

Let's Talk Oil and Gas Loans: Financing the Energy Evolution



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In this two-part episode of Let's Talk Lending, Winston & Strawn Partner Ryan Hunsaker and Associate Erin Webb are joined by guest speakers Brett Fenn, Managing Director at Texas Capital Bank and Blake Kirshman, Senior Vice President at Independent Financial. Listen as they share their perspective on energy lending, interest rates, current trends and the overall market, and predictions for the future.

Highlights from this episode include:

- Recent inflationary pressures due to supply chain issues, labor shortages, and increased commodity prices that have led to increases in interest rates and the market expectation that they will continue to rise.
- Due to recent geopolitical events and increased demand post-COVID, traditional oil and gas continues, and will for the foreseeable future, to play a paramount role in supporting the complex energy landscape.
- Given commodity price volatility, which led to some banks taking losses in their portfolios, general economic uncertainty, and increased public perception of oil and gas as a “dirty” industry over the last few years, some commercial banks have completely exited the traditional oil and gas lending space. Many others have new environmental sustainability considerations that are considered when assessing credit worthiness of an investment.

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Audio Transcript

Ryan Hunsaker: Hi, everyone. Welcome to Winston & Strawn's Let's Talk Lending Podcast. I'm Ryan Hunsaker, partnering up with the finance group with Winston & Strawn focusing my practice on commercial lending and finance transactions, such as reserve based financings, asset based financings, midstream financings and acquisition financings. I'm delighted to be joined today by my colleague Erin Webb, who is an associate here in our Houston office in the finance group and focuses her practice on commercial lending and financial transactions. As well as our guest speakers, Brett Fenn, Managing Director in the derivatives structuring and marketing group at Texas Capital Bank and Blake Kirshman, Senior Vice President of energy finance at an independent financial. Today we'll be discussing current trends and interest rates in energy lending as well as the markets overall and where we see things going in the future. So Brett, Blake, thank you very much for joining us.

Brett Fenn: Thanks for having us.

Ryan Hunsaker: We're very excited to talk to you all today. Figured we would kick this off just talking about the general market as a whole. Obviously, people are very interested in not only the equities market and where that's been going over the last few months, particularly since war broke out in Europe. But also the commodities market and interest rates. Interest rates continue to increase, the Fed is expected to continue to increase rates further this year which is impacting both consumers and businesses as well. Energy prices have obviously gone up as the world reopens after COVID and due to recent geopolitical and also now we're facing certain supply issues. So, can you all talk about a little bit where you've seen the market go recently and where you expect it to go in the foreseeable future?

Blake Kirshman: Just for everyone listening in the background, Brett and I have known each other probably 10 plus years. Families know each other, we coach together. We see a lot of different things and we know a lot of the same clients and I think one of the fun parts before we kick off of this is I remember we were kind of transitioning jobs at one point and a CFO that we had banked out of Dallas, Don McClure had said, You know what? You need to team up with Brett, you all are two pretty good, not to toot our horns, but you all are pretty two good bankers and you all should do some things together and I remember calling Brett and he was like I just don't think. There'd two powers combined. So, here we are. But long term relationship here, but no Brett far off on the commodity area [inaudible 00:02:37] not commodity the rates and stock market side and we'll jump in where we need to.

Brett Fenn: Ryan Hunsaker and I have served on more than a dozen RBL deals over the years. Well I'm a rates guy now, I was also a corporate banker and so we go back lots of years and it's pleasure to work with Erin as well. I've heard a lot of great things. But look from a rate standpoint as we talk about at the bank, there's not a more exciting time to actually have an opinion on this. Having done this since kind of 2003, you go through lots of cycles with rates, and the way we've been going, the Fed is lowered rates twice to near zero essentially. At that point, not a lot of people want to talk about rates because the Fed has done a much better job, or I shouldn't even say much better job, a much different job since the green spin era of the late 90s of being transparent.

