Study: Roughly 175 E&P companies at high-risk for bankruptcy in 2016

Oil & Gas Financial Journal, February 16, 2016

With decreasing financial options, industry faces tough choices

With more than $150 billion in debt on their balance sheets, nearly 35% of pure-play exploration and production companies (E&P) listed worldwide, or about 175 companies, are at high-risk of slipping into bankruptcy in 2016, according to a new Deloitte study. The outlook is almost equally alarming for about 160 other E&Ps that are less leveraged but cash flow constrained.

2016 will be the year of hard decisions. “We could see E&P bankruptcies surpass Great Recession levels as companies struggle to remain solvent,” said John England, vice chairman and US oil and gas sector leader, Deloitte LLP. “Access to capital markets, bankers' support and derivatives protection, which helped smooth an otherwise rocky road for the industry in 2015, are fast waning. A looming capital crunch and heightened cash flow volatility suggest that 2016 will be a period of tough, new financial choices for the industry.”

Seeing the cash crunch, E&Ps worldwide have saved or raised cash to the tune of $130 billion, since the oil price crash. Surprisingly, two-thirds of the savings have come from non-capex measures such as asset sales and equity issuance. However, considering further equity issuance and asset sales will come at much lower prices, the report notes that E&Ps worldwide are entering 2016 with the only option of cutting their already reduced dividends and share buybacks.

“Considering the industry will have fewer financial levers to pull in 2016, operational performance will be the key to sustainability and growth,” said England. “There is still more that can be done by oil players, particularly large ones, to reduce costs. Prices will eventually rebound and companies need to focus not only how to survive, but also how to position themselves to thrive for when things turn around and demand picks up.”

One of the key ways companies have managed to remain viable has been through the reduction of production costs, starting in 2015. Today, about 95% of production costs (lease operating expenses and production taxes) of U.S.-origin players operate below $15/boe, versus 65% in 2Q14. The report states that questions on current breakeven prices and near-term cash flows should give way to the future return on capital employed (ROCE) potential of the industry. As the industry improves performance on costs/efficiency, its future emphasis will not be about its ability to make profits at low prices, but generating sufficient ROCE on a large base of devalued investments made in the past.

Further, economies of scale and scope appear to be benefitting natural gas players more, reflected in the widening gap between large and small gas-heavy companies and marginal cost differentiation between large and small oil-heavy players.

That noted, spending cuts in 2015 and 2016 – the first time since the mid-1980s that industry will reduce capex for two consecutive years – will likely have a substantial and long-lasting impact on future supplies and open new chapters in the geopolitics of oil. E&Ps risk slowing the conversion of resources to reserves in frontier locations and the capex required to maintain aging fields and facilities, the report warns.

The report further anticipates that future M&A activity will most likely go beyond the typical buying reasons of the past–preference for oil-heavy assets and buying for growth/scale. Companies that prioritize returns over size, have a balanced and flexible production profile over a deep inventory of non-producing asserts, and give thought to economies of scope over economies of scale will most likely thrive when the price environment improves.

“There is no silver bullet solution that applies to the whole industry; in fact, the landscape has never been more complicated,” concluded Andrew Slaughter, executive director, Deloitte Center for Energy Solutions. “Each company has its own set of unique factors to consider – from issues specific to each producing region and asset, to various states of financial circumstances. Staying solvent will require the same level of perseverance, innovative thinking and creativity as the technology breakthroughs that led to the boom in supply we have seen over recent years.”