Secured Finance Network

O&G Downturn in 2020 and Why It is Different This Time

By Jay Haber, Stephan Pinsly, Robert Kuhn and Dan Ginsberg




Pictured left to right: Jay Haber, Stephan Pinsly, Robert Kuhn and Dan Ginsberg

The shock to the U.S. Oil & Gas market in first quarter 2020 was sparked by the start of the COVID-19 pandemic and exacerbated by a price war between Saudi Arabia and Russia, massive oversupply and plummeting demand. This shock is now rapidly accelerating into a crisis for upstream E&P, midstream and oilfield services companies, as well as their many financial partners and stakeholders. Headlines in the media focus on the "bust cycle" spurred by public company bankruptcies such as Chesapeake Energy and Diamond Offshore. However, this summer we will hear more about middle-market players reeling from severe short-term impacts and the reality that some wells may not return to profitability (if they really were profitable) anytime soon. While we do not have a crystal ball to foresee the future, our research and oil price sentiment does not indicate a substantive rebound in pricing-per-barrel before the first quarter of 2021 or later. If you combine the current low commodity prices with global evidence of muted demand, growing stockpiles and not nearly enough production cuts, it is logical to expect an increasing number of bankruptcies and restructurings for the remainder of 2020.

Like the downturn of 2014-2016, middle-market players in TX, OK, ND, CO, LA and the Northeast are grappling with dramatically lower income from marginally productive assets pumping at lower price points. Compounding the issue are excessive leverage, high operating costs for many wells and high administrative costs. Unlike that earlier bust cycle, the 2020 downturn leaves upstream and midstream companies dangling without a net due to limited opportunities for sponsor support, capital market funding or near-term asset sales. Further complicating matters is the lack of alignment among operators (i.e., management), equity sponsors and lenders. This mismatch often stems from differences of opinion about the current and forecasted value of reserves and asset collateral. Why?

Oil and gas companies are now experiencing difficulties as they curtail new drilling in today's low-price environment. As the companies limit new drilling, the average well life in their total portfolio will continue to increase. Hiding behind high daily IP (Initial Production) rates on newly drilled wells will get increasingly difficult. A case in point is the saga of Ring Energy, Inc. which overstated its reserve report volumes by more than 500%. Ring reported to the investor community that its central basin platform had a gross EUR (Estimated Ultimate Recovery) of 600,000 BOE (Barrels of Oil equivalent) per well. However, EUR estimates based on publicly available monthly production data indicate the actual gross EUR is closer to 110,000 BOE per well[1]. Why the disconnect? It has been found, particularly in unconventional drilling, that EURs based solely on initial production data may be subjective. EURs based on longer-term production data that eliminates biases and variances over time provide a more reliable magnitude of actual hydrocarbons produced by operators. For the purposes of fundraising for growth during boom cycles, many oil and gas companies rely on daily individual well-production data available to them and not to the general public; the production data available via public sources is a more accurate measurement of recoverable reserves over time. As time goes by and we continue to observe the actual monthly production volumes for each well, any significant differences in EUR estimates based on somewhat limited early production data would be eliminated. In the case of Ring, translating this single well EUR difference points to the potential overstatement of Ring's reserve report volumes by at least 500%. The implications of this production reality are glaring. The amount of Ring's reserves that are truly recoverable is insufficient to meet the company's covenant requirements.

Now what? As was the case in prior downtowns, the O&G playbook calls for a re-assessment of reserves and the factors that dictate which assets should be kept operating versus shut down immediately. The key to this understanding is a comprehensive and technical review of reserves, costs of production and overhead. Once the companies and their stakeholders have more reliable assessments of the underlying value of the assets and costs, we anticipate lenders will become the fulcrum security and will likely lead the decision-making on whether to liquidate collateral or to take equity. Eventually, the wide gap between bids/asks that we see in today's volatile and relatively dry M&A market will compress and we expect to see more forced asset sales via insolvency, production curtailments and energy fund liquidations.

Is that the end? No, the story does not have to end in distress and bankruptcy. Finding the right turnaround partner could be the key to success for O&G companies, lenders and stakeholders.

