In the past what has caused the banks to decrease RBLs for HY issuers?

Overall, since the mid-1990s (start of reliable data), lenders have seen par recovery on RBL facilities in all distressed and bankruptcy situations according to S&P. There are two main reason why this is the case. First, reserve engineers at the major lending banks use a lower price deck than the actual commodity strip price as a base case. And beyond that, the banks run a further sensitivity (aka downside case) that they generally rely on to give them confidence during commodity market dislocations like this one. The second reason banks haven't taken losses on these RBLs is that internal reserve engineers also take a additional discount to the already discounted (9-10%) expected cash flows coming from an E&P's proved reserves. Generally, Proved Developed Producing reserve are discounted at 25%; Proved Developed Non-Producing are discounted at 50%; Proved Undeveloped (PUDs) are discounted at 75%. This is in addition to subtracting out the expected cash flow for the next 6 months of planned production out of the RBL borrowing base. This borrowing base calculation does however give producers the benefit of hedges.

Given a lack of material losses in the types of products banks are generally reluctant to materially reduce the RBLs of E&P especially during dislocations like the one we are seeing in oil right now. The general philosophy of the lending banks has been to be more conservative in both directions. When commodities (oil, nat gas) are rallying, banks are slow to move the price deck up; however, the same is true on the way down, which benefits E&Ps in today's bear oil market. That said, borrowing bases were reduced in 08/09, although these reductions were very minor compared to the over 70% decline in oil prices. There have been situations where the banks will reduce borrowing bases more meaningfully. This can happen when an E&P with an already weak financial profile enters a bear commodity market, or an E&P experiences a sudden change in its reserves or production profile (dramatic and unexpected cost increase, reserve write downs, unexpected decline in current production).

Can E&Ps raise more money in the HY market today?

If necessary BB-rated E&Ps can come to market to issue given average spreads in the 450-470 bps range; looking at our previous liquidity overview, one can see that most of these E&P are in good shape and don't need to issue. Moving down the credit spectrum, lower-rated single-B and triple-C companies are the ones more likely to need the capital. Given that the spreads for energy single-B and triple-C companies are currently 950-970bps and 1,880-1,900bps, respectively, we don't see more traditional unsecured HY deals as feasible today. This highlights the cost of capital problem that lower rated E&P companies now face – these are the real "have nots" in our minds.

With traditional HY avenues not open to them we believe two trends will emerge. First, we will see more bilateral deals between E&Ps and providers of capital (private equity, recently-launched energy funds, special situations funds). We have already seen one recent example of this between Linn Energy (LINE) and GSO/ Blackstone (BX). LINE now has a five- year $500 million agreement whereby GSO will earn up to a 15% RoR on wells drilled by LINE in exchange for providing 100% of the upfront drilling costs. EXCO Resources (XCO) led the way on transactions like this; it struck a similar agreement with KKR & Co (KKR) in July 2013 in the Eagle Ford. Rightly so, we believe investors would rather invest in a company and make survival a self fulfilling prophecy rather than try to build sizable positions through the secondary market where ownership brings no incremental certainty around survival. The second trend will be second lien deals. E&P bond indentures are written with relatively open language around the way credit facilities are defined and the