

The credit crunch and the E&P Sector

Through a dialogue with sector specialists from the banking, private equity and oil company communities this week we have been gauging the impact of the credit crunch on the E&P sector. The collapse of the debt and equity markets has clearly had a major impact with potentially far reaching consequences. The process of deleveraging is underway. This note provides a synopsis of the current situation as seen by London specialists. We address three questions. 1) How bad is it? 2) How long will the current situation persist? 3) What are future financing scenarios and are there innovative funding solutions for the smaller E&Ps?

Conclusions

From the dialogue there is consensus on the following

- All oil companies are impacted but the <\$1-2bn mkt cap <40-50mbd production, listed oil company will be particularly stressed during the credit crunch.
- Some E&Ps without significant cashflow and large commitments may go to the wall in next 6 months.
- Future investment models need to factor in that equity funding through to first production will be the norm for at least the next 2-3 years.
- Exploration activity may be 40-60% lower in 2009.
- Companies that are self funding, with robust projects and flexibility on timing are in the best position to benefit from distressed asset sales and falling industry costs.
- For those with access to funds, now is a very good time to acquire assets providing they have the capital available to invest in those assets.

Highlights

- Smaller E&P company portfolios are still adjusting to the reality of the scarcity and higher cost of capital. Portfolios have been assembled on the assumption that capital would be available when needed to execute the business plan. Many business plans are simply not fundable at present.
- The good news is that a rapid drop in service sector costs is inevitable as demand falls – shallow water rig rates could fall by as much as 50%.
- This means that many companies are waiting for costs to come down before sanctioning projects.
- Management teams are budgeting on basis of commitments and discretionary spending and taking a risk-averse position.

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- Investors should therefore be wary of forced portfolio rationalisation including asset sales, involuntary farming down of equity interests and forced license relinquishments. Companies that are locked into expensive rig contracts are especially vulnerable during the downturn and we expect to see some defaults on obligations soon.
- Company valuations based on NAVs that don't take into account the future availability of capital are meaningless.
- Companies most likely to be acquired are those with financially stranded, undeveloped reserves in geographically focussed areas (e.g. First Calgary, Tanganyika, Revus, Imperial). Premia can be large – up to 150% in the Revus case given that currently, equity markets value oil assets lower than industry.
- The consensus in our group of experts was that companies producing above ~40-50mbd should generate sufficient cashflow at \$60 oil to secure enough capital investment for production growth. Even for this group, however, growth rates will be lower and pushed back due to lower debt capacity, partner drag and voluntary delays to benefit from lower future costs.

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