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FEBRUARY 2019

RESERVE-BASED LENDING: MARKET TRENDS AND RECENT DEVELOPMENTS

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TODAY'S PANEL

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COMMODITY PRICES AND RECENT ENERGY MARKET HISTORY

COMMODITY PRICES AND RECENT ENERGY MARKET HISTORY

- Commodity Prices – Then and Now:
  - Oil:
    - WTI prices above $100/barrel through early to mid-2014
    - By January 2016, below $30/barrel
    - By October 2018, above $70/barrel
    - Current prices around $55/barrel
  - Natural Gas:
    - Henry Hub spot prices as high as $7.00+/MMbtu in January/February of 2014
    - By March of 2016, around $1.50/MMbtu
    - By November 2018, around $4.50/MMbtu
    - Current prices in the $3.00/MMbtu range

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- Bankruptcy/Workout Activity:
  - Well over 100 oil and gas E&P companies have filed for bankruptcy protection since late 2014
  - Well over 100 oilfield services companies have filed for bankruptcy protection since late 2014
  - By contrast, approximately two dozen midstream bankruptcy filings since late 2014
  - Texas and Delaware are key filing locations
  - Hundreds of other energy companies consummated out-of-court restructurings and workouts or obtained lender relief
  - Pace of new bankruptcy filings has drastically slowed

COMMODITY PRICES AND RECENT ENERGY MARKET HISTORY

- Where we stand today:
  - As a result of bankruptcies, workouts, lender concessions, and the divestiture of troubled portfolio companies, many energy companies have current debt loads that have been right-sized for the current commodity price environment.
  - Commercial bank lenders were hesitant to extend “rescue” financings, but commercial lending in the energy space has remained active overall.
  - The market has seen a recent slowdown in acquisitions as commodity prices remain volatile and create a mismatch between buyers and sellers and producers work on developing existing acreage.
  - Private equity/alternative lenders remain active as additional sources of capital, in the form of drilling joint ventures, term loans to finance drilling, holdco loans, and preferred equity.
  - Increasing interest in using holdco loans as equity recapitalization.

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RESERVE-BASED LENDING OVERVIEW

RESERVE-BASED LENDING OVERVIEW

- Borrowing Base
  - Components / Reserve Reports
  - Redeterminations
- Collateral
  - Mortgage and Title
- Covenants
  - Asset Dispositions
  - Hedging
  - Restricted Payments

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RESERVE-BASED LENDING OVERVIEW -TYPICAL TERMS

- Typical credit facility involves an administrative agent (lead bank) and one or more lenders
- Lenders are typically commercial banks
- Common maturity is 4-5 years
- Revolvers (Borrowing Base) and term loans
- No prepayment premiums / call protection to terminate a revolver
- Credit facilities can be available in a wide range of sizes
- Interest rates typically float, with Borrowers having an option to select interest rates based on either the prime rate or LIBOR (plus, in either case, an applicable margin based on utilization)

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RESERVE-BASED LENDING OVERVIEW - BORROWING BASE MECHANICS

- Borrowing Base – Components
  - Lenders' commitments tied to a borrowing base determined by lenders using oil and gas reserves of Borrower, ownership of midstream assets, concentration/quality of assets and other criteria (i.e., Lenders are not committed to lend the maximum face amount of facility)
  - Reserve reports and engineering regarding proved reserves, status of title, existence of other debt, hedges
  - Borrowing base calculations are discretionary (no formula is provided in the credit agreement) and fact/borrower specific (this is often referred to as a "black box" approach)
- Borrowing Base Redeterminations
  - Typically scheduled redeterminations are 2x per year
  - Borrower and required lenders typically may each request one additional wildcard redetermination between scheduled redeterminations
  - Additional redeterminations may be available to borrower upon closing of material acquisitions
  - Automatic borrowing base reductions may be triggered by material asset dispositions or hedge unwinds

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RESERVE-BASED LENDING OVERVIEW - BORROWING BASE MECHANICS

- Consequences of a Decreased Borrowing Base
  - Less loan availability
  - If any baskets are dependent on Borrowing Base size (e.g., debt or investment carve-outs), a decrease in those baskets will occur; however, if drafted correctly baskets will not retroactively decrease
- Borrowing Base Deficiency
  - A Borrowing Base Deficiency occurs if amounts outstanding are greater than the Borrowing Base
  - If deficiency is a result of a sale of assets or hedge unwinds or issuance of additional debt, deficiency must be paid down immediately
  - If deficiency is a result of a scheduled or interim redetermination, Borrower typically has the following options to eliminate deficiency
    - One time immediate repayment
    - Equal monthly installments (typically over a 6-month period)
    - Add additional properties to cover the deficiency

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RESERVE-BASED LENDING OVERVIEW - COLLATERAL AND TITLE

- Collateral typically includes:
  - Mortgages on at least 85% of the total present value of oil and gas reserves evaluated in the reserve report
  - Pledge of borrower and subsidiary guarantor equity interests
  - An “all assets” personal property security agreement
  - Control agreements on deposit accounts, securities accounts and commodities accounts
- Title diligence is a key part of the process (generally required on 80-85% of total present value of oil and gas reserves evaluated in the reserve report)

