CREDIT MARKET CREDENTIALS

Even in this healthier credit environment, lenders focus on myriad issues when evaluating potential loans. Here's how to be best positioned.

ARTICLE BY
DEWEY GONSOULIN and JENNY DILL

ILLUSTRATION BY
ROBERT PIZZO

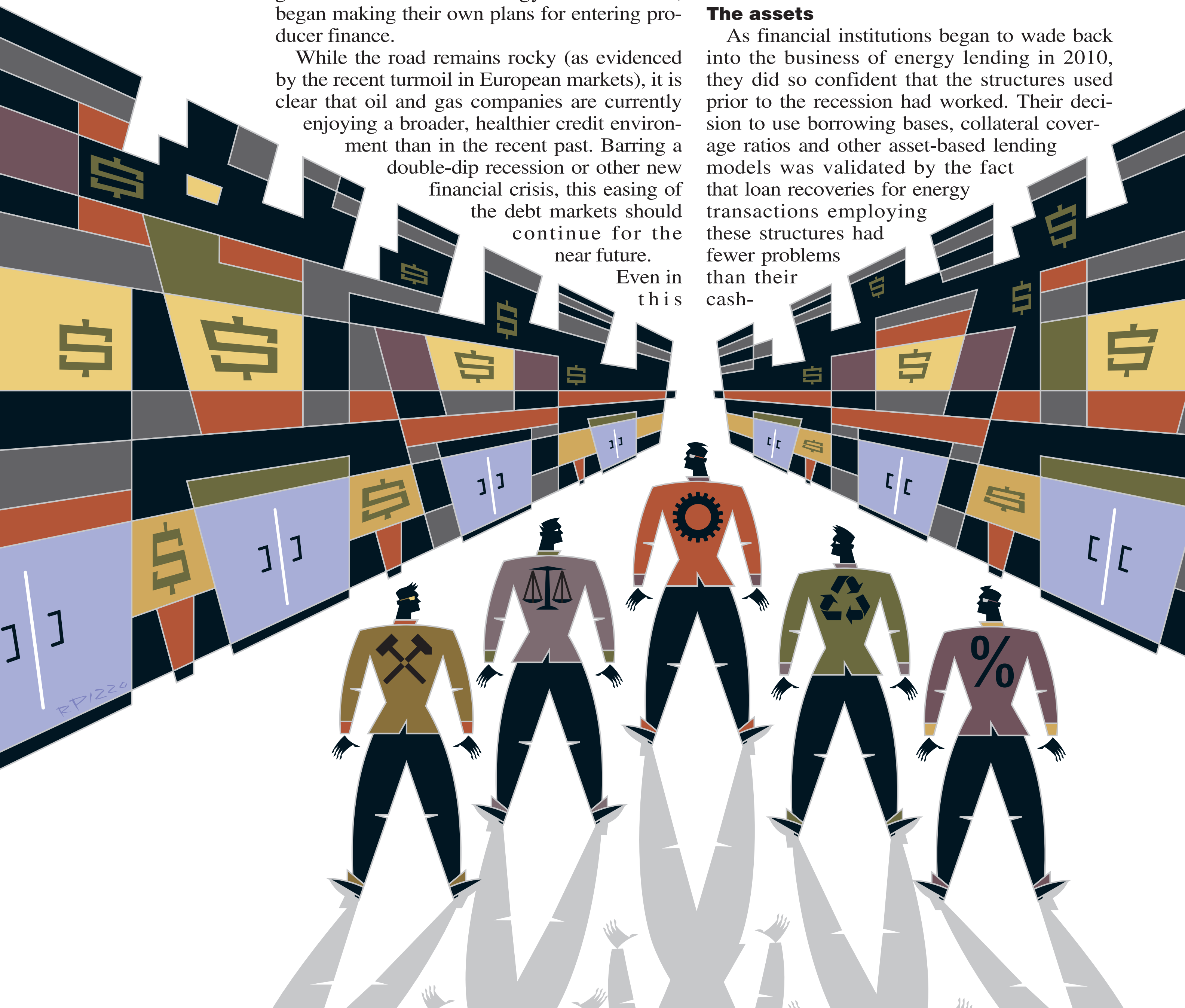
The past three years have been a roller-coaster ride for the world's financial markets, and the energy finance sector was certainly not immune. Halfway through 2010, however, it appeared that lenders had worked through many of those issues and emerged relatively unscathed. In addition, new players from the East Coast, emboldened by the prospects of higher returns and the history of good outcomes from energy finance loans, began making their own plans for entering producer finance.

