

"Laws of supply and demand are called laws for a reason. More money is better than less money. But less debt is better than more debt. Quality never goes out of style."



Bill Swanstrom

Partner
Houston
T: 713-226-1143
bswanstrom@lockelord.com

Bill Swanstrom serves as co-chair of the Firm's Energy Practice Group. Mr. Swanstrom has over 25 years of experience working with energy companies in their significant acquisition, divestiture, project development and finance activities. He also has substantial experience in energy private equity transactions, representing both investors and companies. He is a regular speaker and writes on energy M&A and project development issues. Mr. Swanstrom is recognized in *Chambers USA* as "an incredibly talented lawyer who is an excellent resource for clients."



David Patton

Partner
Houston
T: 713-226-1254
dpatton@lockelord.com

David Patton is co-chair of the Firm's Energy Practice Group. He has over 35 years of experience in various legal aspects of the oil and gas industry, including acquisitions and sales of assets or equity interests, drafting and negotiating leases, contracts, and agreements related to field operations. Mr. Patton has represented clients in connection with surface use conflicts, day to day exploration and development activities, and the resolution of oil and gas disputes. In addition, he was lead attorney in over \$4 billion in oil and gas property transactions in 2011-2013. He is a frequent speaker on oil and gas issues and is active in the Rocky Mountain Mineral Law Foundation and the State Bar of Texas.

Quality of Assets Driving Distressed Energy Sector Dynamics

Editor's Note: This is one in a continuing series of Q&As with Locke Lord lawyers on key legal issues confronting companies engaged in industries that have national and global impact.

It seems the price of oil has stabilized, moving slightly up or down rather than taking dramatic shifts. If this pattern holds, how will this impact the challenges companies will face in the next few months or for the rest of the year?

We are already seeing some of the benefits of increasing price stability. Several energy companies have accessed the equity markets and high yield debt markets in the last couple of weeks — including some companies that market speculators thought would have a tough time getting new debt and equity. This trend definitely is partially the result of less price volatility — but it also reflects a view by many companies that crude prices are not likely to increase significantly anytime soon — and so they might as well access the markets now if they can, even though they are paying a pretty high price for the financing they are receiving.

It's worth noting that a number of analysts — certainly not all, but some — are predicting a sharp (although temporary) drop in crude prices — possibly into the 20's — before prices improve.

Even if the pricing dynamics have stabilized, there will be winners and losers in the coming months, years. What will determine who wins and loses in this, the latest down cycle of the energy industry?

As in every cycle, the winners and losers are determined primarily by two things — quality of assets, and financial flexibility. A low commodity price environment presents a classic opportunity to see who is really wearing swim trunks when the tide goes out. Companies that have acquired quality assets at reasonable prices and with reasonable leverage will do fine. Those companies also are likely to have the best access to additional debt and equity financing — enabling them to take advantage of opportunities to buy quality assets from competitors that took on more debt than their assets could support.

Once this down cycle ends – whether it takes a few months or a year or more — what lessons should be learned from this current downturn in the price of oil?

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Will the energy industry be stronger once it comes out of this down cycle or will short-term memory take over as prices climb back to the \$100 per barrel mark?

Certainly some weaker players will get weeded out, and their assets will end up in the hands of better managed — or at least better financed — companies. That is generally a good thing. But we will always have cycles in the energy business. As lawyers, the best thing we can do for our clients is use our years of experience — including plenty of down-cycle experience — to help guide our clients through the rocky waters. Hopefully, with our help, they will come out stronger on the other side.

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