I used to be on the trading desk in 03', 04', 05' where we would make little side bets about whenever the Fed would come out it would be like. All right, it's coming out at 1:00, who thinks they're hiking? Who thinks they're cutting? Are they staying the same? It was an unknown. Now, I feel like the Fed does a pretty good job of hinting at what they're going to do. Or they would say back in the 70s. Everybody wants to talk about the 70s cause of stagflation and everything we're seeing now with moderated growth was high inflation and stagflation. He would surprise the market with 200 basis points in a very short amount of time and not highlighted for his Greenspan like to give speeches. Long story short, it's fun yet it's scary. We're in an inflationary environment, no doubt. Everybody has an opinion on rates. They see mortgage rates going up. If you're a new home buyer, that freaks people out. But there's everything that we see staring us in the face, which is everything we talk about, right? Whether you're buying a car for your 16-year-old, like we're going to be doing, or you've got housing prices. You've obviously got energy prices, food prices. Those are the obvious ones, but we've got a huge number tomorrow, which would be... We're taking this on the 12th, so on July 13th, you get the CPI number, which is what moved the market a month ago. I don't want to meet after that, but it's expected to once again, be kind of that crazy high of, 8.6 plus percent, which is wild, year over year. I would just say, from my standpoint, the Fed's in a real pickle. You can say they did it to themselves, but at the same time they were given a tough hand. I'm not saying pro or against. I'd love to know if you're a Dove or a Hawk, Blake, that would be something I definitely want to get to. We printed money and you look at history, history repeats itself. You have to pay for that at some point. And so that's, that's just one aspect, but what I think what's so cool about interest rates now and why, if anybody looks you in the eye and says, "Hey Blake, I know what rates you're going to do." It's not overly true. I think the Fed is an uncharted territory. Similar to price. Although, if I can say, Blake told us at lunch, kind of a humble brag, that he did call oil prices within a dollar.

Brett Fenn: They're dealt with the decision tree that if I mapped it out between supply demand, wars, money being printed, things that are beyond their control. And I think you keep going down to FX, etc. They're kind of in a no-win situation where they're picking inflation versus growth and they've got a midterm election coming up. So, there's sub currents there. The Fed does a pretty good job with the presidency, all jokes aside, of being independent. But if you look back at notes and I was looking back at notes earlier from the February timeframe, right after we hit the all-time high in the S&P. People were saying, if this war ends soon, then volatility will be reduced and then all of a sudden you can get a market. That's going to return five to 10% this year. Now look forward where we are four months from now.

Blake Kirshman: And you are down 20%.

Brett Fenn: There's no way we're going 5-10%. We hope we're 5-10% down. And that's highly, highly, highly unlikely. I'll go through it later, but there's all bursts, as I call them. Where if this happens, this has always happened when it comes to recessionary environments and we're blowing through this list where it's like, well, here's one. If oil price is double in a year, recession follows and that's happened five times in 73', 79', 90', 00', and 08'. That would tell you that if it doubles within a calendar... Not a calendar year, trailing 12 months, it'd be like one 120 or one 130. So, I don't know what you think about that.

Blake Kirshman: I think the happy medium on all process longer term is that 60 to 90, I'm sure our producer friends like the 90 side of that better, but from an economic standpoint, when people are paying \$5 at the pump or electricity bills, \$400 versus \$200, that adds up. I don't think it's sustainable. The war, there's a lot of things that came to head also, I know we're going to get into this ESG stuff. There's a lot of wins against the oil space that occurred over the last five years. I remember an engineer I worked with for many years, 10 years ago, he'd always say these are going five-year cycles. So, if you're not investing from five years down the road, you're going to get yourself in a pickle. You're not going to see it down. So, you see it with the Gulf stuff. If you're not investing in those projects, which we weren't for the last five years, they're not coming online. You take that off this spot, then you

throw in a war, you throw in record car movement with prices. I think there's been a counter on the miles driven because people are like, wow, I don't want to deal with the airlines right now. Yes, I'd really just drive. And also there's a lot of it, it's the culture shift after COVID. There's a lot of factors that, you look at the playbook, like you just read off what has happened in the past, post COVID. I don't think you apply it. There's a lot of similarities. There's also just a different mentality from the people driving those.

