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Bust in oil prices trigger mergers and acquisitions

By Chris Tomlinson | August 18, 2015 | Updated: August 18, 2015 8:58pm

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Photo: Jerry Baker, Freelance

IMAGE 1 OF 2

Noble Energy made a deal for Rosetta Resources this year for $2.1 billion. Rosetta was an example of a company with strong assets but that had posted a big loss.

Just as night follows day, busts follow booms in the oil industry, and that leads to mergers and acquisitions to clean up the damage.

Companies that loaded up on debt and drilled when prices were high are having an increasingly hard time keeping above water now that prices are so low. Not only are short-term bonds coming due, but the value of the oil in the ground has dropped 60 percent from last summer's highs. That means they have less collateral for their lines of credit and therefore more distress.

Many companies bulked up while West Texas Intermediate crude prices were consistently around $100 a barrel from 2013 to 2014. Most analysts believe oil prices are likely to remain low for at least another six months and will remain below $80 through 2020. The closing price on Tuesday was $42.62.

While lenders have kept oil companies afloat for this long, reality is setting in.

"Raising new capital will likely become increasingly difficult for speculative-grade companies as commodity prices remain low and the industry slump lingers," analysts at Standard & Poor's Rating Service concluded.

There's a clever nine-box matrix for looking at companies that specialize in oil exploration and production. Along the top is whether the company has a low, medium or high level of debt. Along the side, the company has high-, medium- or low-quality wells. Low debt and high quality wins, and high debt and low quality loses.

Where a company falls on this matrix

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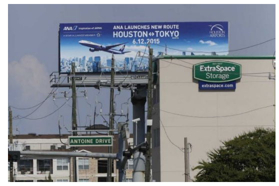
determines whether it is a buyer, an acquisition target or headed for insolvency. The weakest companies have already declared bankruptcy, including Samson Resources, Quicksilver Resources, Sabine Oil & Gas and American Eagle Energy Corp. If oil prices remain low, more companies will sink toward the bottom of the matrix.

Low oil prices mean distressed companies, and that means a wave of mergers and acquisitions. To learn more about these transactions, I sought insight from two attorneys who specialize in them.

Houston-based Baker Botts Corporate partner Kelly Rose said acquisitions have been stalled because sellers are holding out for a price recovery, while buyers are looking for bargain-basement discounts.

Airport officials expect bigger Labor Day crowds



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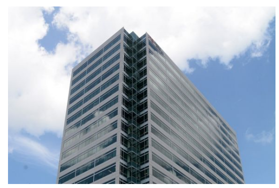

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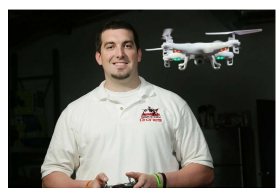

Drones deliver on business promise for Houston company

"The issue of doing M&A in a volatile commodity price environment is that you don't know what the right price is," she said.

Financially distressed companies, though, can only hold out for so long. Companies with fat checkbooks but mediocre wells are hunting for cash-strapped companies with great reserves.

Houston-based Noble Energy completed one of the first deals this year and purchased Rosetta Resources for $2.1 billion. Rosetta had good assets but had posted a $540 million loss in the first quarter and had $1.8 billion in debt.

"I think we will see more distressed situations in the second half of the year," Rose said. "It's going to be an interesting six months, to say the least."

Some companies are in trouble because banks have been warned that many of their loans to oil companies are now considered substandard. That means banks are limited in providing additional capital.

"Now you're going to see a stricter review and evaluation, and that's probably going to end up then being a catalyst to require some borrowers to start selling off some properties, put up some more collateral or pay off some of the loans," said Hunter White, a lead energy attorney at Thompson Knight in Houston.

When approaching acquisitions, buyers need to make sure they fully understand what will likely be a complicated debt picture, White said. Big-ticket liabilities can be obvious, while some smaller contracts can be treacherous.

"Are they overpaying for gas, or are they receiving less than they should for oil on long-term contracts?" White said. "You are not likely to get a seller who is willing to represent and warrant to you that they've never entered into a stupid contract."

Whenever possible, it's a good idea to know why the company is selling. Is it a fire sale? Is there a private equity firm trying to make an exit? Is this a case of bad timing, too much debt or has the seller lost faith in the company's assets?

Buyers should also remember they are not the only ones who see opportunity in the downturn.

"What people have to remember is that there is a lot of money waiting on the sidelines," White cautioned. "You've got a lot of investors coming out of the woodwork who have no knowledge of this particular area and maybe want to gain entrance."

So what is the worst thing a buyer can do?

"The biggest mistake people are going to make is thinking they know what prices are going to do," he said.

The oil price bust so far has not been as hard on oil companies as past down cycles. And while this one is far from over, there are signs the market is behaving rationally, with strong companies buying out weak.

Perhaps that's because we know that day follows night, and another boom is on the horizon.

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