While the road remains rocky (as evidenced by the recent turmoil in European markets), it is clear that oil and gas companies are currently enjoying a broader, healthier credit environment than in the recent past. Barring a double-dip recession or other new financial crisis, this easing of the debt markets should continue for the near future.

Even in this healthier credit environment, given the lessons of the recent recession, lenders will focus on myriad issues when evaluating a potential loan. There are three overarching factors that producers can expect lenders to evaluate: the asset base and the integrity of the information supporting such asset base; corporate structure, governance and housekeeping; and the management team.

The assets

As financial institutions began to wade back into the business of energy lending in 2010, they did so confident that the structures used prior to the recession had worked. Their decision to use borrowing bases, collateral coverage ratios and other asset-based lending models was validated by the fact that loan recoveries for energy transactions employing these structures had fewer problems than their cash-



Most debt capital providers prefer to lend directly to the entity that actually owns the oil and gas assets, rather than to a holding company.

flow loan counterparts. By consistently keeping a sharp focus on the assets of their customers, banks and other financial institutions were able to maintain a cushion on their loans that proved vital when commodity prices plummeted. This, together with effective hedging prior to the recession, allowed many companies to maintain healthy cash flows and service their debt through the crisis. As new loans are made, this emphasis on assets remains firmly intact.

Not all assets, however, are viewed equally by lenders. Various factors related to the assets may influence a debt provider's decision to extend credit. Some of these determining traits include whether the assets are largely comprised of oil or gas, are onshore or offshore, consist mostly of proved developed producing (PDP) or proved undeveloped (PUD), are operated or nonoperated, or whether there is a developed infrastructure or not.

Different types of lenders will have differing risk tolerances associated with each of these issues, and their respective decisions to lend will be influenced accordingly. For example, oil prices rebounded more quickly than their gas counterparts and have remained, for the most part, subject to less volatility. In the past 18 months, many bank lenders seeking more conservative transactions for their capital have favored companies with onshore, long-life oil reserves over companies that have offshore, gas-heavy reserves with shorter reserve lives and potential Macondo-type environmental risks.

Conservative lenders may also favor assets that are operated by their customers over non-operated collateral packages, preferring to have their customers maintain control of drilling schedules (and corresponding capital expenditure requirements).

They also look at the reserve mix of the various assets serving as the subject of the loan. If the value is concentrated in one or two assets (e.g., one well comprises 75% of the value of the overall reserves), or the percentage of reserves categorized as PDP is small compared to the overall proved reserves, some banks and other lenders may have concerns over the stability of future cash flows.

Mezzanine lenders and other more aggressive banks and non-bank lenders, however, may not be deterred. They are often willing to, for a price, take more risk if they believe that the underlying assets are solid and that there is a good plan for developing them.

Having a good reserve report (preferably one audited by a reputable petroleum engineering firm) is a critical step in raising debt capital. These reports allow potential lenders to understand the nature of the reserves and their potential, model the anticipated cash flows from the reserves, and run various sensitivity cases. Care should be taken to reflect any potential future changes in cash flows from back-in or reversionary interests, farm-outs, overriding royalties, net profits interests or any other similar rights or interests that may impact either the working interests or net revenue interests (or both) of the borrower. Being upfront about such items in discussions with prospective lenders and reflecting them in the data will prevent a potentially awkward conversation later if these issues come to light after time and expenses have been incurred.

In addition to engineering data, lenders also want to know whether the borrower has good title, whether there are environmental issues or other litigation surrounding any of the properties, whether there are any issues with infrastructure necessary to get the product to market, and whether there are any unique contractual arrangements required in connection with the maintenance of the assets (e.g., farm-outs, mandatory drilling obligations, etc.).

While all of these issues are important, perhaps the one that gains the most attention (and corresponding due diligence expense) is title. One's perception of "good and defensible" or "reasonably acceptable" title is very much a subjective matter, with borrowers and lenders often having varying viewpoints on the definition of such terms.

Many start-ups and other companies that are short on precious cash are loath to spend their limited resources on title opinions and other title diligence as they acquire assets and develop them, particularly if they feel that a simple check of the title records by a land manager might suffice.

While this strategy may make sense during a company's infancy, borrowers taking this approach often end up spending large sums on attorneys and other landmen to provide such reports after the fact, when they go to obtain their first significant debt financing.

It is typically easier (and cheaper) to build such files as the company grows, instead of deferring the task and creating the paper trail later. Similarly, having good records on environmental issues and other matters affecting the assets demonstrates to the lender and its attorney that the borrower understands the importance of legal compliance and that the data presented is reliable.