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RESERVE-BASED LENDING OVERVIEW - TYPICAL COVENANT PACKAGE

- Typical covenant package includes:
  - Limits on debt and liens
  - Limits on payments of dividends / other equity payments
  - Limits on asset sales
  - Limits on investments
    - Direct acquisitions of oil and gas assets (other than those constituting an entire business unit or company) typically permitted without restriction
    - Stock or equity purchases, or purchases of all assets of a business unit or company typically subject to basket limitations and/or liquidity or other pro forma financial tests and other “permitted acquisition” conditions (lender diligence, etc.)
  - Limits on volumes that may be hedged to avoid speculative hedging and to address credit concern
  - Financial Covenants
  - Other (affirmative financial reporting requirements, use of proceeds, mergers, environmental covenants, transactions with affiliates, collateral and guaranties)

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RESERVE-BASED LENDING OVERVIEW - FINANCIAL COVENANTS

- Typical financial covenants include one or more of the following:
  - Maximum leverage ratio (debt to EBITDAX)
  - Minimum current ratio (current assets to current liabilities)
  - Minimum interest coverage ratio (EBITDAX to interest expense)
  - Minimum fixed charge coverage ratio (EBITDAX to fixed charges)
  - Minimum asset coverage ratio (discounted value of reserves to debt)
    - Typically found in second liens or term loans since the Borrowing Base nature of the RBL already governs this aspect
- E&P financial covenants typically use EBITDAX in place of EBITDA - the “X” is for exploration costs, which can be added back to net income in the calculation of EBITDAX
- Importantly, credit facility financial covenants are “maintenance” tests, not “incurrence” tests, which are typically tested on the last day of each fiscal quarter

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RESERVE-BASED LENDING OVERVIEW - ASSET SALES AND HEDGE UNWINDS

- Like most credit agreements, RBL credit agreements have negative covenants placing limits / parameters on asset sales
  - RBL credit agreements also include limitations on unwinding hedges in this covenant since hedges are taken into account when determining the borrowing base
- Prohibition vs. permitted with mandatory borrowing base reduction
  - A typical prohibition type covenant might be along the lines of "borrower may not sell oil and gas properties / unwind hedges with a borrowing base value greater than 5% of the borrowing base in between scheduled redeterminations"
    - Typically a combined basket for asset sales and hedge unwinds
    - Borrowing base value typically determined by administrative agent since lenders may assign different values to individual properties
  - In some RBL credit agreements (including most sponsor backed forms), asset sales and hedge unwinds over a given percentage are permitted, but sales/unwinds over the given percentage result in an automatic and immediate borrowing base reduction; the threshold for the trigger in sponsor-backed forms is sometimes higher (e.g., 7.5% vs 5% of the borrowing base)
- Other conditions on asset sales / hedge unwinds
  - Minimum percentage of cash consideration, fair market value, no default, proceeds used to eliminate any resulting borrowing base deficiency

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RESERVE-BASED LENDING MARKET TRENDS

RESERVE-BASED LENDING MARKET TRENDS - COLLATERAL

- Mortgage Requirements – 85-90% of present value of proved reserves (historically this number was 80%)
- Title Requirements – Trending to 85% of present value of proved reserves (historically this number was 80%)
- Minimum hedging requirements becoming more common
- DACAs/Control Agreements are universal
- Anti-cash hoarding provisions are not common; replaced by solvency reps made at each credit event and DACAs/Control Agreements

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RESERVE-BASED LENDING MARKET TRENDS – PRICING AND FEES

- Pricing – still relatively borrower-friendly in the upper-middle and large cap space; 1.75-3.25% range, based on borrowing base utilization or leverage, with unused commitment fees in the .375% to .500% range.
- Fees:
  - Upfront fees in the 12-20 bps/year range for a commercial bank deal
  - Arrangement fees in the 50 bps to 75 bps range (best efforts)
  - LC Fronting fees in the 12.5 bps (for large public companies/sponsor backed companies) to 25.0 bps range

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RESERVE-BASED LENDING MARKET TRENDS – LIBOR

- LIBOR floors are less common; however, LIBOR cannot be less than zero
- LIBOR may cease after the end of 2021; the replacement is expected to be SOFR (Secured Overnight Financing Rate), which is currently used for hedge agreements
- LIBOR replacement provisions are included in new facilities and in amendments to existing facilities; each agent bank has its preferred LIBOR replacement provisions, most of which deem a replacement rate effective if the borrower and agent agree, unless other syndicate banks object (and the minority of which require direct syndicate bank consent)

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ENERGY FINANCE SERIES
RESERVE-BASED LENDING MARKET TRENDS – RBL MECHANICS

