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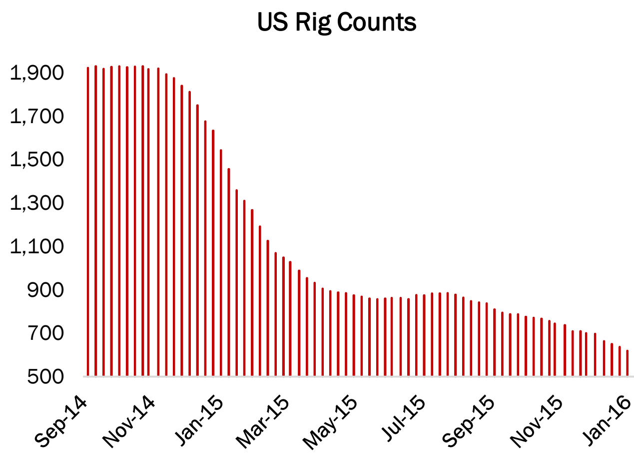
Middle-Market Oil Field Service Companies: Fighting Zombie Loans in the Oil Patch

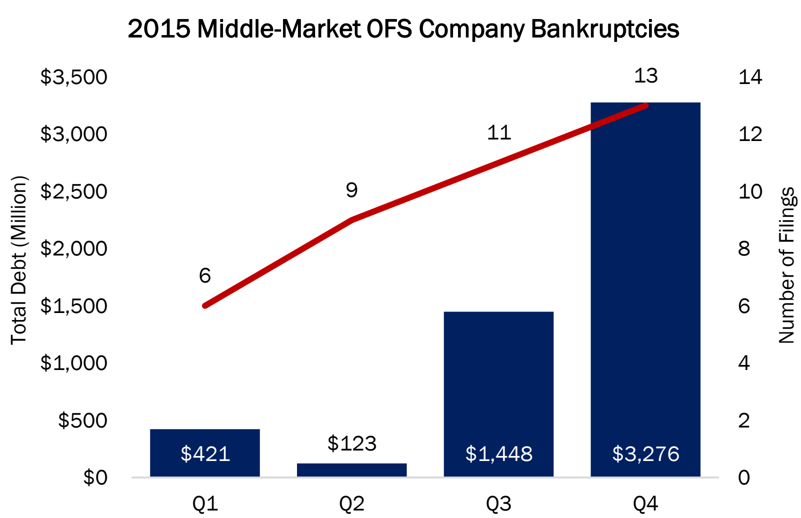
The severe drop in energy prices has inundated the oil + gas industry with failing middle-market Oil Field Services ("OFS") companies, providing a continuous supply of zombie assets that lenders need to be weary of. As US active rig counts plummeted 70% below their September 2014 peak to just 571 at the start of February 2016, massive revenue declines and EBITDA losses became the "virus" that spread throughout the OFS population. The larger, diversified and bettered capitalized public and upper middle-market OFS companies are surviving, but many middle-market and lower middle-market companies are not. The afflicted companies have cut labor costs, operating expenses and capital budgets, but can't stem the tide of negative cash flows. Many face imminent collapse and liquidation after becoming increasingly over-levered and saddled with equipment they can't sell. They are the zombies in the oil patch, still trying to operate but often not paying all their obligations to lenders, vendors, sub-contractors, employees and other creditors in order to survive. As a result, the market is operating at overcapacity due to lack of demand and saturated with companies who continue to stagger on and won't die. A thorough assessment of which OFS companies are still viable has yet to be done.



Source: Baker Hughes

During the boom years of high energy prices, most of these zombie assets rode the credit-fueled wave of rapid expansion across multiple traditional and unconventional oil fields, acquiring large and diverse equipment portfolios to meet the growing demands of their Exploration + Production customers. Now their revolver, capital equipment and cash flow lenders are all wondering how, if ever, they will be repaid with many middle-market companies facing insolvency. In 2015 alone, 39 OFS companies with over $5 billion in aggregate debt were reported to enter bankruptcy by Haynes and Boone, LLP, ranging from smaller players with $10 – $15 million of total debt to Vantage Drilling with over $2.7 billion. As the price and drilling recovery is now predicted to be lower and further away than initially expected, 2016 bankruptcies could easily be twice the volume of 2015.