Corporate structure and governance

Lenders will also look closely at the structure of the corporate enterprise itself. Most debt capital providers prefer to lend directly to the entity that actually owns the oil and gas assets, rather than to a holding company. If, however, the oil and gas properties are held by several subsidiaries of a single holding company, the holding company may be the best entity to serve as the borrower.

While having a complex corporate structure with multiple tiers of subsidiaries and sister companies is not necessarily a deterrent, as a general rule a more complicated structure will give potential lenders pause. First, these struc-

tures may make the lender more susceptible to fraudulent conveyance risks if one or more of the companies is pledging its assets as collateral for the loan or providing other credit support, but it is not clear that the pledging entity is receiving any corresponding benefit from the transaction.

Second, getting the prospective lender comfortable with financial reporting data may be more difficult, as it may need to review several sets of financial statements and attempt to reconcile intercompany transactions between entities in order to understand the complete financial picture.

Finally, some lenders still suffering from post-Enron hangovers generated by the complex transactions of the late 1990s may be reluctant to lend to borrowers with complicated organization structures. To the extent the organizational structure can be kept simple, it is often advisable to do so.

Regardless of structure, all lenders expect the applicable companies to have solid corporate records and financial data. For each entity, in addition to the governing documents required to be filed under law (e.g., articles of incorporation, certificate of formation), there should be formally adopted bylaws (in the case of a corporation), fully executed operating agreements or limited liability company agreements (in the case of a limited liability company), and fully executed partnership agreements (in the case of a partnership).

Failing to pay attention to proper corporate documentation and observing corporate formalities (e.g., proper authorization of transactions, appointment of officers and directors, and proper execution of instruments) will, at a minimum, cause lenders to have concerns about the way the organization is run and may, in some instances, result in them requiring that the company "rehabilitate" its files to correct such deficiencies prior to closing the loan. Employing good corporate counsel on the front end for basic structuring advice and entity formation is usually relatively inexpensive and can pay off significantly later.

Similarly, having good financial reporting data (including financial statements audited by a reputable third party accounting firm) is critical. Lenders will use financial statements to build compliance models and run sensitivity case analysis in connection with the proposed loan. It is imperative that they have confidence that the underlying data is accurate and complete. Again, spending money on a high quality chief financial officer, financial advisory firm, public accounting firm or other accounting professional is a good investment.

Management

Notwithstanding the importance of having solid assets, a well-planned corporate organization and efficient record keeping, perhaps the most important ingredient to any successful lending proposal is having a reliable management team in place. The closing of a loan transaction begins a new relationship between borrower and lender, and with that comes an expectation that company management will comply with a multitude of new covenants and restrictions.

Companies should have the necessary expertise (either on staff or at their disposal) to handle not only the geologic and engineering aspects of the business, but also financial, legal, title and environmental matters. A deficiency in any of these areas may cause the lender to question whether the company is properly staffed to identify and avoid problems in the future that could negatively impact either future cash flows or the value of the assets of the company.

Additionally, while it may seem obvious, it bears mentioning that lenders expect management to be honest and forthright with any and all issues, both negative and positive, that may potentially affect their lending decision. The loan relationship is built on the presumption that the information provided by the borrower to induce the lender to extend credit is accurate, reliable and complete. If management fails to be upfront about issues or problems, it can damage the relationship later and affect how the loan is handled going forward.

Lenders expect management to be honest and forthright with any and all issues, both negative and positive, that may affect the lending decision.

With the easing of the debt markets and the influx of new players into the world of producer finance, a great deal of debt capital is currently waiting to be deployed with producers that can demonstrate viability with their assets, corporate governance and management. Those companies that take the time to get organized, present their data clearly and completely, and offer a reliable, forthright management team will improve their chances of successfully closing a loan transaction that is acceptable to them. By planning and organizing title information, corporate structure and financial records, a company will more effectively and more efficiently attract lenders. Moreover, by hiring reputable management, a company will instill confidence in their ability to comply with loan terms and to maintain the loan relationship for years to come. Taking time to address all of these factors will help companies put their best foot forward. □

Dewey Gonsoulin is a partner in the Houston office of Bracewell & Giuliani LLP, where he focuses on energy finance. He may be reached at dewey.gonsoulin@bgllp.com.

Jenny Dill is an associate in Houston focusing on energy finance, and may be reached at jenny.dill@bgllp.com.

Excerpted from

Oil and Gas Investor

January 2012
Copyright© Hart Energy Publishing LLP
1616 S. Voss Rd.
Suite 1000
Houston, TX 77057
(713) 250-6400