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THE GREATEST OILFIELD INNOVATION OF THE 21ST CENTURY

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BOWED
Part 2 of 3
BUT NOT BROKEN

Hard Truths and
**SAVING
GRACES**

By Jesse Mullins

In Part 2 of this three-part series, we delve deeper into some of the implications of the oil and gas downturn of 2014-15, as it affects the Permian Basin. Are the fire sales about to commence? Maybe. But there's hope for the savvy players who hope to avoid such, and there's a "floor" in place that not everyone expected.

When we left off Part 1 in the last issue, Dana Engelstad, managing partner of the Midland office of Johnson Miller and Co., PC, Certified Public Accountants, was discussing the raft of difficulties that confront businesses in the Basin during this prolonged stretch of depressed prices for crude oil. Prices that have been about half of what they've been for many years. It's gut-check time in the Basin, as was illustrated by Engelstad's concluding remark:

"There are people out there that have trouble keeping their properties going or keeping their leases up and [therefore] prices come down and bargains start popping up. And service companies are up for sale, and some oil and gas leases and production are up for sale. There's a yin for a yang."

We pick up the discussion there, with the idea that a realignment of the regional industry is not just impending... it's here. In this installment, we examine survival tactics and mergers-and-acquisitions strategy. Whether a company is in the market to be an acquirer, to attract an acquirer, to avoid being acquired, or to just hang on for everything they're worth, it all calls for strategy. Boom times were boom times—they were the time for capitalizing on opportunities. Now, for all

players, there has come the time for navigating the straits.

A Yin for a Yang

Engelstad is a CPA who has had decades of experience analyzing the foibles and fortunes of Basin oil and gas companies, and helping them chart a course to solvency and even prosperity. He makes light of his role, saying that he came to this part of the world 35 years ago "cold turkey, not knowing a tangible drilling cost from a tennis racket. And maybe I still don't, but it sure has been a fun ride." [laughs] "But I'm in a unique position because that's really all we do—oil and gas."

First, Engelstad debunks a misapprehension many "outsiders" have of the oil and gas business in general, and the hard-driving Permian Basin in particular.

"The common misconception from everybody outside of our industry comes from the fact that they see all these huge dollar figures, at \$110 a barrel, trading hands, going into all these oilmen's checking accounts or whatever," he said, suggesting that outside observers just take note of the income side, apart from the expenses side.

"But this economy isn't run by the money they're putting





Dana Engelstad

into the bank," he said. "It's running by the money they're writing to the service companies for payroll, for supplies, for operations, for the true economy, which is why we've had the lowest unemployment rate in the country, paying the highest wages. It's all the good things that come with the boom. All the bad things are deferred until you slow down.

This economy is going to screech."

If the Yang was the flush times, the Yin is the widespread fallout that affects more, much more, than just the E&P companies that were hitting payzones left and right.

"It's always harder, I guess, on a working man than on a boss man," Engelstad said. "Those [working people] are the people that are going to be hurt. The service companies. For every hundred out there, my theory is that one-third of them are probably just going to... well, the mom-and-pops and some of the smaller ones are just going to have to shut their doors and go away because there's no work. There'll always be service company work, but just not the volume that's out there. Then the other two-thirds are going to essentially cannibalize, or merge, or consolidate like they did during the '80s, when Hobbs was the Emerald City of service companies and all of a sudden everybody just merged, and consolidated, and went away. Fell down. There's going to be a contraction. Nobody's got the right crystal ball, but I think the people that are planning ahead are hunkering down for an extended lackluster flat period."

Engelstad said there will still be drilling of oil and gas wells out there, and the Permian Basin will still be the biggest oil and gas producing region in the country. It's just that things will proceed at a different pace.

"Or it might be in a different manner," Engelstad said. "I was talking with a drilling contractor, the sales manager for a big

drilling contractor, the other night, and he was saying, 'We can't drill at these prices, so we've got to stack our rigs.' I made the point to him, 'Well, I understand that, but if those rigs sit there and don't pay for themselves and you borrowed any money to keep them running, you're going to have to realign your costs just like everybody is.' The truth is, everybody's going to have to come back and fall back. I said, 'Those rigs will probably be drilling for oil and gas out here, but they may not be drilling the same way that you've been drilling for the last five years.' There's going to be realignment."

Realignment can take various forms. It can be a rescaling and restructuring of a going concern. It can be a fire sale of a formerly going concern. It can be the reactivation of a bunch of drilling rigs, but under the ownership of new owners. There are a lot of ways whereby things can sort out.

Asked if we might have a better oil and gas industry in the Permian Basin once these realignments—and corrections and consolidations—work their way through the industry, Engelstad said yes.