Long story short, what is the happy price? It's probably in the 90 range. Will, is it probably going to hover between 80 and 110 for the next five years? Sheffield at pioneer thinks so. The day after he said it was going to be over 100 for five years. It went down to 90. So, you don't know, and what you do and what we've seen, not to jump the gun on the RBL market and the energy guys is the discipline that was applied in, we'll call it the post 2018 era, post the automotive bankruptcies. That was really the big one that shifted the post, move back a little more. I break up the RBL world into, to three segments, pre 14', 15' downturn. There was this awkward time in that 15', 16', 17' that it felt okay, but there was a lot of things structurally were done and there's that post 19' error and a lot of the deals now, there'll be something we look back on in five years, man, we wish we've done that.

But in general, structure and pricing and things have held in that RBL market that I think are healthy. And you're seeing, also the private equity guys and the public companies returning cash, hard cash to investors, which is what they said. And then you have an administration come in that says, no, just turn it on, we want it now. Ever since, not picking political sides here, ever since Joe Biden came in office. And even since things under the Trump were not conducive to oil and gas producing. So, you add a lot of things in that and here's what you have. And so, that was very long winded and reversing, back and forth.

Brett Fenn: Outstanding.

Blake Kirshman: It's where we are today and you asked me the question I wrote this down for Brett is, whether it's with the inflation going on and we can pull everybody in the room and check back in a year, you have \$10,000 to put in I bonds, S&P 500, or Bitcoin, which would you take?

Ryan Hunsaker: Is cash an option?

Brett Fenn: There you go.

Ryan Hunsaker: I think you've seen, we're not here to talk about crypto, but crypto's going through the crypto winter. A lot of people made a lot of money of that but now it's kind of who's going to catch the falling knife? There's really no end to that in the foreseeable future, seeing exchanges just go bankrupt overnight. People not able to access their coins, things like that. I wouldn't pick crypto though. Maybe there is some upside there. Definitely wouldn't pick an NFTS. I think bonds, you'll probably get some, S&P I think we've got ways down to go before we go back up. So, I'm not joking when I'd say cash, but maybe not all cash, but a lot of cash.

Blake Kirshman: What cash?

Brett Fenn: First, I bonds have a limited, how much you can do per year. So, just going to-

Blake Kirshman: That's why I said 10,000.

Brett Fenn: I think, side note on crypto, I view there's a future there just from the infrastructure that's in place. I also view it, I think in a weird way, there's a correlation with ESG and crypto. They're both infancy stages. You could argue that both have a long life that are going to be completely different. So, they're kind of apples and oranges. But at this point, they're figuring out who they are when they grow up. And we don't know who the winners and losers will be, but is there a future there? From talking to different funds, I can tell you, they are accepting these massive billion, multi-billion dollar funds that are international accept crypto for their investments.

They're doing test cases so there's this underlying current and then obviously we have ESG that we'll get to and that no doubt has a future. It's just a matter of, what's it going to look like?

You mentioned something on inflation. It's the hot topic right now. It's all people want to talk about. It's this weird situation where the Fed is having to hike rates when technically they would be. With inflation, you have to hike rates,

right?

Ryan Hunsaker: Cool the economy.

Brett Fenn: Got to cool the economy so they've left themselves with no choice. The question is, why didn't they height rates last year? If you looked at this chart that I've got here from Bloomberg, look at this is CPI, you have March of 21', it went over 2%. What's the Fed's mandate when it comes to price ability it's two percent-or should we...

Blake Kirshman: Or should we have never dropped rates during COVID and even some of the pain then, I think you hit on the head. They're coming home to roost, and we're going to be paying for some of the things that we've done, because you have to pay for it at some point.

