Bridgepoint Consulting

Austin Bar Association
Bankruptcy Section

Oil and Gas Industry Update

March 6, 2015

Industry Trends – Overview

- Falling prices
- High Inventories
- Slowing production growth
- High future price uncertainty
- Near historic U.S. production highs
- Rapidly falling rig count
- Slowing consumption growth in China, Russia
- Consumption declines in Europe, Japan

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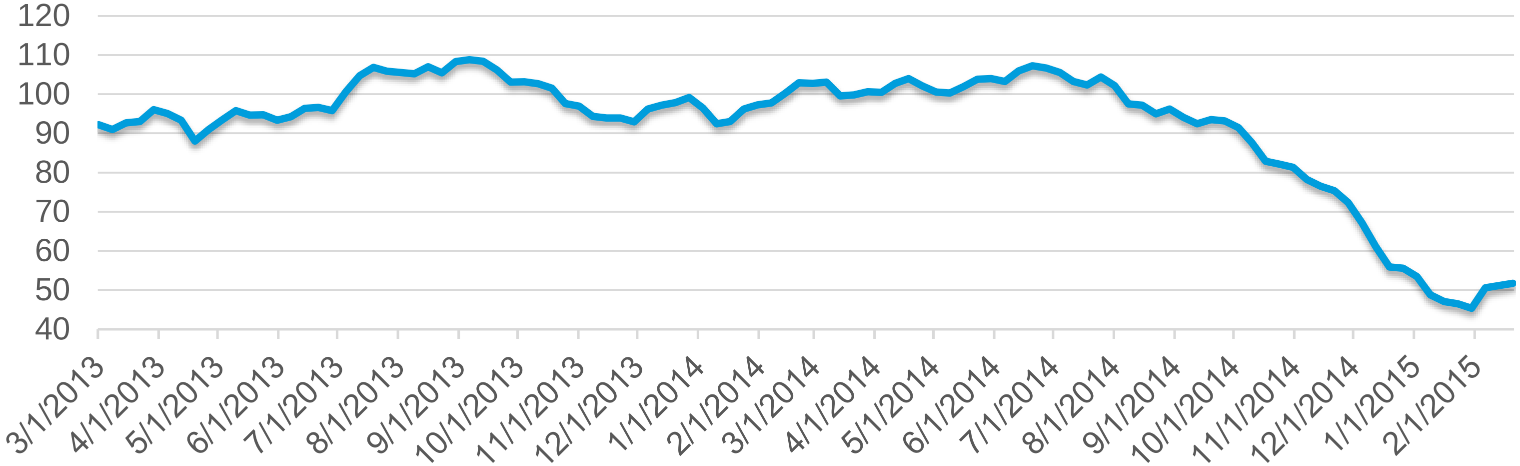
Dropping Oil Prices

Cushing, OK WTI Weekly Spot Price FOB (Dollars per Barrel)



- The monthly average WTI crude oil spot price fell from an average of $59/bbl in December to $47/bbl in January, its lowest level since February 2009.
- EIA expects the WTI crude oil price to average $55/bbl in 2015 and $71/bbl in 2016

Source: U.S. Energy Information Administration – Short-Term Energy Outlook – February, 2015