"Yes, you have a better industry. It's been cleaned up," he said. "I've seen a lot of good and bad. Extremely high oil prices are just as bad for the oilfield as extremely low prices. People want to be in the middle where you can count on it. But we're in a volatile industry and there's political risk and war risk and what-are-the-Saudi's-doing? It's our business but it's a tough one. In times of excess prices, well, you know the prices are going to eventually fall and they're going to be deficient for a while and that's going to clean out the pipes and get people ready. For folks with capital, access to capital and their own capital, you build net worth from the bottom up; you trade dollars at the top."

The "Floor"

Paul Puri is someone with his finger on the pulse of acquisition activity in the Permian Basin. As managing director of Capital Alliance and Global Head of Energy Investment Banking for M&A

International, Inc., it's his business to know how to prepare companies for mergers and acquisitions. He spoke on that subject at the Midland Energy Expo (and on media outlets during those two days) and was to speak at a Midland-Odessa Roundtable event at the Odessa Country Club on July 7. His topic was the Oil Price War, "with emphasis on the anticipated global changes, their impact on the U.S. business climate, and the resulting heightened urgency to conduct comprehensive business planning (to include succession and exit strategies)."

It was Puri who remarked that, despite much of the worries that "fire sales" will consume many of the weaker companies in the Basin's energy community, there is a "floor" that could put some limits to how dire things might be.

In an accompanying sidebar, we share three trends that Puri sees unfolding in our current business climate. The first of these evokes that "floor" metaphor:

"A record amount of private equity funding has been raised through the past two years that needs to be invested. This has generally put a floor in negotiations and has created a more competitive pricing environment for strongly positioned companies."

PBOG asked Puri what he meant by a floor, and here is how he responded:

"We're in a low-commodity-price environment," he said. "Certainly, that's impacted the performance of companies here, coming into this year. As in any down cycle we've navigated before, there's optimism for those companies that have built a good brand, that have uniqueness to them, and that service good clients. The 'floor' I'm referring to there is not only do we have good branded companies in the Permian that in the right environment would thrive and are looking to the next environment to thrive, but there's also this: in any negotiation it's also a function of how many parties are successfully brought to the table to be part of a negotiation."

And that's where a bright spot potentially exists.

"Because there's so much funding

that has already been raised up into the last two years, there are more parties that have to deploy that cash that has been raised," Puri said. "More often than not, if we know that multiple parties can be brought in and there's interest from them, it always makes a difference—a difference between what could be a fire sale [and what could be something better]. People think, 'Well, that's what my company is,' but [it helps to also] know if it's got the right characteristics and the capacity to get to the next up-cycle in good standing."

Puri said that companies like Capital Alliance have the connections and wherewithal to bring many different parties who have that funding already, to bring them into play. "It rules out [the prospects of] having the wrong parties, parties that think they're the only ones, the only game in town here. It means more competition, more opportunity, more upside, and better pricing."

An acquirer, Puri said, can be thinking like this: "If I get the company out from the burden of debt and the financial pressures, the upside would come in next cycle. If I can bridge that time to the next cycle, not only with the right company [acquisition] but with business owners and bench management that have multi-year commitments," then the potential is indeed there.

In a case like that, the acquiree/seller does not have to be in the mode of "All right, we're out, it's your ball."

"Some companies... will not survive."

Instead, the acquiree (and acquiror) can be of this mindset: "We truly think that with the right funding, the right cycle, and the right pressures, we can grow it into the next uptick."

In cases like that, Puri asserted, "There would be a lot of upside to go around the table, management and investor. That's a good sense of where we're at. Yes, the floor is in, but certainly with the time horizon we're getting what collectively is a much better return than what owners would think at this point."

PURI ON M&A PROSPECTS



Paul Puri

Capital Alliance's Paul Puri offered this additional perspective on the mergers-and-acquisitions climate in the Basin, which has become ripe for acquisitive activity in 2015.

"Certainly rig counts, pricing, and service activity have come markedly down," said Puri, who is managing director of Capital Alliance and Global Head of Energy Investment Banking for M&A International Inc.

"Many companies have been affected, but the M&A market and pricing are unique in the shale plays, especially the Permian. It goes without saying [that one should] talk with an experienced transaction advisor that has substantial oilfield transaction history and has navigated this environment before. There is an immense amount of real world advice here, but know that each individual company and its value to an acquirer are unique. Generally, if you have a strong brand, a unique service or product, and a motivated shareholder group, there are several avenues that can be considered. The backdrop is more important than ever in a low commodity price environment—things that make a big difference in value are the company's product or service differentiation, the shareholders' exit timing, the strength of its bench management, and its capacity to thrive in the right environment."

