Tudor Pickering Holt Energy Thoughts (4-6-09, Monday) RGNC, E&P revolvers, electricity, rigcount

E&P revolver redeterminations (S&P1500 E&P $365) *E&P Research*

- *Company-by-company spreadsheet available upon request*
- *Summary:* Even with conservative commodity price assumptions, we think most E&Ps will not experience any distress from the semiannual process where commercial banks redetermine revolving loan limits. Compared with this time last year, bank price decks are more conservative and willingness to lend is generally down. This is typically going to result in a lower revolver limit – but not one that puts the borrowing company in trouble. While some banks have scaled back lending activity, we see relatively healthy willingness to lend, with smaller/regional banks filling the voids created by less interested lenders (mainly larger national banks which have TARP/non-energy issues to deal with).
- *Background:* Nearly every buyside marketing meeting begins with discussions around liquidity and the ongoing April bank redeterminations. Reserve financing is a major source of funds for small-mid cap E&Ps. Reserve-backed revolvers usually provide the first slice of outside capital to help an E&P grow production, add reserves and increase cash flow. These committed funds also act as lifelines during downcycle periods, keeping some growth-oriented companies above water until prices improve and credit markets thaw. Therefore, lots of investment community interest (particularly after microcap KRU saw loan limits cut below outstanding borrowings, ultimately driving Chapter 11).
- *Overview:* We reviewed the 29 E&P companies in our E&P coverage in order to gauge who is most at risk for borrowing base reductions. The conclusion is that April redeterminations will probably not be an issue for most because of existing hedges. As these hedges roll off, however, there are several companies which are at risk of seeing lower borrowing limits during the next redeterminations (typically done in October). Highest exposure: PXP, BEXP, XCO, and CXO. It should be noted that each lead bank has its own individual metrics and business relationships with the companies. Additionally, contributions from other assets (e.g. hedges and midstream) will influence the credit available.
- *Process*: The redetermination process generally happens in Spring and Fall and there is no published formula by which all banks establish their lending limits – each bank has a different risk tolerance and relationship with the borrowing E&P. Through multiple conversations with commercial lenders and E&P CFO's, we built a template for analyzing redeterminations. Most E&Ps backstop/secure bank lines with the value of their proved reserves. In general, reserve lending is based on a percent of the value of proved developed reserves (PDPs) using a 9-10% discount rate. Undeveloped reserves (PUDs, 2P, 3P) are assigned very little (if any) value. Hedges and new production are accretive to value, but discounted significantly at some banks. Other considerations include midstream/gathering assets, working capital requirements, EBITDA/interest ratio, and Debt/EBITDA margin covenants. For each company in our E&P coverage, we calculated the NPV 9% value of PDPs using a price deck of $3.80/MMbtu gas in 2009, $4.50 in 2010 and $5.50 longer-term and $35/bbl oil going to $50 long-term. We then compared their current credit facility with 60-70% of the calculated NPV 9% (banks won't loan 100%, preferring to have some extra collateral to incorporate for the inherent uncertainty of estimating reserves).
- *Results*: To date, most E&Ps have not pushed the envelope in requesting credit and banks are happy to oblige. Feels to us like the tight credit markets of the past six months have kept E&P CFO's fairly cautious, with a desire to have a cushion. For bigger companies, many have requested a revolver limit somewhat below their theoretical maximum (in case the theoretical max gets lowered). Our calculations show that this leaves them with decent

breathing room. A few examples include HK (TPH-calculated revolver max likely $1.0-1.4B vs. current revolver limit of $0.95B), RRC (TPH-calculated revolver max likely $1.8-$2.5B vs. current revolver limit of $1.5B), and PXP (TPH-calculated revolver max likely $1.5-$2.0B vs. current revolver limit of $1.4B). Tightest likely redeterminations are BEXP ($145mm currently borrowed with $40mm cash, new base likely ~$120mm) and PLLL ($ 225mm currently borrowed with $36mm cash, new base likely ~$230mm).