Lenders are realizing that these zombies lurk in their portfolios, and are witnessing companies, in essence, liquidating to survive. Past due accounts receivables are collected to fund ever dwindling operations, leading to smaller future collections. Better or unencumbered equipment is being sold to plug cash shortages while revolving credit facilities and equipment loans are only



Source: Haynes and Boone, LLP

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partially paid down. Unfortunately, fearing an imminent collapse and uncertain liquidation, lenders continued to provide over-advances, interest-only payments options, maturity extensions and other forms of debt relief throughout 2015.

In today's market, options are limited as over-supply has led to incredibly low realizable values for OFS equipment. Anecdotal evidence indicates that many sales are occurring at prices significantly below their "forced liquidation values" that are based upon appraisals performed three to six months ago. On newer pieces of equipment, liquidation can mean a recovery of under 30% of the underlying loan and many assets just won't sell as they are simply not needed in a low rig count environment.

Waiting and hoping for the business to return is no longer an option for lenders. Further delays result in the company's continued deterioration and possible free fall into restructuring or liquidation during a period of ever-lower equipment valuations. Lenders increasingly need to assess and deal with these zombies.

It's in the lender's best interest to enlist, as soon as possible, the help of an outside Chief Restructuring Officer ("CRO"), or perhaps a more appropriate name is the "Responsible" Officer. An outside professional can provide their OFS companies with the expertise and guidance needed to address the company's immediate lack of liquidity concerns. Additionally, the "Responsible" Officer can assess the company's situation, evaluate the viability of its business plan and supplement any management team needs. The "Responsible" Officer can develop restructuring alternatives for the company and execute the strategy that maximizes recovery value for lenders. Often, wind-down and liquidation is the best alternative or even the only option. There is a growing need for the "Responsible" Officer (or CRO) to lead the process as management teams will likely be too conflicted, distracted and expensive to effectively run a liquidation process.

A Comprehensive Restructuring Assessment and Action Plan for Lenders

Immediate Cash Management and Control

Liquidity is quickly evaporating and must be immediately addressed so that the company can continue relatively normal operations while cash must be controlled to prevent leakage and limit lender exposure.

- ✓ Understand the company's liquidity position and future funding requirements
  - ☐ Develop realistic 4-week, 13-week and 26-week cash flow forecasts to highlight funding requirements
  - ☐ Monitor cash flows on a weekly basis and effectively communicate the company's position to all lenders, enabling informed decisions
- ✓ Optimize the company's liquidity position through effective management of accounts receivable and payable
  - ☐ Halt payments on equipment leases and loans, especially for equipment not being utilized
  - ☐ Control cash by requiring "cash dominion" and confirm collections are being deposited into the lockbox
- ✓ Identify liquidity enhancements and funding alternatives
  - ☐ Unencumbered or less encumbered assets that can be sold
  - ☐ Capital infusions from owners and other stakeholders
  - ☐ Increase revolving credit facility ("Revolver") availability (in- or out-of-formula) and assess collateral

Situational + Operational Assessment

Assessing the viability of the business is the critical next step in determining if, and how much, the lenders will recover on their loan. Scrutinize operations at the granular level as many of these companies cannot survive at lower levels of revenue.

- ✓ Review existing business plan and financial forecasts
  - ☐ Examine the company's business plan and its viability given current market conditions
  - ☐ Understand the crucial details of market demand: profitability by oil field (division/branch/location) and service line, customer base, current projects, project pipeline and pricing dynamics
  - ☐ Assess management's turnaround strategy of current and planned revenue enhancement opportunities and cost reductions as the cost structure is likely to no longer commensurate with decreased revenues
  - ☐ Ensure the business plan incorporates any operational divestitures and asset sales that can support the plan's funding requirements or be used for debt repayment
- ✓ Analyze the company's debt capacity based upon the financial forecast and any divestitures/asset sales
  - ☐ Understand the current level and complexity of all debt and capital lease obligations
- ✓ Assess the management team and its ability to execute the turnaround plan
  - ☐ Recognize that the current management team may need to be supplemented with additional resources

Debt Restructuring Alternatives

Build restructuring alternatives and execute the strategy that yields the highest recovery for lenders.