Puri said that the following trends are playing out in this particular mergers and acquisitions environment in the Permian—trends that are highly relevant to shareholders looking to exit today:

1. A record amount of private equity funding has been raised through the past two years that needs to be invested. This has generally put a floor in negotiations and has created a more competitive pricing environment for strongly positioned companies.
2. There is a good sense among interested acquirers that they can assist management in getting out from under their debt, deploy new cash to capitalize the business, and jointly succeed with management who have a long term plan to grow through the next cycle. A good advisor knows the right players to bring into the negotiation to support this strategy.
3. A multi-year commitment by management and/or successors speaks to the long-term interest that most acquirers have in growing and capitalizing the business. Certainly, this separates the "fire-sale" prices from the "longer-term," better-return prices.

Added Puri: "As we negotiate many options on behalf of our clients, most shareholders see better returns by committing several more years to grow the business."

Some Won't Survive

Puri might have been thinking of best-case scenarios for some distressed companies, but there are some worst-case scenarios playing out in the marketplace today, too.

Ken Goldsmith, who is founder and owner/operator of Mudsmith, Inc., has seen a lot of the strain that his contacts and customers are enduring, and he knows that some will just not make it.

They might, he said, if they are willing to take a hard-enough look at themselves and at their books and make some hard choices. But not all will.

"The thing is, some companies won't see it. They won't take a look at it. They will not survive it," Goldsmith said. "Their bank is looking at them saying, 'Man, that situation is so messed up, we're going to cut our losses right here.'"

"And so some have already gone out of business. Some have overreacted and laid off way too many people. Some of them are going to have to go hire back, because things pick up. What's interesting to me is to see how companies can come in here, and they can over-hire like crazy. They can do ridiculous things during the upturn that are not good business sense, and then they've got to have ridiculous corrections during the downturn."

Asked how his own company is dealing with the soft market, Goldsmith said he is having to make adjustments just like everyone else.

"Obviously, we've had to reduce our retail pricing to stay competitive," he said. "And on the drilling fluids side, definitely there's less drilling rigs, and we've been affected by the lower rig count. Maybe not affected as much as some of

ing at getting our vendor costs down, and our supply costs down, as well. So, you know, it's not as bad as it seems, but what has sustained us is focusing on workovers, completions, and equipment rentals, on wholesale sales and some other things.

"But overall, yes, definitely. You can't be in it and say I'm not affected by it."

The Elusive Turnaround

Two years ago, when *PBOG* magazine interviewed Midland banker Chris Whigham about energy lending in the Basin, the story was all about the tremendous volumes of money that were chasing Permian deals.

And that sort of activity has not curtailed entirely, even today. But when we spoke with Whigham this spring, we learned that a lot of adjustments have been made.

There's still money wanting to get invested in oil and gas, Whigham said. "Yes, there really is—there's still bank money, and there's still mezzanine money and equity funds that are seeing this also as a time to buy and deploy capital in the right places. We're just fortunate that right in the heart of the Basin is still a very good place."

Whigham is senior vice president and manager of energy lending at West Texas National Bank. He said he still talks to energy customers and writes deals, even in these times.

"It has slowed, for sure, but there's still long demand, and I think the other banks would agree with that," he said. "We've recently been in our borrowing-based redetermination season, going through that as well, and we're encouraged—especially here with the little bump in price we've seen recent times. It's been encouraging."

What about the prospects of a turnaround? Does this energy lender have an idea what that might look like?

"Honestly, there are so many variables, that no, I really don't," Whigham said. "The two things to consider are (1) what price is it (oil) going to be, and (2) how long is it going to be at that price? It just seems that you can even read conflicting articles in the same day from

people who act like they know what they're talking about, and one will say it's going to do this, and the other saying, no, it's not, it's going to do that.

"The forward curve for oil right now is going up to the high 60s within several years, the strict curve," he concluded. "We hope that that's right and that it kind of hangs in there and allows some stability to reenter the market."

Finally, we asked Paul Puri if he felt there were sectors of the Basin oil and gas industry that looked more interesting, right now, to potential investors than other sectors.

"Yes, there are many, I would say," Puri replied. "I would probably divide it like this. The [companies with] exposure on the midstream and the pipeline side. And on the testing, the inspection. Things are quite in play with companies serving that part of the market [and they] are still getting a good tailwind. We can continue to do big things in that space."

Puri said he also likes the companies that have built a great brand. "Say, for example, machining services or manufacturing fabrication. If they're still competing and they've been successfully able to change their cost structure to accommodate the new environment. Those are the ones that have everlasting appeal, inasmuch as they continue to go through the ups and downs and make the right choices. Certainly companies that are benefiting from others that are under stress, those that are stabilizing and able to capitalize on that next leg up. Certainly those with intellectual property and those on the manufacturing side who have a unique and differentiated product."

Next month: We conclude with some prognostications and prescriptions. And we hear from some more sources about their strategies to ride out the storm and capitalize on the eventual upturn. 📖



Chris Whigham



Ken Goldsmith

the bigger companies who had a hundred rigs running. But we haven't lost on a percentage basis as much as they have. But we definitely had less drilling rigs running, and the jobs that we are drilling are at a lower profit margin. Obviously we've been work-