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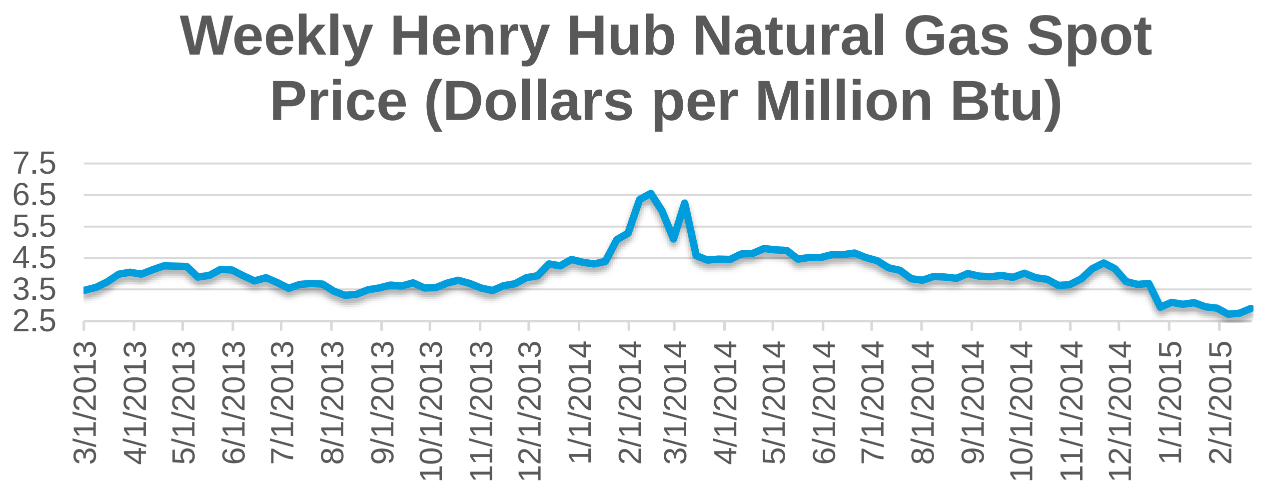
Dropping Natural Gas Prices



- In January, the Henry Hub natural gas spot price averaged $2.99/MMBtu
  - A decline of $0.49/MMBtu from December
  - First monthly average price under $3/MMBtu since September 2012.
- EIA expects monthly average spot prices to remain less than $3/MMBtu through the winter, and less than $4/MMBtu through the remainder of the forecast/
- The projected Henry Hub natural gas price averages $3.05/MMBtu in 2015 and $3.47/MMBtu in 2016.

Source: U.S. Energy Information Administration – Short-Term Energy Outlook – February, 2015

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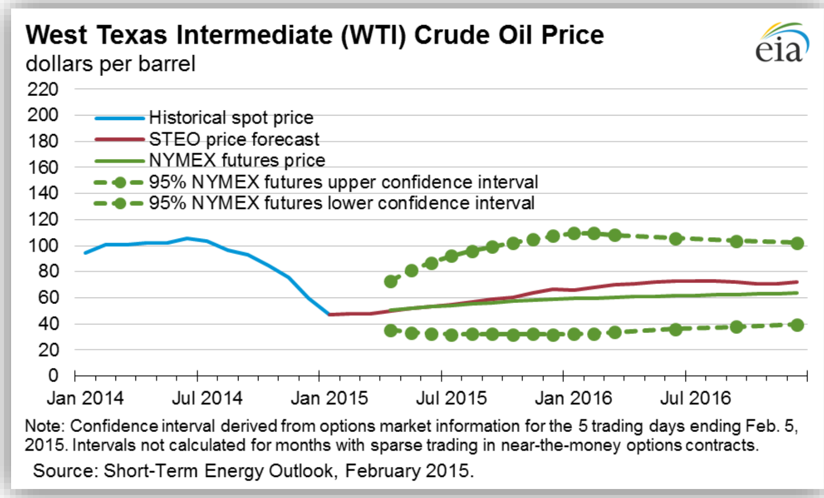
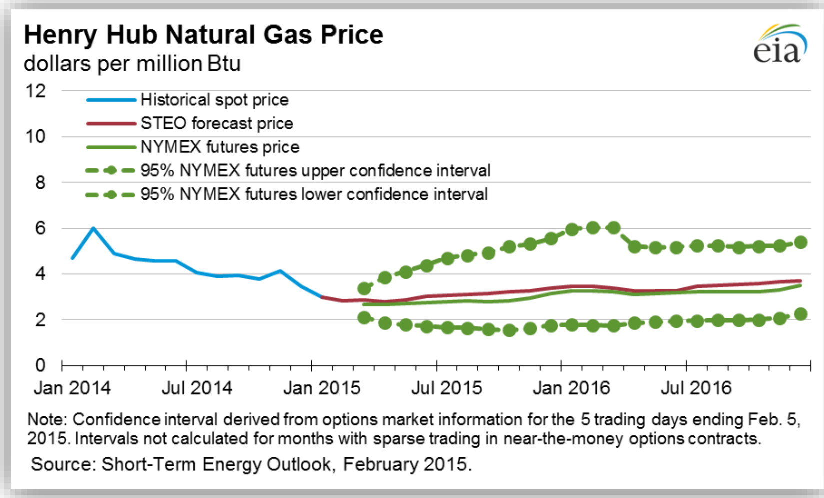
Future Pricing Uncertainty



