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ValueScope's Oil & Gas Price Outlook July 2016:
"Buying Time" Is Expensive for Oilfield Service Companies

ValueScope recently analyzed and provided a fairness opinion for a private equity ("PE") firm's subsequent investment in an oilfield service company. Based on our analyses, the service company would violate the EBITDA covenants on its debt in 2017 and would need cash to buy back a portion of its debt. Due to recent market conditions, the company did not have adequate working capital for this and was unable to take on any more bank debt.

Therefore, seeking an additional equity investment was required, versus risking bankruptcy next year. Previously, the existing shareholders had invested at $1.00 per share. A PE firm agreed to invest $100M dollars under the following terms:

- The security would be a preferred security, senior to all other equity classes
- This additional investment would provide allow them to get through the 2017 debt paybacks required
- Capital was also earmarked for a $50M acquisition of assets (at a fraction of their original cost) from another bankrupt service company

In addition to being senior to all other classes of shareholders, the "new money" negotiated for its shares to be valued at 60 cents per share. This price reduced value of existing shareholders in an exit scenario, and gave new money approximately 70% more shares than a value of $1.00, thus creating even more dilution for the existing shareholders.

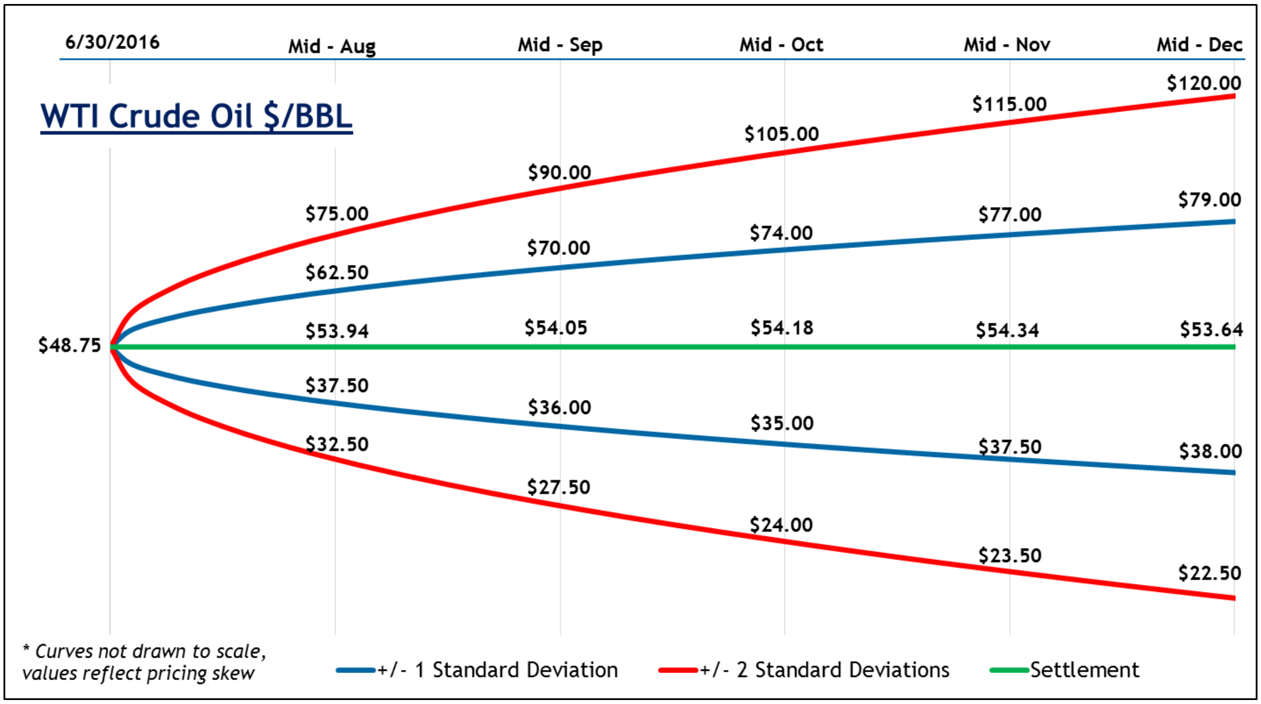
The good news is that new equity capital is being invested in this market, but it requires tough choices for existing shareholders:

- take a significant valuation haircut now, in exchange for financial flexibility and duration, or
- roll the dice (effectively betting the entire value of their equity) on acquiring a future source of capital under better terms.

Crude Oil Outlook

While futures markets aren't a crystal ball, their price levels and related options are useful for estimating future price ranges or "confidence intervals" for crude oil and natural gas.

The graphic below shows the crude oil price on June 30, 2016 and predicted crude oil prices based on options on oil futures contracts (ticker /CL). The blue lines are within one standard deviation (σ) of the settlement price (green line) and the red lines are within two standard deviations for each month (for a refresher on standard deviations, see the January 2016 blog).



Based on the June 30, 2016 prices, the markets indicate that in mid-August, there is about a 68% chance that oil prices will be between $37.50 and $62.50 per barrel. Likewise, there is about a 95% chance that prices will be between $32.50 and $75.00. For a longer-term view, by mid-December 2016, the +/- 1σ price range is $38.00 to $79.00 per barrel. This upward skew in the price ranges also drives the expected midpoint of $53.64 per barrel at year end.

Natural Gas Outlook

We can do the same thing for natural gas futures, currently trading at about $2.89 per MMBTU on the Henry Hub (ticker /NG). Although more affected by seasonal factors than crude oil, in mid-December 2016, the +/- 1σ price range is $2.65 to $4.25 per MMBTU and the 2σ range is $2.05 to $5.75 per MMBTU. The expected midpoint of natural gas prices is $3.29 for the end of 2016.

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