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[1] “Ring Energy: an RBL Case Study,” Reserve Report, Matthew Sterett, May 8, 2020.

About the authors:

Stephan Pinsly, managing director at Getzler Henrich & Associates, is a veteran CRO/CEO/CFO of publicly- and privately-owned middle market corporations, providing strategic turnaround leadership for 30 years. He has a wealth of experience in solving intricate and difficult debt refinancing and complex business viability issues, as well as the installation of cash flow management techniques and processes, systems and controls, and reporting applications in manufacturing, technology, retail, and distribution industries. He is considered an expert in the field of cost accounting

Most recently, Stephan served as CEO of the leading leak detection and repair services operator of US oil refineries, where he identified ineffective, untimely billing processes and procedures. The net effect of corrective action was the collection of more than $1 million in unbilled invoices. He instituted reporting mechanisms and cost analyses that brought to light variable losses at customer sites, and managed the day-to-day operations of the business.

Mr. Pinsly is a certified turnaround professional and a certified public accountant, and has a bachelor’s degree in accounting from Queens College, CUNY.

Jay Haber, senior energy consultant at Getzler Henrich & Associates, has more than 30 years of experience in the oil and gas industry. As the founder and president of Haber Resources Corp. (HRC), an independent oil and gas exploration and production company, he was responsible for the review of all drilling prospects for investment criteria suitable to the company and acted as liaison to participating industry groups. HRC drilled and operated more than 150 wells, primarily in Texas, Louisiana, and Mississippi, including more than 25 new field discoveries. Most notably, HRC drilled the first discovery well in the deep Granite Wash area of the Deep Anadarko basin. This discovery is considered the largest US onshore discover during the past 25 years.

In 1994, Mr. Haber started a seismic company, Geokinetics Inc., and built it into the second largest onshore seismic company in the world. Listed on AMEX under the GOK ticker, GOK had $596 million in revenues in 2012. Prior to the founding of HRC, Mr. Haber was a Vice President of Investment Banking and Associate General Counsel of duPont Glore Forgan Inc., the second largest investment firm in the world at the time, and a partner in a New York law firm with a specialty in investment banking. Previously he served as an attorney for the New York Stock Exchange. Jay has a B.S. in Business Administration (Finance) from Boston University and a Juris Doctor from the State University of New York at Buffalo.

Dan Ginsberg, managing director at GHValens LLC, has over 20 years of experience advising company executives, private equity firms and other financial institutions on financial and operational performance improvement, achieving revenue growth, cost reduction and working capital performance goals, building high performance teams, and implementing realistic solutions in a wide variety of industries.

Dan was the leader of the private equity practice of a supply chain and operations implementation consulting firm where he advised executives and private equity firms on operational due diligence and post-acquisition value creation. Previously, he was a leader for the working capital practice of a publicly traded consulting firm, partner and member of the board of directors of Mitchell Madison Group and consultant with First Manhattan Consulting Group. Dan has been cited as a subject matter expert by *The Wall Street Journal, CFO Magazine, Bloomberg* and other publications. He studied Economics in a five-year bachelor of science/masters program at the George Washington University where he graduated Magna Cum Laude.

Robert A. Kuhn managing director at Getzler Henrich & Associates, focuses on turnaround management, financial restructuring, and bankruptcy consulting. Mr. Kuhn's expertise was honed during more than thirty years with JPMorgan Chase Bank and its predecessor entities, with key roles in the bank's workout and special credits areas. For the past three years Bob has served as a financial advisor.

Bob joined Chemical Bank as a loan workout officer and attorney and went through the Chemical Bank credit training program. Over the years Bob was an integral part of the mergers between Chemical Bank and Manufacturers Hanover, then Chase, JPMorgan, Bank One, Bank of New York, and Bear Sterns. He then rejoined the special credits group and was promoted to managing director and took over responsibility for the southeast and northeast regions of the commercial bank which covered the middle-market, mid-corporate, not-for-profit, asset-based and real-estate sectors.

Bob earned a B.S. degree from the Newhouse School of Public Communications at Syracuse University and a J.D. from Suffolk University Law School in Boston, MA.