- Borrowing Base increases continue to require 100% lender approval
- Borrowing Base decreases and reaffirmations require 2/3 lender approval
- Increased flexibility for voluntary increases of the Borrowing Base in connection with material acquisitions
- Some agreements only require annual scheduled Borrowing Base redeterminations if leverage and usage are below certain thresholds
- Sales / hedge unwinds exceeding 5% of the Borrowing Base result in a redetermination – while 5% still most common, starting to see some 7.5% triggers; these provisions are also being drafted to take into account new mortgaging and new hedge positions in real time
- Increased flexibility for acreage trades and receipt of partial or full non-cash consideration for sales of Borrowing Base properties

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RESERVE-BASED LENDING MARKET TRENDS – HEDGING

- Increased flexibility for Borrowers to prospectively hedge production from assets to be acquired prior to closing of the acquisition, subject to certain limitations, and hedges must be unwound within a certain time if closing does not occur
- Requirement that Borrowers unwind hedges within 30 days of quarter's end if projected hedged volumes exceeded 100% of actual production on a quarterly basis

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RESERVE-BASED LENDING MARKET TRENDS – OTHER COVENANTS

- Restricted payments still tightly limited. In sponsor-backed acquisition financings seeing unlimited restricted payments if leverage is less than 2.50x/3.00x and liquidity is in the 10-20% range; or restricted payments up to 10% of contributed capital per year with slightly more flexible leverage and liquidity requirements
- Leverage ratios at 3.75x to 4.00x very common
  - Ability to net out unrestricted cash was scrutinized in recent years
  - Currently, however, ability to calculate based on “net debt” (subject to a cap to be agreed) is far more common
- Current ratio of 1.00x is the fairly common second financial ratio, but still see interest coverage ratios
- As market interest rates rise, interest coverage ratios should be carefully considered

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- Beneficial Ownership Information
  - Commercial banks subject to federal regulation requiring them to identify beneficial owners of certain Borrowers
  - Banks require Borrowers to complete "Beneficial Ownership Certifications" which vary from bank to bank and are short forms which enable banks to comply with the federal regulation
  - Typically addressed as a reporting covenant and representation by the Borrower

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RESERVE-BASED LENDING MARKET TRENDS – DE DIVISIONS

- Delaware Limited Liability Company Divisions
  - Required due to a change to Delaware limited liability company law (Section 18-217) effective August 1, 2018, permitting limited liability companies to divide into one or more limited liability companies
  - Dividing company may cease to exist or continue its existence, division does not require the dividing company to wind up, and a division does not constitute a dissolution; assets / rights transferred are not deemed assigned or transferred under Delaware entity law
  - Each of the debts and liabilities of a dividing company is allocated to, and constitute the debts and liabilities of, the applicable company according to the plan of division

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ACQUISITION FINANCE LOAN MARKET TRENDS

ACQUISITION FINANCE LOAN MARKET TRENDS – RECENT HISTORY

- As commodity prices began to fall in late 2014, oil and gas E&P companies were hesitant to divest assets despite severe liquidity needs
  - Wait and see approach – maybe prices will rebound?
  - No one wanted to be the “example” cited for selling at the bottom of the market
- Through much of 2015 when it was clear that commodity prices were not going to rebound and acquisition and divestiture activity may be in order, the market of willing buyers was limited
- The market recovered in 2017 and through most of 2018 as prices stabilized and companies sought to enter profitable basins and consolidation of core assets and positions

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ACQUISITION FINANCE LOAN MARKET TRENDS – CURRENT TRENDS

- A&D activity through most of 2018 was robust
  - The perceived "stigma" of selling at uncertain commodity price levels waned due to relative stabilization of prices, though volatility remains
  - Private equity funds have addressed many problems posed by existing portfolio companies
  - Opportunistic capital was raised / reserved and was ready to be deployed
- Most of the major acquisition finance deals we have seen have been focused on oil and gas E&P and the underlying buy/sell transactions are frequently structured as "asset" deals
- Very early indications are that 2019 A&D activity has paused in the E&P space
- Alternative capital may be used for equity recapitalizations if A&D activity in 2019 is not as prevalent

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ACQUISITION FINANCE LOAN MARKET TRENDS – PRICING TRENDS

- “Fully underwritten” acquisition finance trends:
  - Many current deals are being structured as RBL revolvers only
  - Equity commitments at 45-50% of purchase price
  - Relatively limited market flex rights:
    - Pricing flex usually in the 100 bps range
    - Ability to require tighter leverage ratios or increased pro forma availability/liquidity to make unlimited restricted payments
    - Flex periods run for 60 days after closing (unless a successful syndication has been achieved sooner)

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ACQUISITION FINANCE LOAN MARKET TRENDS – PRICING TRENDS

- “Fully underwritten” acquisition finance trends (cont’d)
  - Pricing on the unused fees, margin and upfront fees are consistent with non-underwritten transactions
  - Structuring / arrangement fees of 1.00% to 1.75%; possibly another 25-50 bps just to the lead-left arranger
  - Seeing a return to top-of-the-market, sponsor-backed credit documents like in early 2014 for certain top-tier sponsors

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