Oil and Gas: Where Do We Go Now?
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As a result of COVID-19, oil prices have experienced substantial changes. In contrast to 2019 when West Texas Intermediate ("WTI") prices were $55-60 per bbl, we believe such prices <u>*will*</u> retest a $10 bbl level in upcoming months, and maybe settle out in a $15-25 range, as a result of the pandemic and its effect on the global demand for crude. Prices for natural gas, while not as affected, have also come down recently, with NYMEX prices of $1.60-1.90 per mcf observed. While the futures markets anticipate a pricing recovery to some degree in 2021, advisors' evaluations of oil and gas offerings must account for recent movements in pricing to serve the interests of their stakeholders.

In addition to the underwriting challenges relating to the assets, lenders, non-operated position holders and other stakeholders must also now consider the financial strength of the well operators and how COVID-19 may have impacted their liquidity and abilities to service debt. From 2015-2016, Boone & Haynes, LLP reported that 114 oil/gas companies filed for bankruptcy after oil prices dropped below $30 bbl in 2015. *Following a similar pattern*, U.S. distressed energy debt is on the rise, which includes bonds that yield 10% over comparable term Treasuries and secured loans that trade for less than 80 cents on the dollar. According to Bloomberg, U.S. distressed energy debt hit $190 billion in April 2020.

As it will be months until the world's GDP is back to normal, the trend of distressed energy companies may get worse before it gets better. Unfortunately, it is not easy for stakeholders to learn that a company is distressed until it is too late. Mid-year 2020 borrowing base determinations and related loan compliance analyses will occur in July/August based upon mid-year reserves and financials, not to mention that public reporting companies will not file their Q2 financials until early August 2020. *This complicates the questions surrounding the prospects for an oil/gas company to remain viable through the COVID-19 storm*.

On a better note, some sources believe that a pricing recovery will come sooner than later. In April, Raymond James published its oil pricing expectations of $55 bbl for 2021 based upon its expectations about changes in worldwide supply and demand. Goldman Sachs also remains bullish on oil prices in 2021, with its expectations being almost identical to the Raymond James' forecast.

It goes without saying that opportunism will surface in some circles due to the pandemic. In the MLP sector, the Alerian Index is 30% of where it was two years ago, thereby presenting an opportunity for investors to get into MLPs at low prices. Energy debts are being sold at significant discounts, and a number of program sponsors within the private placement sector are positioning to buy assets at opportunistic prices through the offerings of opportunity fund programs. While many may suffer, others with ample cash will thrive.

Despite the sentiments about pricing recovery, the possibilities for success will require disciplined underwriting methods in analyzing asset returns. *Such an approach must factor, <u>at least in part</u>, the economics of the assets at current NYMEX-based prices*. As a higher-case analysis, conditions that assume a balancing of supply/demand in 2021 may also be analyzed as

long as the higher case model results are considered side-by-side with the lower NYMEX-based results (with the higher case models perhaps premised upon pricing held flat at $50-55 bbl beginning in 2021 or possibly later).

Prudent underwriting of oil assets must also analyze the economics of the assets based upon localized factors that consider extra costs due to water disposal requirements (i.e., the #1 shortfall of up-stream pro formas) and oil pricing adjustments based upon transmission costs and local discounts. Prudent underwriting will also include production assumptions based upon *collective* operator experience in the field being drilled, as opposed to the use of production curves that incorporate the absolute best results seen in a field (i.e., the #2 shortfall of up-stream pro formas).

In summary, interesting times are ahead for those that work in the energy finance sector. Stay disciplined with respect to your underwriting of energy assets.