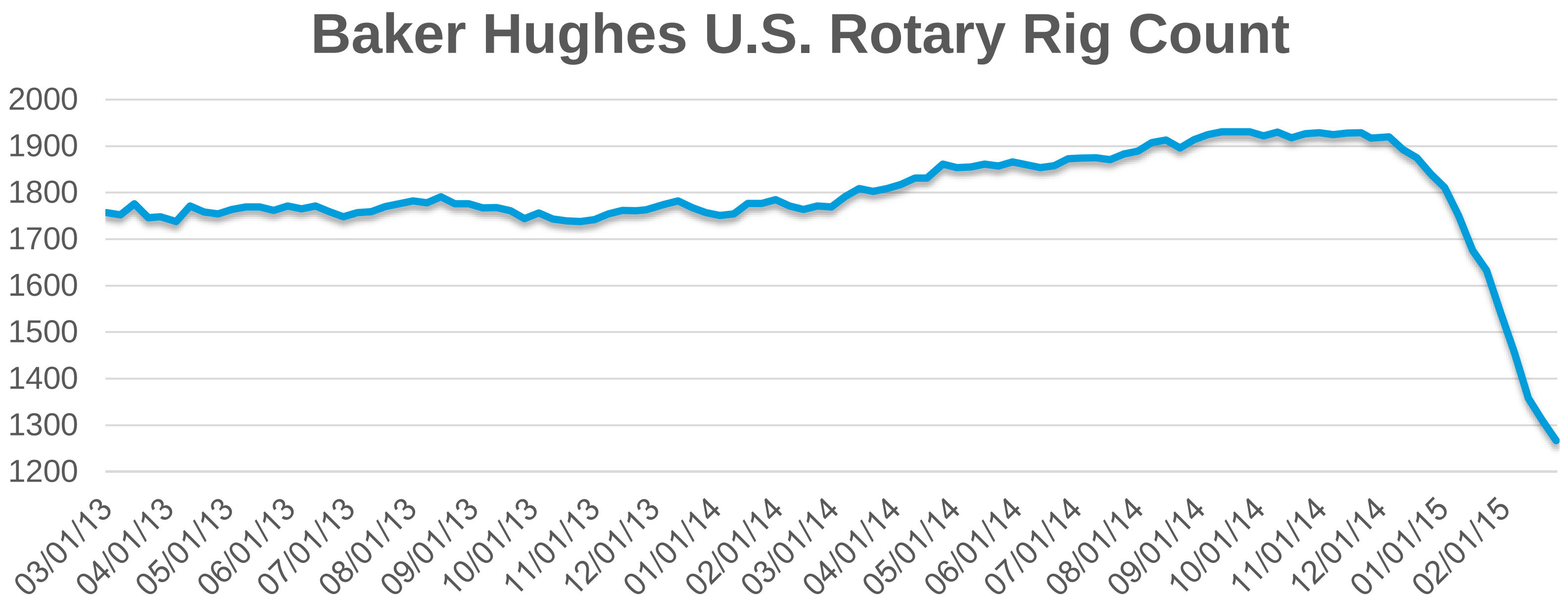


- WTI futures contracts for May 2015 delivery, traded during the five-day period ending February 5, averaged $52/bbl.
- Implied volatility averaged 52%, establishing the lower and upper limits of the 95% confidence interval for the market's expectations of monthly average WTI prices in May 2015 at $33/bbl and $81/bbl, respectively.

