Oilfield Service Sector Set for Wave of Restructurings

Prepared By EIAP

Energy & Industrial Advisory Partners

Introduction

While most industries face the need for large numbers of restructurings cyclically, for the oilfield service industry restructuring events have been ongoing for the last five years. Even before the dual shock of COVID-19 related demand destruction and the Saudi/Russia led price war the industry was already facing challenging conditions, driven by overcapacity and low pricing. Many companies' balance sheets were severely over levered, including companies that had already completed chapter 11 restructurings in 2015-2017 with the expectation that demand and pricing would rebound quickly but were now faced with growing liquidity issues as the recovery failed to materialize as strongly or quickly as projected.

2019 and early 2020 saw a number of major restructuring events such as Weatherford, Key Energy Services, McDermott International, Superior Energy Services, Shale Support, EPIC Companies, Offshore Marine Contractors, Pioneer Energy Services, Tri-Point, and Carbo Ceramics. Prior to the current crisis another round of restructuring was imminent, with a large number of private and public OFS names seen as restructuring candidates. Now, OFS companies across the space have appointed advisors, an early sign that the dam is beginning to break.

For an industry already facing tough conditions, the dual hit of COVID-19 related demand destruction and the OPEC / Russia alliance's increase of supply has both accelerated likely restructurings and put in play companies that even the most pessimistic projections would not have foreseen. Realistically, in 2020-2021 the oilfield service sector will see if not the largest ever, certainly the second largest ever number of bankruptcies after the mid to late 80's bust. The third factor, and perhaps in the long run the most impactful is the growing realization that U.S. unconventional activity levels, as seen in 2016-2018 were never sustainable. The U.S. shale industry despite trumpeting 100+ percent single well rate of returns, in reality, has led one of the most efficient bouts of capital destruction in living memory. Having destroyed hundreds of billions of dollars while at the same time being the leading creator of its own demise, as US oil production continued to grow offsetting any production cuts by the OPEC+ group and pushing the group over the brink and into all-out war with each other and the shale industry.

While the reaction of OPEC+ and the decline of US shale was certainly foreseeable, the dual hit of demand and supply disruption was not. With the outlook for the global economy continuing to worsen, storage filling up and commodity markets continuing to shrug off any seemingly positive news, it is clear that the near-term outlook for the industry is bad, and worsening. What does that mean for the OFS industry?

Where You Are and What You Do Matters

While the outlook is negative across the board and no one will be immune from the near-term pain, the companies most at risk are those exposed to the wrong geographies and service lines. In general, companies more exposed to US unconventionals will see the most rapid and drastic reduction in activity. While companies exposed to offshore and international will see demand reduction and pricing pressure, longer investment cycles (and already lower activity levels) will cushion the blow. Activity levels will likely be off 15 to 25% in these areas, though given the massive disruption in the market and companies' ability to conduct work, 2H 2020 may see a temporary drop of up to 50%.

For companies active in the U.S., basin exposure matters. If overall US unconventional activity levels are off 50%, work in the SCOOP/STACK will likely be off 80%. Gas producing areas such as the Haynesville and Marcellus may see a benefit due to the drop in oil prices, as associated gas production in the Permian and other basins falls due to reduced oil focused D&C activity. A huge number of shale focused E&Ps will go bankrupt and for many, the other side is not a clean balance sheet and back to how things were, but either liquidation or much lower activity levels focused on whatever actual "good acreage" is in their portfolios. While it is widely known that the closer to the wellhead a service provider is, the greater the volatility they will face, it is still worth repeating. Companies directly involved in drilling and completions (and the companies that sell to them) are seeing the fastest decline. However, no one will be spared, wells are already being shut in or left off when experiencing a failure which will quickly read through to artificial lift, production chemicals, well service, and other production focused companies.