- ✓ Compile a list of encumbered and unencumbered assets that includes recent appraised values
    - ☐ Determine validity of appraised values given the appraisal date and more recent transactions
    - ☐ Understand the type, value and relative secured position of each equipment lender
    - ☐ Determine availability of assets to fund the turnaround plan or obtain additional collateral to support restructuring or liquidation efforts
- ✓ Develop forced and orderly liquidation analyses
    - ☐ Utilize realistic time frames that are based upon the ability to sell assets in the current environment, the company's short-term funding requirements and adjust the cash flow forecasts to reflect wind-down or operation cessation
    - ☐ Address the appropriate legal process and liquidation risks
- ✓ Evaluate debt restructuring alternatives (in-court or out-of-court) based upon debt capacity
    - ☐ Consider debt modifications, debt-for-debt and debt-for-equity exchanges
- ✓ Examine the opportunity to sell the company as an ongoing concern or as an asset sale via Section 363 of the bankruptcy code
    - ☐ Ascertain whether the divestment of assets should be done through a liquidating Chapter 11 or Chapter 7
- ✓ Communicate the restructuring alternatives and negotiate the appropriate plan and process with the existing stakeholders
- ✓ Identify the CRO or "Responsible" Officer to effectively execute the plan with the management team or manage operations while an orderly liquidation takes place if no viable business exists

Liquidation

Most zombie OFS companies are already the "walking dead" and liquidation is the best, if not the only, alternative for all stakeholders.

- ✓ Lock down cash, focusing on short-term funding with the Revolver lender and other secured lenders, while ensuring accounts receivable collections are controlled
- ✓ Secure all revenue producing equipment and corporate assets (usually GPS tracking)
    - ☐ Equipment can include tractor/trailer and other trucking assets and be located on-site at customer locations, at company yards or branch locations or in-transit to/from customer sites
- ✓ Immediately assess completion or termination of all jobs in process
    - ☐ Communicate status with customers; confirm job timing and collectability
    - ☐ Incentivize employees to complete jobs timely and within budget
    - ☐ Ensure equipment is maintained and returned
- ✓ Establish equipment return protocols for individual equipment lenders/lienholders and lessors, excluding major secured lenders with Revolver assets and large pools of equipment
    - ☐ Evaluate situations to monetize equipment with "equity" value
    - ☐ Negotiate elimination or limitation on deficiency claims, if appropriate
    - ☐ Arrange delivery or pick-up and preparation/cleaning as necessary
- ✓ Develop and implement detailed asset liquidation plan with secured lenders
    - ☐ Establish asset-specific action plans and monitoring documentation for effective communication
    - ☐ Coordinate individual, or categorical, asset plans with appraisal and auction/liquidation professionals
- ✓ Eliminate all but essential personnel for corporate wind-down – cash collections, equipment security and liquidation, accounting finalization and estate management (legal)

Summary

Dealing with distressed OFS companies is similar to any middle-market situation; our experience has taught us that timing is the critical determining factor for recovery. Lenders must proactively evaluate these zombie assets and move to resuscitate or liquidate them as quickly as possible, not just for their own recovery, but to maximize the value of the assets. With increasing regularity, lenders have asked about LM+Co's playbook and experience advising in zombie situations. We have served as CRO, financial advisor, investment banker and liquidator for numerous distressed companies and have developed an approach for lenders to address these troubled companies in their portfolios before it is too late.

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About Loughlin Management Partners + Co

In Private Equity Value Creation, Turnaround + Restructuring and Corporate Finance, LM+Co has distinguished itself with management teams and investors for more than a decade by focusing on actionable solutions across a broad range of industries, and delivering results that maximize value. LM+Co provides a full range of advisory services to companies and their investors, as volatility continues in global energy markets. LM+Co's Energy + Power team can help companies adjust their strategies, restructure their operations and capital structures to confront turbulent market conditions. For further information, please see www.lmcopartners.com