- Natural gas futures contracts for May 2015 delivery, traded during the five-day period ending February 5, averaged $2.71/MMBtu.
- Current options and futures prices imply that market participants place the lower and upper bounds for the 95% confidence interval for May 2015contracts at $1.79/MMBtu and $4.11/MMBtu, respectively.

Source: U.S. Energy Information Administration – Short-Term Energy Outlook – February, 2015

Plummeting Rig Count



The U.S. Rotary Rig count has dropped from 1,931 rigs as of 9/26/2014 to 1,267 rigs as of 2/27/2015

Source: Baker Hughes North America Rotary Rig Count 2/27/2015 www.bakerhughes.com/rig-count

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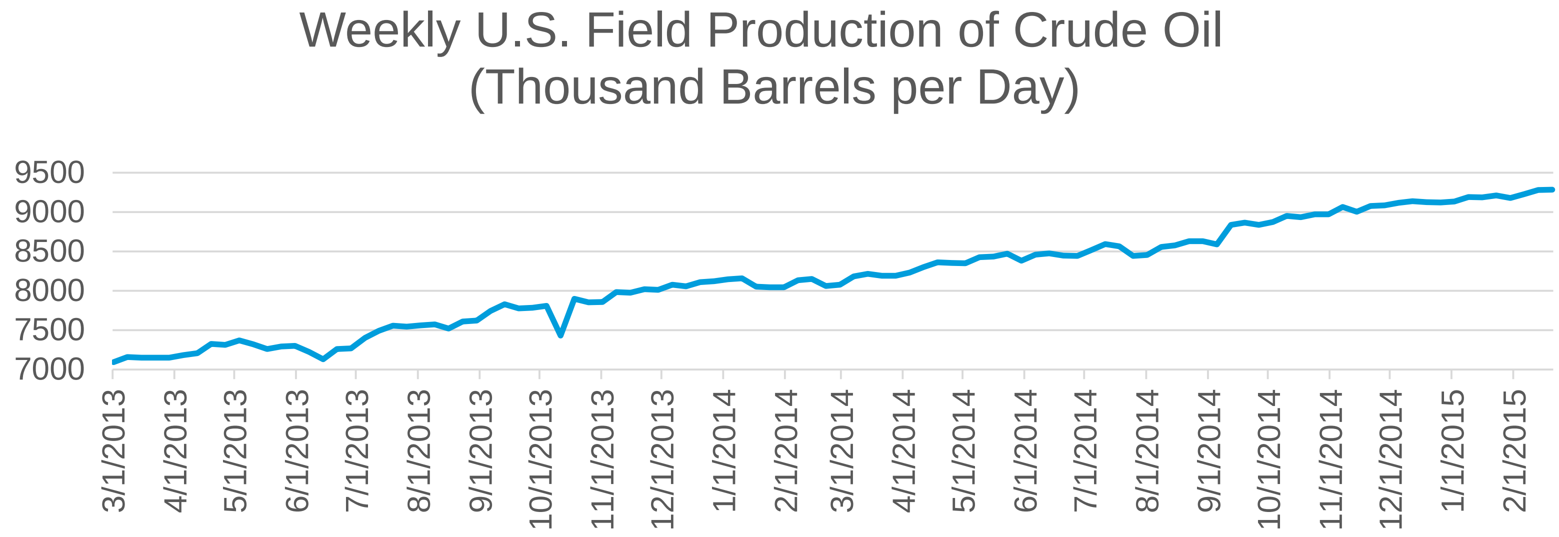
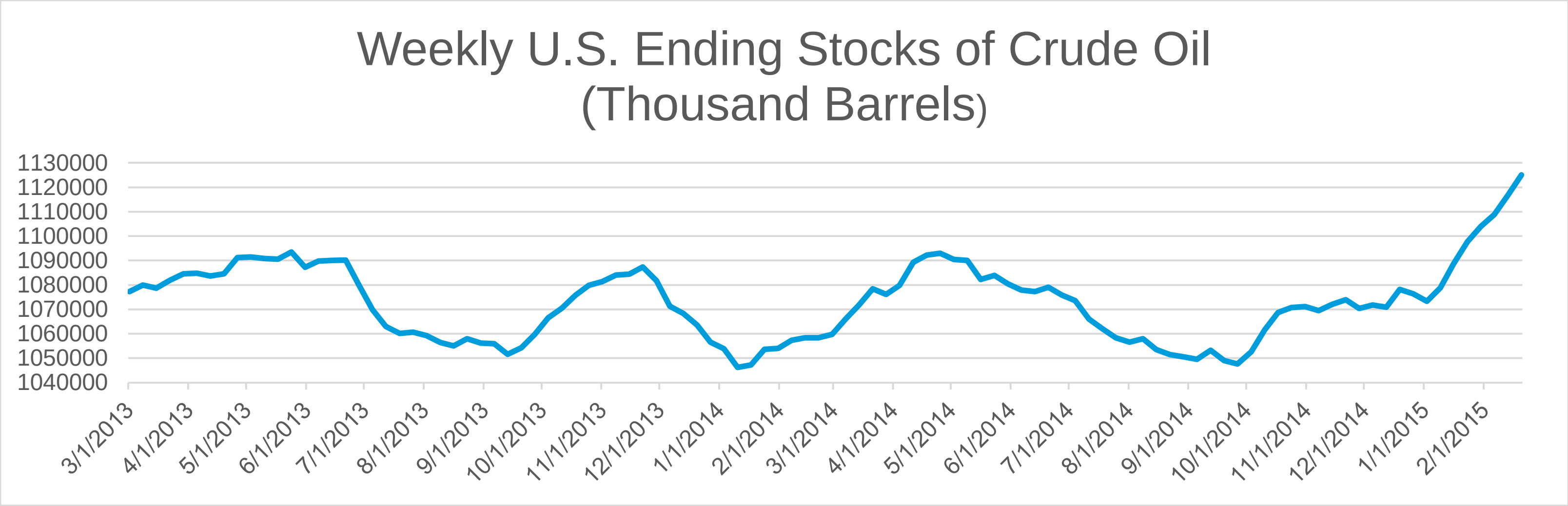
Approaching Record Production Levels