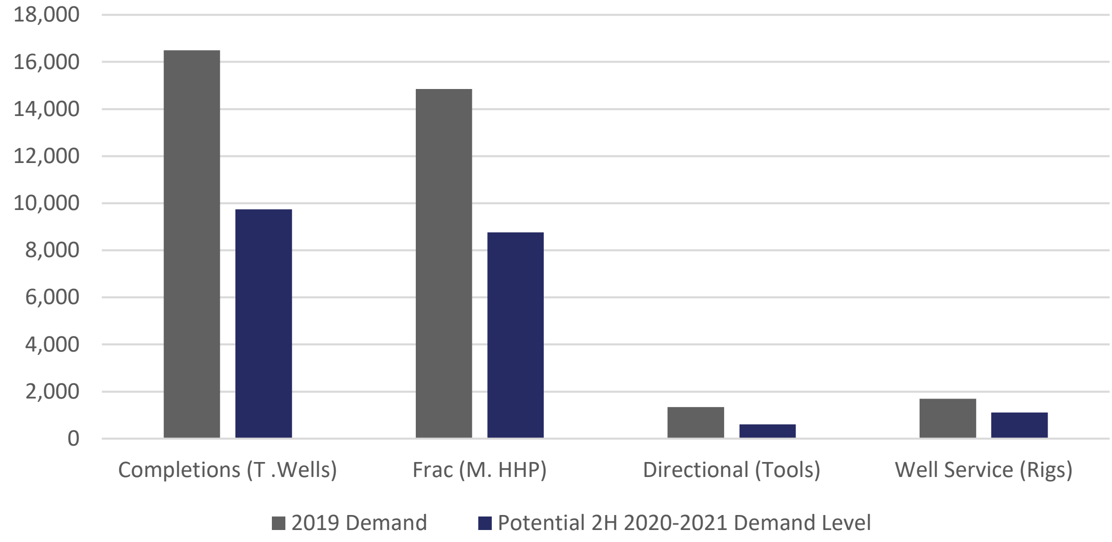
Pricing

E&P companies are always quick to ask for pricing concessions, and this downturn is no different. Within days (in some cases hours) of the market open on Black Monday (March 9th) E&Ps were not only dropping rigs and frac crews but were also asking for 20-30 percent pricing concessions. In contrast to previous downturns, the scope for major pricing concessions is minimal. Most OFS companies were either barely profitable or losing money in 2019. Material pricing concessions would lead to most companies losing money on the gross margin level. In contrast with the previous downturn investors' appetites to keep pouring money into companies in order to lose money is non-existent. There is truly no more blood to squeeze from the stone.

So, Where Does That Leave OFS Companies?

OFS companies, especially those with exposure to US unconventionals, are forced to deal with a task that few companies have ever successfully achieved. First, companies need to realistically forecast what demand for their products and services will look like in the future. While we don't have THE answer, a good place to start is less than 50 percent of 2018 levels, and we don't mean temporarily. In addition to rapidly falling demand, efficiency gains made in recent years will not be reversed. It is entirely reasonable that the long-term US rig count, where US unconventional activity is actually economic at $40-$60 per barrel, will settle somewhere in the low 400s. What does this mean for different parts of the O&G supply chain?

Figure 1: 2019 vs. Potential 2h 2020 -2021 US Demand for Select Verticals



Source: EIAP Estimates

Any activity increase in 2020 is likely to be heavily weighted towards late Q3 and Q4, though as the end of the year approaches budget exhaustion and weather will begin to weigh on any push for increased activity. Even if oil prices return to relatively healthy levels (~$50 BBL) the US unconventional industry is almost certain to be structurally changed due to bankruptcies and consolidation, and smaller due to a lack of funding and a realization that many of the unconventional wells drilled in recent years were developed based on fundamentally flawed assumptions related to costs, decline rates, and estimated ultimate recoveries (EURs). Faced with a step change in long term demand levels the OFS industry will be forced to remake itself to reflect this new reality or face a never-ending low price, low margin environment which will be unsustainable without capital inflows.

