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CLIENT ALERT

Five Key issues for Oil & Gas Private Equity Right Now

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As the oil and gas industry continues to face significant challenges, private equity professionals have their hands full. Entire industries have been upended overnight, especially the oil and gas industry. Valuations, once reliable, are now fraught with new complexities given the extreme oil and gas price volatility. And investors everywhere clamor for guidance after a sudden freeze in global commercial activity caused by the COVID-19 pandemic. We have summarized five key issues for oil and gas private equity professionals to consider in the current environment.

1. *Know the downside risks lurking in your partnership agreements*. Sponsors should be reviewing their fund documents to determine whether any of the actions they plan to take or have already taken could have negative effects on overall fund performance. For example, most partnership agreements will contain clawback or reserve provisions to adjust for distortions of the intended economics based on the timing of gains and losses. These provisions should be analyzed to determine whether any obligations have been triggered as a result of the decline in portfolio company valuations. In addition, leverage provisions are common to most agreements and set forth limits on how much the fund can borrow to support its portfolio companies and their operations. With reserve-based loans being re-determined on updated commodity price decks, sponsors should determine whether they are in compliance with such provisions and whether they would be able to seek additional leverage to support their businesses. Finally, sponsors would do well to manage their funds to the letter of the fund documents. It is during times of distress that limited partners (LPs) and counterparties are most likely to throw the flag on any violations.

2. *Prioritize your portfolio*. Alongside analyzing fund-level obligations, general partners (GPs) should work with their portfolio companies to ensure survival and plan for future success. The health and safety of employees at each portfolio company should be a top priority. In addition, sponsors should look to resolve any cash management and liquidity risk issues. Access to the government lending programs, such as Main Street Lending Program, may be key to getting small and medium-sized oil and gas companies immediate relief from existing obligations. For more information, see our recent briefing titled Federal Reserve – Main Street Loan Facilities. However, careful attention should be paid to any notice and covenant provisions under existing credit facilities to understand the interplay between the two loans. Once liquidity issues have been resolved, sponsors should look to stabilize operations and begin rebuilding their companies for the future. Shutting-in production due to a lack of economic transport and storage options is one operational tool likely to be used. For newer fields and wells without much drilling pressure, this may actually be beneficial to producers in the

short run as the oil is essentially stored in the rocks until it becomes economic to drill again. But for depleted fields and aging wells, a shut-in could mean complete loss of the well and anticipated economics forcing sponsors to change course on a particular strategy. Given that many producers and oilfield service companies will likely seek protection in bankruptcy, sponsors should also encourage their portfolio companies to review their contracts and their counterparties' viability.

3. *Support your investors*. Now more than ever, sponsors should become acutely aware of the needs of their investors. The crisis has effected everyone in different ways, so sponsors would do well to understand how investor appetites have changed. Given the distressed energy market, sponsors should understand that some investors may be hesitant to make future deals until there is more stability in commodity prices. Investors may also be worried about the "denominator effect" and its knock-on effects. When public markets fall in value, the relative value of illiquid assets—like private equity—rises, while the LP's overall portfolio size contracts. This can suddenly disrupt an LP's targeted allocations to private equity, forcing the LP to take remedial action. Generally speaking, investors want to hear from their investment managers when markets are in flux to get their views and insights. Market insights are a powerful tool – for both calming nerves and exhibiting a GP's competitive advantage.

It is very likely that new fund managers will not have much experience working with their LPs in a downcycle. Thus, sponsors should be familiar with default remedies in the event of an LP default on capital calls. The COVID-19 pandemic is an ESG-related event. Perhaps, now is the time for GPs to increase their commitments to those areas in future investments. For more information, see our recent briefing titled ESG, Capital Access, and the Future of the Oil & Gas Industry.

4. *Adjust your diligence processes*. As deals get kicked off again, sponsors should look to enhance their diligence processes to deliver better investment results. Any diligence completed on active deals should be revisited to account for COVID-19-impacted issues. For target companies in oil field services, such issues will focus on data privacy, operational and supply chain matters, HR, and employee benefits. For upstream targets, key diligence areas will center around engineering, geology, and asset evaluations. Most importantly, sponsors should determine the impact on financial performance of the target companies in such key areas. In light of many lockdown restrictions, most diligence processes will now need to take place virtually. Not all is lost in moving to a virtual future. Artificial intelligence technology is reshaping certain diligence tasks leading to greater efficiency. Nevertheless, it will be important for sponsors to identify any areas that still require physical in-person diligence (*e*., environmental, land and mineral title, inventory counts, etc.) to understand the impact and potential for delay in timing of the transaction. Thus, successful GPs will chart parallel paths, learning to grow their diligence capabilities online while crafting safe and effective plans for resuming in-person diligence once applicable restrictions have been lifted.

5. *Consider alternative investments*. Once the immediate fund-level and portfolio concerns have been addressed, focus will shift toward new investments. From the outset, fund professionals should understand their mandates to know whether they are allowed to seek out alternative investments from the normal course, such as 363 acquisitions from companies in bankruptcy. Take-privates and toehold transactions are popular when there are deep declines in the public markets. Of course, there are many regulatory issues (state, local, SEC) to consider when planning such transactions. There is also a strong likelihood that litigation will follow such transactions, based on breaches of fiduciary duties or disclosure obligations, so sponsors should prepare accordingly. A "roll-up" strategy is another common theme in distressed environments. These transactions allow sponsors to add acreage or combine existing portfolio companies in a way that trims costs and aggregates assets, thereby changing the narrative. Whatever path is chosen, it will need to involve creativity and cooperation from all members of the capital stack in order to get a deal done.

For additional guidance on this and other restructuring issues we recommend our recent presentation on the topic, available here.

Winston & Strawn's COVID-19 Task Force brings a comprehensive approach to the complex legal and strategic challenges presented by the pandemic. View all of our COVID-19 perspectives here. Contact a member of our

COVID-19 Legal Task Force here.

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