AN ALERT FROM THE BDO NATURAL RESOURCES PRACTICE

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DISTRESSED ASSETS IN THE OIL & GAS INDUSTRY

It's been a tough year for the oil and gas industry. With oil prices fluctuating wildly—even dropping as low as $27 per barrel earlier this year—businesses have been struggling to make decisions as the future remains murky.

More than 50 North American producers have declared bankruptcy in the past year, according to a Reuters analysis of regulatory filings. At least 20 publicly traded companies and 30 privately held companies have filed for creditor protection since the start of 2015. These figures are expected to grow as banks are likely to cut credit lines to energy firms in their biannual review of borrowing limits in April, something many banks declined to do during their October 2015 reviews.

As the price slump continues, many oil firms may be wondering what to do about their distressed assets. How can companies identify if they are in trouble? What options are available to companies concerned that they may be headed toward bankruptcy?

COMMON WARNING SIGNS

Financial and operational distress rarely happen overnight. In addition to denial of circumstances, poor communications and inadequate internal reporting, distressed companies often have management teams that are successful in growth mode but unequipped for the rigors and disciplines required when growth stalls and decline sets in. This can cause a delay in seeking outside help for the situation at hand, ultimately causing the company more harm.

In identifying the telltale signs of a company in distress, there is generally a one- to two-year history of all or some of the following:

- Continual under-performance to budget/plan
- Recurring operating losses
- Liquidity constraints
- Lapses in receivable collection
- Risk of loan covenant violations or defaults
- Loss of customers or suppliers
- Increasing personnel turnover
- Wide disparity in financial/operating performance by location
- Chronic maintenance delays/increased facility and repair costs
- Increasing quality of service lapses
- Inadequate financial expertise
- Lack of active board involvement/expertise
- Expiration of hedging contracts

It's not uncommon for companies to experience headwinds. But before turning to bankruptcy, a company should first evaluate its situation and consider some strategic alternatives. In conducting operational and financial reviews, a business can determine where it can cut costs or sell nonessential assets. Hiring a third-party advisor can greatly aid in this process and also help a company evaluate its enterprise to ascertain whether it's possible to find new sources of financing from banks, distressed lenders or equity investors, or if it's possible to restructure to avoid bankruptcy.

HOW DO I GET MORE INFORMATION?

For more information on navigating distressed assets in the oil and gas industry, please contact:

GREG BARACATO
Managing Director, BDO Consulting
214-665-0704 / gbaracato@bdo.com

DAVID BERLINER
Partner, BDO Consulting
Business Restructuring and Turnaround Services
212-885-8347 / dberliner@bdo.com

SCOTT HENDON
Partner, Natural Resources Practice
214-665-0750 / shendon@bdo.com

KEVIN HUBBARD
Partner, Natural Resources Practice Leader
713-986-3149 / khubbard@bdo.com

CLARK SACKSCHEWSKY
Tax Principal
Natural Resources Practice
713-986-3101 / csackschewsky@bdo.com

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Regardless of what path a company ultimately selects to navigate its way out of distress, it's imperative that all options are explored, some of which are outlined below.

OPTIONS AVAILABLE

Private Equity: Private equity (PE) may be a particularly compelling option for those companies that could benefit from a quick infusion of capital but are struggling to secure additional debt financing. In the early days of the price crash, many PE firms sat on the sidelines, waiting to see how quickly the situation would resolve itself. With the slump rapidly approaching the two-year mark though, PE firms are ready to deploy their capital, and energy companies are eager recipients: The 2016 BDO Energy Outlook Survey found that 55 percent of energy CFOs say they are likely to use PE as a source of outside capital in the coming year.

Using PE financing to shore up a troubled business has multiple advantages:

- PE firms can provide large amounts of funding at one time;
- They are often actively involved in the running of the business to maximize its value; and
- PE firms have strong personal incentives (i.e., performance fees) to encourage success.

However, there are also disadvantages. PE firms are looking for particular types of companies to invest in—specifically, those with the potential to generate substantial profit in a given time frame—and may reject those opportunities that don't meet their requirements. Additionally, companies acquired by a PE firm experience a dilution of their ownership stake, as well as a potential loss of management control in the business.

Out-of-Court Settlements: Sometimes, a business can survive if creditors agree to forgive a portion of the debt or defer other debt maturities into the future. So, one alternative for companies is an out-of-court settlement. In an out-of-court settlement, the company must formulate a plan to get back on track financially, and either pay all or some of its liabilities or sell non-essential assets to generate cash. However, the business must develop a restructuring plan that all of its creditors can agree upon. If one or two creditors disagree with a proposal, the business may be forced to file for bankruptcy and use the courts to reach an agreement.

If the amount of general unsecured debt is not too large in relation to the other debts and the company's lenders all agree, they might broker a deal that doesn't involve any impairment for unsecured creditors. Such arrangements can result in a pre-packaged bankruptcy filing, in which the deal terms are agreed to up front, requiring court approval only to cement the deal.

Bankruptcy: If a distressed company cannot secure outside financing, restructure the business or agree to an out-of-court settlement, it may ultimately need to file for bankruptcy protection. Bankruptcy gives businesses the chance to start fresh by compromising some debts while offering creditors a chance to receive some repayment. Generally, two options are available in seeking bankruptcy protection for a business: Chapter 7 (dissolving the business and liquidating assets) and Chapter 11 (restructuring the business), both of which are court processes. In Chapter 7 situations, a trustee is appointed immediately and the management of the company is phased out. Most businesses choose to elect Chapter 11 bankruptcy to allow the management team to stay in control of the company as they restructure or liquidate.

Bankruptcy provides a number of benefits to the company in question:

- Automatic stay prevents creditors from taking action to collect their debts;
- Debtors and/or trustees have the right to assume, assign or reject executory contracts or unexpired leases of real property;
- Bankruptcy provides a fair and open process for selling assets;
- Bankrupt businesses are able to sell assets without transferring liabilities; and
- Bankruptcy allows businesses to reduce their liabilities.

However, both Chapter 7 and Chapter 11 bankruptcy can involve a long legal process with extensive costs, which can reduce the amount of recovery for creditors—demonstrating why companies should explore other options before going this route.

It's worth noting that Canadian bankruptcy laws vary from those of the U.S., so operators with assets in both countries may want to seek counsel on this matter. BDO Canada provides a resource guide here.

Assignment for the Benefit of Creditors (ABC): When reorganizing debts may not be feasible and a business is forced to close its doors, an ABC may provide a viable alternative route to shedding distressed assets.

An assignor is authorized to conduct the ABC process, to monetize assets for the benefit of creditors. The ABC must follow the rules in the state in which the process occurs. ABC is not very common, and the rules vary on a state-by-state basis. However, it can cost creditors less time and money than bankruptcy proceedings.

A Note on Tax Planning: Though they may not stave off bankruptcy, struggling businesses can also take advantage of a number of tax planning strategies that could benefit them in the long term. For example, companies should focus on slowing down deductions to increase opportunities for deductions post-bankruptcy that will not be limited by 26 U.S. Code Section 382. Additionally, companies should be aware of the cancellation of debt income in all negotiations to ensure they are not suddenly in a taxable income position. Finally, companies should take the time to clearly understand what bankruptcy proceedings could mean for alternative minimum tax payments.

LOOKING FORWARD

If the current industry circumstances are to continue, many more oil and gas companies will likely consider bankruptcy in the near future. Smart companies that identify early signs of distress, like those symptoms listed above, will seek a financial advisor and restructuring counsel as soon as possible. A knowledgeable third party will be able to analyze the state of your organization and advise on the pros and cons of each option available to you.

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