Other Issues

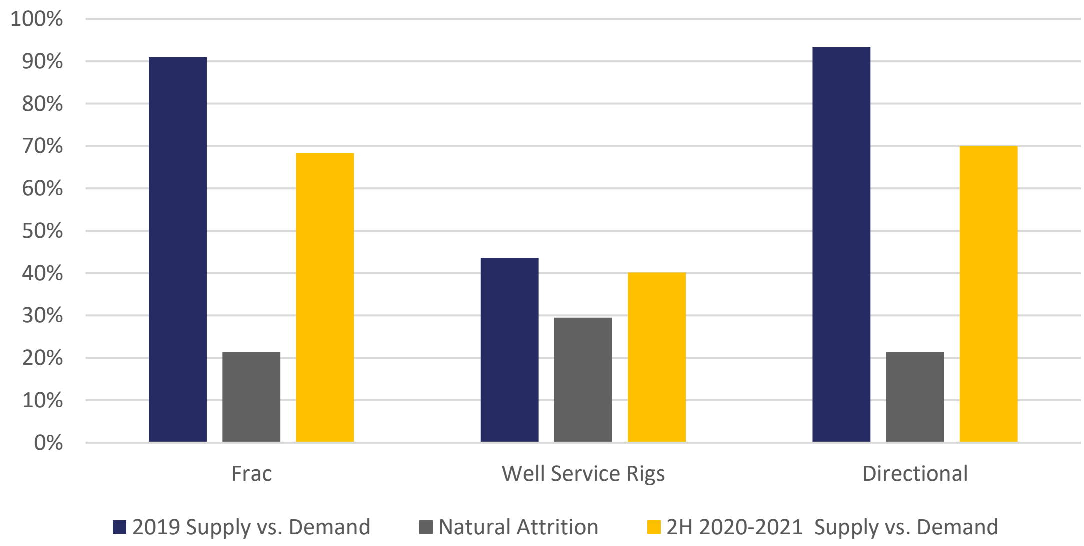
Although the extent of the impact remains to be seen, channel checks with suppliers indicate that trade receivable ageings are rapidly increasing. This trend is being confirmed by large public service companies as they report. Companies across all industries are focused on hoarding cash and the oil and gas sector is likely to be one of the worst affected. This will put additional pressure on oilfield service companies and their suppliers, and companies have little recourse. In the near-term the cost and availability of financing sources such as factoring and the ability to recover meaningful amounts via collections will likely rapidly decline.

Although some midsize oilfield service companies have successfully received forgivable loans from stimulus initiatives such as the Paycheck Protection Act for now at least this pool of funding seems to be closing. Private equity backed oilfield service companies have faced extra hurdles as rules related to "affiliate" companies may deem them ineligible if they are owned by a sponsor who collectively employs more than 500 people across its majority owned portfolio.

What are the Take Aways?

If this admittedly gloomy scenario were to be true, what are the key takeaways for the OFS sector? First, somehow, the industry must drastically reduce the size of its asset base focused on US unconventionals. On the plus side, the investment in new OFS assets has undoubtably reached near zero, so supply growth won't be part of the equation for the foreseeable future. Additionally, the poor state of the OFS industry in recent years has led to significant underinvestment in repair and maintenance. A percentage of the necessary attrition across sectors will likely happen naturally as poorly maintained equipment is cannibalized, scrapped, or left to rot in yards.

Figure 2: 2019 Supply vs Demand, Natural Attrition and 2H 2020 – 2021 Potential Oversupply Select OFS Verticals



Source: EIAP Estimates

The majority of oilfield service verticals were already oversupplied in 2019 due to activity reductions from 2018 and overinvestment in the industry. Overinvestment was driven both by an influx of private equity money and excessive fragmentation in the market. The frac market was perhaps ten percent overcapacity at the end of 2019, with positive signs for the market as multiple providers were reducing capacity (HAL, SLB, PUMPCO). However, compared to 2H 2020-2021 demand levels, even with accelerated attrition (on the level of 3.5 million HPP), demand will still be under 60 percent of capacity. Drilling demand is projected to be more robust than completions demand, almost solely due to long term rig contracts held by more financially stable E&Ps. Natural attrition may account for a loss of around 300 directional tools strings due to a lack of R&M spending leaving the market around 30 percent over capacity as activity improves in the back half of 2020 to the first half of 2021. The well service market, which was perhaps the most oversupplied major US OFS vertical prior to the current downturn is also likely to see demand well below capacity through next year. Even if the nearly 1,200 stacked well service rigs were to leave the market, demand would still account for around 40 percent of capacity, despite the expectation that production related activity will be more robust versus 2019 levels when compared to drilling and completions.