- Total U.S. crude oil production averaged an estimated 9.2 million barrels per day (bbl/d) in January.
- Forecast total crude oil production averages 9.3 million bbl/d in 2015.
- Given EIA's price forecast, projected crude oil production averages 9.5 million bbl/d in 2016, close to the highest annual average level of production in U.S. history of 9.6 million bbl/d in 1970.

Source: U.S. Energy Information Administration – Short-Term Energy Outlook – February, 2015

High and Growing Inventory Levels



- EIA estimates that OECD commercial oil inventories totaled 2.74 billion barrels at the end of 2014, the highest end-of-year level on record and equivalent to roughly 58 days of consumption.
- Projected OECD oil inventories rise to 2.83 billion barrels at the end of 2015 and again total 2.83 billion barrels at the end of 2016.

Source: U.S. Energy Information Administration – Short-Term Energy Outlook – February, 2015

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Goldman Sachs Shale E&P Matrix

Exhibit 1: Quadrants #1 and #3 offer the most opportunity for credit investors
Comparing High Yield E&P balance sheet and asset quality

Shale Asset Quality		Balance Sheet Quality: High (Leverage <2.5x)	Balance Sheet Quality: Low (Leverage >2.5x)
	Core	**Group #1** **High Quality Assets/Strong Balance Sheet** **Key Decisions/Strategic Options** Acquire distressed assets or companies? Sell to an IG E&P? **Representative Names** Chesapeake Energy Cimarex Concho Resources Diamondback Energy	**Group #3** **High Quality Assets/Weak Balance Sheet** **Key Decisions/Strategic Options** Sell to a HY or IG E&P? **Representative Names** Antero Resources EP Energy Laredo Petroleum Oasis Petroleum Parsley Energy Range Resources Rosetta Resources Whiting Petroleum
	Fringe	**Group #2** **Lower Quality Assets/Strong Balance Sheet** **Key Decisions/Strategic Options** Acquire distressed assets or companies? **Representative Names** Newfield Exploration PDC Energy QEP Resources SM Energy WPX Energy	**Group #4** **Low Quality Assets/Weak Balance Sheet** **Key Decisions/Strategic Options** Monetize assets to bolster liquidity? Issue secured debt? **Representative Names** Approach Resources Exco Resources Goodrich Petroleum Halcon Resources Magnum Hunter Midstates Petroleum Rex Energy Sabine Oil & Gas Samson Investment Sandridge Energy Swift Energy

