independent sector. That has since been completely suspended.

Yet he stresses that transactions are taking place, if somewhat more laboriously. “I was on the telephone with a client who has an acquisition in mind,” Weidner relates. “The client has a strong balance sheet and credit rating, good assets, and can get the property at a good price. Yet we are having to push our banking group to get in the room with this client.”

He notes that the problems in the en-

ergy markets are a very recent development. Even as the credit crisis made lending more difficult in other markets, he says it was nearly business as usual in energy until about September. “We always have heard lenders tell our clients things such as, ‘Sure we will hold that paper,’ or ‘That is our core business, we do it all the time,’” says Weidner. “Now all of a sudden we are being told, ‘We are going to have to check on that.’”

He says he also is concerned about the price of hydrocarbons. “The commodity price is not helping. As the economy slows, we are starting to see demand destruction,” Weidner intones. “On the other hand, the cost of steel is going down, so the cost of pipe is going down. At the same time, rig availability is rising and so is the availability of personnel. We have one client that is putting together a big drilling plan.”

Not to put too fine a point on it, Weidner states, “For those companies that are well capitalized or can become well capitalized, this could be a very good Christmas.”

He says one of the important deals done this year may have escaped the notice of producers with their eyes riveted to the midsummer record highs for oil and gas. Rodman & Renshaw acquired COSCO Capital Management LLC, which he says brings together Rodman & Renshaw’s expertise in public issues with COSCO’s capabilities in private equity.

From his new view across both worlds, Weidner says he is sure there will be consolidation all along the independent sector, from the “mega-independents” to the smallest family producers. That pressure

has been building for a couple years, he calculates, and will continue because, “There absolutely is credit and capital. We can’t say there have not been cutbacks in the energy space, but maybe that is a good thing.”

He reiterates, though, “There is a lot of cash on the sidelines. Things are tough in public issues, but there is a lot of dry powder waiting for private transactions, and there are a lot of smart and savvy oil and gas investors. I am telling clients to pursue the opportunities they see, as long as they can articulate why they make sense.”

### Downside Risk

Where opportunities do not make sense or where producers are already overextended, the outlook cannot be sugar-coated. “The party is over,” flatly states Fadel Gheit, managing director of oil and gas research at Oppenheimer & Co. “Companies in this sector are going through a reality check, and companies without strong balance sheets may not survive.”

Gheit agrees that money can be found for compelling transactions. “At the right price, you will see people with money crawling out of holes in the ground,” he ventures. “But we are in a major correction that will be followed by a major consolidation. Overall the industry is in the best financial shape ever, but some producers fell into euphoria. Those companies expanded too rapidly and borrowed too heavily. They may not be able to keep all their marbles.”

The healthful result at the far end, Gheit asserts, is that lenders will “have to start acting like banks. Their appetite for risk has been curtailed, and lenders are going to have to clean up their acts.”

He notes that UBS, which had been a major player, has shut its energy trading desk. Gheit speculated in early October that oil prices, which had fallen to about half their summer highs, might still be 35-40 percent above their floors.

Irving, Tx.-based Natural Gas Partners was among the more prudent upstream capital providers, assesses Managing Partner William J. Quinn. “As investors, we never underwrote \$145 oil; we have not even underwritten \$95 oil,” he says. “Our price decks have been fairly consistent at \$75-\$85 for oil and \$7-\$9 for natural gas.”

With prices at or below those levels in early October, “Clearly the industry is at an inflection point,” Quinn expresses.

One other problem, he notes, is that despite the plunge in asset values and lack



of available financing, the spreads between offers and asking prices still yawns very large. “The market was very tight in June and July,” Quinn characterizes. “If owners were thinking their assets were worth a certain price three months ago, then they are reluctant to sell at half that price or less today.”

But even when the bid-ask spread is narrow, buyers are challenged to find financing, Quinn allows. “For a deal that requires \$100 million of debt financing, you can still find \$50 million from one bank and \$50 million from another,” he suggests. “But you would be very unlikely to find \$50 million from 10 banks to fund a \$500 million bank deal.” □



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Managing Partner  
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