Still, natural attrition will not be enough. The industry is in desperate need of a mass scrapping, the likes of which has never been seen before. However, historical "scrapping" has taken place in name only, with assets being sold at auction to smaller (often mom and pop) companies or opportunistic investors and thus not actually solving the oversupply problem. Given the lack of capital interested in OFS, there is at least a glimmer of hope that this time will be different and equipment will end up where it belongs, as scrap metal. How this (hopefully great) scrapping plays out is key to the future of the industry, until the overhang of zombie assets is erased the future looks bleak. OFS companies have always been reluctant to truly scrap assets as it benefits their competitors as much as them, this time may actually be different. Early signs are positive, with both Halliburton (22% of their fleet and additional unspecified equipment alluded to in their Q1 2020 earnings calls) and Patterson UTI (300 thousand HHP) announcing scrapping of significant pressure pumping assets and most public companies announcing impairments. Consolidation must and will play a role, though most companies were reluctant to pull the trigger before the crisis. Those that have were not appropriately rewarded by the markets. While the situation is likely too fluid currently, companies must continue to pursue all stock deals to reduce the overcrowding in the market.

What does this mean for investors? Recoveries on assets that are not either incredibly differentiated or useable in other industries will be minimal and more in line with scrap steel prices. Most asset backed loans are likely already functionally overdrawn if the assets were marked to market.

The Other Take Away – Balance Sheets

The OFS industry was heading for a wave of restructuring before the current crisis, many companies were too highly leveraged and faced upcoming 2021-2022 maturities that, barring a miraculous turnaround could not be serviced. Now that we have the opposite of a turnaround, companies that had hoped to ride it out have to come to terms with their need for restructuring. Companies with unhealthy balance sheets and earlier maturities should get started right now, companies with 2021-2022 maturities and enough near term liquidity can cut costs and wait a few months to gain a better understanding of what the realistic demand for their services may be, but should not delude themselves or their lenders into believing that some event which will fix their business is around the corner. Lenders should put pressure on management teams to realize this and act and are doing so by trying to prevent companies from defensively drawing down revolvers. Capital markets remain mostly closed for all but the largest and most robust OFS companies. Even equity holders who may face a significant haircut will be better served by accepting that action needs to be taken now. In fact, many OFS companies should and will likely use current conditions to opportunistically restructure using the cover of COVID. Even companies with relatively "healthy" balance sheets need to assess if those balance sheets will be healthy if their business is half the size it was in 2018, in most cases the answer will be no. There will likely never be a better time to deflect blame and have realistic conversations with investors and lenders.

How Did We End Up Here?

Even before the current crisis the OFS sector was in rough shape, oversupplied, facing declining demand levels, and unrecovered pricing. Unconventionals led to increasing commoditization. Industry titans such as SLB and HAL were faced with their lowest market caps of the new century. Smaller public companies market shares dipped into the $75-250 million range. Privately owned businesses that missed the few small windows to sell were valued at historically low multiples and even at these prices, investors were not particularly interested. Even investors who saw what they considered attractive opportunities found it difficult to attract financing.

Quite simply the industry's investment pipeline had stalled from top to bottom. Entrepreneur owned businesses that traditionally would have sold to PE could not, smaller PE couldn't flip all but the most attractive investment to larger PE, and large OFS companies that missed the brief window in late 2017 and early 2018 couldn't IPO. These failures reverberated as specialist funds tried and failed to raise new funds. Companies tried and failed to execute a sales process or IPO. As the realization that sales processes would be difficult refinancing processes became more common, but even these increasingly failed. Now, a majority of companies (and their investors) are faced with an uncomfortable reality, businesses with significant equity value only a few years ago likely have none. Sponsors are performing portfolio triage and picking winners and losers.

Creditors, Banks, etc.

Even here the pipeline continues to break down, up until the current crisis there was still significant interest in distressed OFS debt from credit funds who were attracted by debt for control type situations. While there is undoubtably still interest in distressed opportunities, with the current state of the industry this pool of investors is shrinking rapidly due to ample distress across the wider economy. OFS debt markets face wide bid - ask spreads and minimal liquidity, when paper does transact it is trading at deep discounts. In some cases, lenders who are unable or unwilling to unload their loans at such deep discounts may find themselves holding the keys of a company or assets they don't know how to, nor want to manage, and that they can't divest quickly or easily.

What do We Need and Who is Best Positioned to Survive?