Source: Goldman Sachs Global Investment Research

Source: ZeroHedge.com

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Goldman Sachs Shale E&P Matrix Commentary

Jason Gilbert of Goldman Sachs:

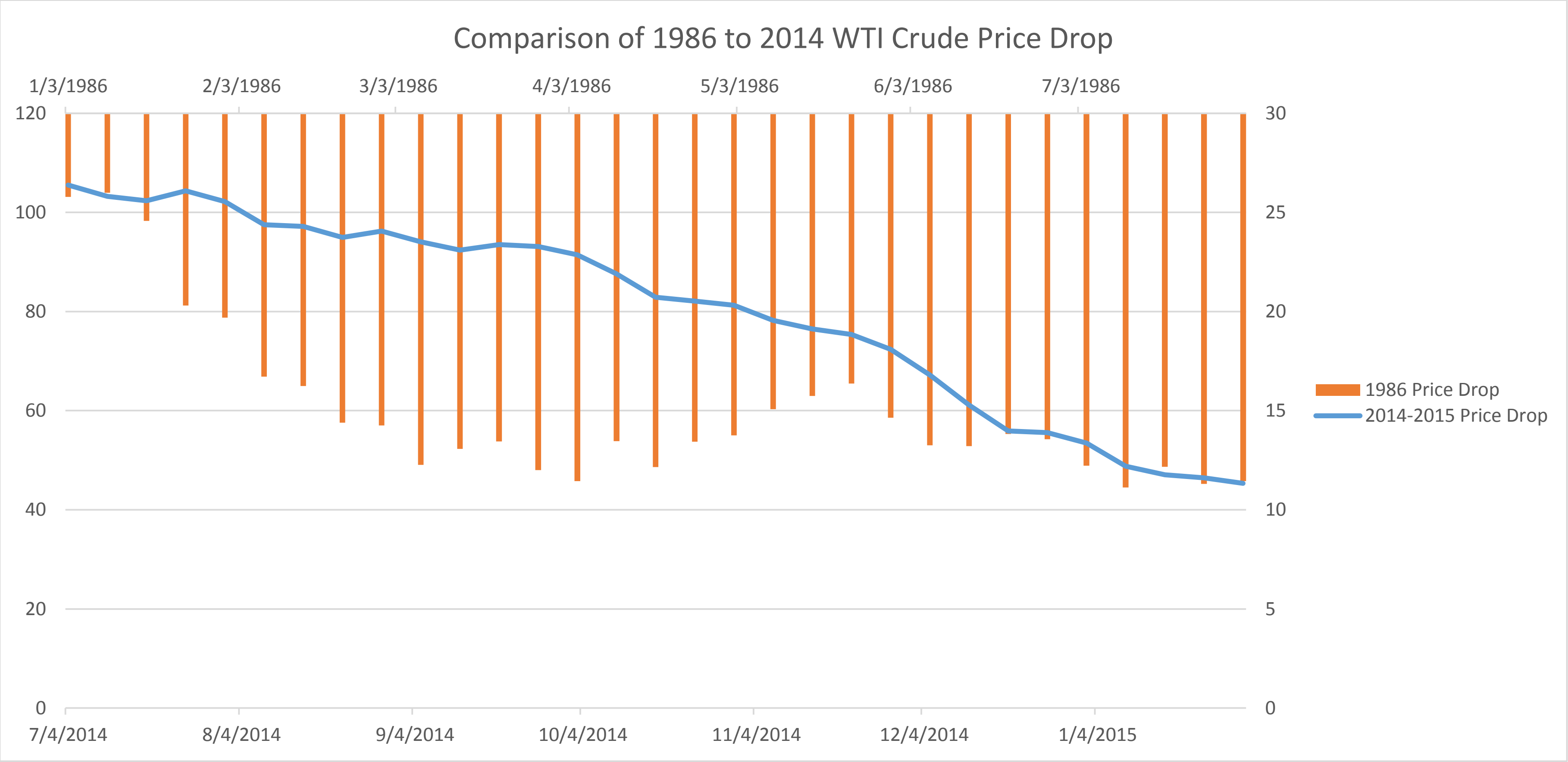
> *"We believe oil market weakness presents H&Y E&P management teams with difficult decisions. For certain stronger companies, the challenge may be one of deciding if and when to high grade the portfolio through M&A. For some weaker companies, the decisions may be more stressful, with many lower-quality names being forced to consider (1) selling themselves, (2) restructuring/filing for bankruptcy protection, and/or (3) bolstering liquidity through asset sales and/or second lien debt issuance."*

