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'Next shoe to drop': Energy sector braces for potential credit crunch - BNN Bloomberg

Tara Weber

Deadlines are looming again in the energy patch amid growing fears of an imminent credit crunch after a number of companies managed to postpone key negotiations with their lenders until July – in other words, now.

“So that’s the next thing to come out,” said Dan Tsubouchi, chief market strategist at Stream Asset Financial Management. “We saw all of these companies that came out in June, saying our banks have extended our credit redetermination until July.”

For many energy companies, their borrowing base redeterminations are now taking place twice a year – once in the spring and again in the fall instead of just annually. They're even taking place more frequently for some companies considered more at risk. This is when banks determine a company’s current value and decide how much debt it will be allowed to take on. The process has taken on increasing significance over the last few years as banks look to cut their exposure to the oil and gas sector.

But this year, the spring redeterminations coincided with historically low oil prices thanks to a short-lived price war and a massive drop in oil demand due to COVID-19. As a result, many lenders agreed to extensions in the hope that the operating environment would improve.

“I think one thing that a lot of these companies, along with the banks that they’re negotiating with, are looking at is what, if any, assistance they can get from the Business Development Bank of Canada and Export Development Bank,” said Tom Pavic, president of Sayer Energy Advisors, a broker specializing in financing, mergers and acquisitions in the Canadian oil and gas industry. “I believe that’s one of the reasons why they’re agreeing to these short-term extensions.”

Take the pressure Bonterra Energy Corp. is under, for example. Its annual borrowing base redetermination had only been extended from May 29 until June 30. Then it was extended again, but just briefly, until July 15. In a press release on June 30, the company said the additional time would allow it and its lending syndicate “to assess the impact of developments in current market dynamics, including the proposed programs initiated by the Federal Government through Export Development Canada (EDC) and Business Development Bank of Canada (BDC), and to establish a credit facility renewal that underpins Bonterra's ongoing financial flexibility.”

While oil prices have stabilized somewhat, albeit around US$40 per barrel for West Texas Intermediate, help from the federal government has yet to materialize. Back on April 17, Ottawa announced BDC and EDC would make “higher risk financing” available to companies in Canada’s oil and gas sector. Firms can apply for loans of between $15 million and $60 million to help fund operational cash flow issues for a 12-month period and “ensure a degree of continuity of operations during this period of uncertainty.”

“That’s going to be the next shoe to drop, ahead of the second-quarter results,” said Tsubouchi. “What happens if we still haven’t seen anything from BDC? And for those guys who extended one month and they are thinking OPEC is doing better, the problem now with the COVID-19 [case] increases is that people are worried about demand not picking up as quickly and I think that’s the next shoe to drop.”

“The banks have been playing nice in the first part of the pandemic, but I think now they’ve started to realize they need to make some adjustments,” said Patrick Maguire, vice-chair and Calgary managing partner at Bennett Jones LLP.

Maguire says so far, banks have been bringing in tougher covenant packages, in which they put stricter conditions on how the borrowed money can be spent, however he believes more borrowing base redeterminations are on the way as lenders look to adjust their exposure.

“I think there was enough volatility in the commodity prices that they were careful not to overreact,” he said. “I suspect everyone will be watching a little more closely when the redeterminations come up in the fall."

COMPANY	CURRENT AMOUNT	NEW RETERMINATION DATE
Altura Energy Inc.	$7.5M	July 31
Bonterra Energy Corp.	$325M	July 15
Cardinal Energy Ltd.	$325M	July 15
Gear Energy Ltd.	$75M	July 10
InPlay Oil Corp.	$75M	July 14
Journey Energy Inc.	$77M	July 31
Kelt Exploration Ltd.	$350M	July 15
Painted Pony Energy Ltd.	$325M	July 31
Petrus Resources Ltd.	$96M	July 13

Source: Company reports, SAF, courtesy of Stream Asset Financial

But it is a fine balancing act - trying to manage the debtor-creditor relationship while ensuring the business is sustainable. And a redetermination is a big step that can trigger an immediate repayment that the company may not be able to afford.

"Cash flow and returns are significant, but often banks would prefer to not wind up owning an exploration and production company, much less an energy services business," said Bryan Benoit, a partner in energy at Grant Thornton LLP. "As a result, terms are often extended and perception around oil and gas prices relied on for internal marks by commercial bankers may be as much as 20 per cent higher than spot. This may persist for some time but long-term may be unprecedented."

"At some point, a loan is a loan, cheap is cheap when it comes to commodity price, and that may be just flat out – inescapable," Benoit says.

Already, some oil and gas companies are seeing some purse tightening. Gear Energy Ltd. is frequently pointed to as the poster child for what's to come.

Gear's borrowing base redetermination was completed on July 10. While the junior oil and gas company had a credit facility of $90 million on March 31, that has now been revised down to $75 million, and it will be further reduced by $5 million each quarter until the first quarter of 2021. Three banks are in the lending syndicate: ATB, BDC and National Bank.

"So down to $60 [million] by next March 31," said Tsubouchi in a recent email. "$90 [million] to $60 [million] in a year."

Gear Energy has yet another borrowing base redetermination set for August 31.

Another Calgary-based junior oil and gas company, Southern Energy Corp., is facing a similar squeeze. On July 20, the company announced its borrowing base was redetermined to US$13.9 million. But of that amount, lenders deemed the company's reserves that back the loan are only worth $8.5 million. That means the remaining $5.4 million is deemed a non-conforming credit facility, which is now being charged a higher interest rate and is due on September 1, 2020, when the company's next redetermination takes place. Southern, a smaller player that produces just over 2,500 barrels of oil equivalent a day in the United States, now has to move quickly to potentially raise that kind of cash.

Southern Energy's Chief Financial Officer, Calvin Yau, said the company is still cash-flow positive and that these actions are simply "bringing the company's debt in line ahead of the next redetermination period." Yau told BNN Bloomberg on the phone the company's assets are U.S.-based and they're working with a U.S. banking counterparty, which tends to be more flexible then Canadian lenders.

In the bigger picture, as the availability of credit shrinks, there is even less money to invest in the growth and expansion of the energy sector. That is in addition to the billions of dollars in capital expenditure cuts already seen over the last five years.

But there may be some light on the horizon.

Maguire says he's hopeful that the volatility is over and oil prices are starting to stabilize. He says he's also hearing that federal cash has begun to flow.

“That’s a process that’s really just started,” Maguire said. “We have seen some initial [memorandums of understanding] and discussions with BDC, but it has not yet taken off. So to those companies that are situated to take advantage of the BDC program, I think we need to see how that’s going to unfold over the next few months.”

But many in the oil patch are losing sleep during these uncertain times. Pavic adds it is still tough to say what actions financial institutions or lending syndicates will decide to take and notes it will always be on a case-by-case basis.

“It’s just a wait and see for so many companies right now.”