The need for restructuring across public and sponsor backed companies cannot be overstated, companies that bury their heads in the sand and hope things will get better will likely only face worse prospects. Companies and investors need to take a hard look at their balance sheets and realistically assess if their positions are sustainable in a world where activity levels are perhaps more than half less than 2018 levels depending on geography and product/service lines for the foreseeable future. Lenders need to be willing to work with equity holders and consider if it makes sense to bring forward a restructuring event and leave equity holders with a slightly larger share in the restructured company than would be the case typically. In the same vein equity holders in many companies may need to realize that a haircut is a matter of when, not if.

Restructured companies need clean balance sheets, while nearly full equitization and deploying more capital may be a tough pill to swallow for many lenders, companies that emerge from restructuring with still large debt loads will be setting themselves up for Chapter 22/33 and in many cases liquidation events. Exiting bankruptcy with unsustainable debt loads based on the expectation that activity would quickly recover was a common theme of earlier restructurings across the space with offshore drillers, US land focused service companies, and larger integrated service companies all falling into this trap.

Given the minimal recoveries, lenders should expect minimal recoveries in the near term whether via asset sales or liquidations but that these routes may be the best choice, and therefore a realistic assessment of a company's reasons for existing and its outlook must be made. Lenders should unemotionally weigh whether liquidation is the best choice for some businesses.

In addition to the strength in their balance sheet, also look for OFS providers with a dynamic business model that has changed to meet the increasing demands of the shale plays. All aspects of how we drill, complete and produce the shale plays has changed exponentially over the last five years. Too many OFS providers have been unable or unwilling to change with the market. The advent of pad drilling and its associated efficiencies has forced these providers to become more efficient. One example of this is the overall efficiency on a typical completion location that has reduced the amount of equipment required to perform operations. In conjunction with this gain in efficiency, the oil and gas operators have driven the decoupling of things like sand, diesel and chemicals from service companies which has further wreaked havoc on many providers' profitability. Companies that have adapted to these demands as opposed to fighting them are more likely to emerge on the other side of this market. Companies that perform best in these tough conditions will be the ones who are highly focused on their core markets (those who are not should aggressively shutter non-core product lines that have been unprofitable in the long term) and who exhibit superior operations performance. E&Ps will focus on companies who can do more, better with less. Companies with poor operational performance who try to compete on pricing will likely be faced with losses at the gross margin level. Companies whose fleets of equipment are younger and better maintained are also likely to be winners as this should drive lower R&M costs in addition to better operational performance.

Now more than ever, the OFS industry needs opportunistic investors. Despite the carnage and bleak outlook there are opportunities available at steep discounts across both sponsor backed and public companies. Opportunities exist for investors to take microcap public companies private as part of a restructuring event as the costs of being public for many companies greatly outweigh the benefits, especially considering the public markets' lack of appetite for oilfield services.

Although the oil and gas sector faces an unprecedented set of near and long term challenges, the silver lining is that on the other side of this is a very different, smaller sector where well run companies have an opportunity to make money. Whether there are investors who can see through the carnage and embrace that potential, however, remains to be seen.

About EIAP

Energy & Industrial Advisory Partners (EIAP) was founded to provide companies and investors across the energy and industrial markets with strategic consulting and M&A advisory services from seasoned consultants with significant industry experience.

Our team and our subject matter experts have worked in the industries we cover and have maintained that focus during our consulting careers. We don't take on engagements outside our core verticals. This specialism enables us to provide proprietary insights into the perspectives of key customers, suppliers and competitors. Our collective experience amounts to hundreds of transactions and strategic engagements alongside some of the world's most sophisticated investors and companies.

We understand your products, services and the markets you operate in which allows us to ask the right questions and continue the conversation in a way generalist firms can't. Our large network of subject matter experts and industry connectivity also gives us access to the key decision makers relevant to your business.

Our service offering is focused on M&A and strategic consulting. We understand the M&A process, our team has worked on hundreds of transactions, with a focus on understanding how buyers and sellers create value. We understand the challenges facing our clients. We're from your industry and have the experience and industry connections to develop a tailor-made strategy based on a deep understanding of the markets you operate in and your clients. We don't provide cookie cutter solutions to the problems facing your business or your strategic goals.

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