And, specifically regarding the Group 4 companies:

> ***"Given high leverage and the lack of strategic interest, we believe many companies will need to seek alternative sources of capital.*** *While the options here will vary case by case, we note that most of these names have secured debt baskets that can be used to bolster liquidity. Based on the phone calls we receive, investor interest in this type of security remains high, which suggests to us we will see robust second-lien issuance as soon as the conclusion of 1Q earnings.* ***The bottom line is that, for now, we think investors should tread lightly in this group, despite the average bond yield of 19% (excluding obviously distressed names Swift Energy, Samson Investment, and Sabine Oil & Gas)."***

Source: ZeroHedge.com

Comparing 2014 to 1986



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2014 vs 1986

- Banking
  - 1986 – weak banking sector, especially in Texas
  - 2014 – strong banking sector, especially in Texas (e.g. Karnes County NB, deposits increased from $80 million in 2009 to $350 million in 2014)
- Liquidity in Market
  - 2014 Eager investors – still 'wait and see', but looking for opportunities
- Recent technology advances makes production costs must lower compared to results
- Many more drilling basins / sites in 2014 compared to 1986
- Broad financing backing in this oil boom (PE's; bond financing; public financing) compared to much heavier reliance in Texas commercial banking sector in 1986

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E&P Companies

- Completing active drilling activity
- Generally not starting new drilling activity, except for ‘keeping office open’
- Analyzing break even price for drilling activity – Eagle Ford Shale lower than some other shale plays (Haynesville; Marcelles). New offshore drilling activity off the table for now
- Hedging – most lenders for E&P companies required hedging of 50% to 75% of production for 12 to 24 months; so, earning protected until end of 2015/early 2016 for these companies
- Negotiating lower rates with suppliers (at least 10%, maybe as much as 30%) like oil rig operators, etc.
- Reserve Re-determinations – Lenders require reserve valuation every 6 months. In process, effect will be felt in after Q2 2015
- Quality of production will sort out strong and weak players

Oil Services Companies

- Laying off workers and other variable costs
- Significant capital spending over past 10 years to get to current drilling capacity
- Lenders typically have covenants requiring borrowers to perform valuation of Machinery & Equipment at least annually
- Borrowers will have major impairment issues with idle equipment in upcoming quarters
- Currently, number of defaults are minimal, but upcoming quarters will have different scenarios
- Loan pricing has already gone up for the best customers; poor performing customers will not have access to credit

Ancillary Services

- Over leverage with support companies will result in real estate and company defaults
  - Man camps; apartments, etc.
  - Restaurants, entertainment, etc.
  - Services companies for oil
- Lenders are very skiddish
- Pricing more expensive on a go forward basis

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Takeaways

- Strong performers with weak balance sheets will be attractive acquisition targets for investors
- Weak / highly leveraged companies will experience defaults in 2^{nd} half of 2015 and 2016 without taking action
- Instability and uncertainty are keeping most players on the sidelines for now
- Companies need to be positioning themselves to ride out lower oil prices for an extended period
- Oil prices are certainly a classic supply/demand issue, but geopolitical aspects effecting supply make dynamics that much harder to predict

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