Brett Fenn: Which comes back to, will there be a recession which everybody wants to talk about? Why we had to do COVID and PPP and print money, etc. But if they get inflation down to four to five, then the big question becomes, what does the Fed do then? Do they wait? Because keep in mind, every Fed hike or cut takes roughly six months to kind of reverberate in the economy. Well, we've got real time decisions making. If you look at governor Bullard, out of St. Louis, he just said recently that look, we're not going to stop and start, his view. We're not going to stop and start most likely. And we're going to have a full six to eight months at least of like constant rate movement. Well, if that happens and it reverberates, but then you've got all these cool things like for the rate geeks in the room, like the two year treasury, tenure treasury inversion, or you could look at the three month versus the two year treasury inversion.

When that happens, there's cool stats that I can totally geek you out with where on average, if the three month and the two-year invert, it's 11 months until a recession. If the two and the 10 kind of on average, those numbers are roughly 18 months. These are tried and true numbers. But my thing is, two things. If they hike, they keep hiking until inflation comes out at 4-5% and they stop and they just chill out. People are now calling for the Fed to get to what 3.5-4%, 3.25-4% and then actually start to cut rates next year. Which to me is, I'm not a huge fan of that. I feel like that's hiking and cutting.

But one of the arguments is, there's this thing called the Fed put, which is, Hey, the Fed's always got your back. And if you're a stock market investor, right? They're going to cut rates. That's always going to create a base level. Well, they can't do that now, which is why the S&P can keep falling. But if they hike rates really quick, they can cut rates just as fast. And there's your new Fed put. So, there's a hint of let's do 75 in June, 75 in July, let's do another 50 or 75. Let's do an intro meeting cut and let's just blow the socks off this thing. Then next year we can cut rates and right after midterm elections, we can all be heroes. There's a lot of decision trees you can take there.

Ryan Hunsaker: If you're a borrower out there and you're looking at getting new financing for either, refining your existing deal or growth CapEx going forward, and you're looking at these proposed increases and potential cuts, how are you able to evaluate? Or how can you give yourself some certainty that the pricing you're going to get today or the pricing you're going to get six months from now is going to be something that you have any certainty over?

Brett Fenn: Is it all that different than how you view commodity hedging?

Blake Kirshman: It's the same in my book because I know from an oil perspective or an oil and gas perspective, as prices ran up as quickly as they did, a lot of people had been hedged, pretty severely at low prices. But at the time, I heard 90 guys were complaining since they were locked in at 60 and can't hedge anymore this year. The only reason you had to lock in at 60 is because you loved to at the time because the other price was 40 and you could lock that in but also you had too much leverage and your banks demanded it or required it. If banks are dictating your head strategy, that's a bad thing? I know every RBL deal has most, especially on the lower high yield and single BWS have some sort of hedging structure that really hasn't fallen away.

But the guys that manage their balance sheet, every deal we've done this year, we've done 17 new deals this year. I think maybe one has been over, one times levered. It's just, it is unbelievable, and it's priced well. The structure and pricing have stayed in the RBL market.

Blake Kirshman: From that standpoint, it's been nice to see. Now what is the next thing? Because another banker called me and is like, how are you evaluating energy deals these days? I was like, well, very similar to how we always been, it is asset base and management teams. It really goes down to those two things. If you're doing a tier three asset with a tier three management team and a hundred dollars hole, you're probably fine. When it all goes down, you're probably not going to be fine. Guys who I have done business with for many years that know how to operate, know how to bring in the people to operate the right basin. You're in tier one, tier two, or well-priced tier three basins entry price, and ability to lock in. It's pretty good. We've seen a lot more deals start sliding across the desk where it's like, we're good, thanks a lot, good luck to you. And I think with, with a sustained high oil price, work over rigs, come out. Everybody gets smart instantly and I think we'll see more of that, but from what I've seen and knock on wood, the discipline has stayed both on the borrower and the lender side and it really need those to be synced up to have a strong market like that.

Ryan Hunsaker: Well, and you've seen more traditional banks either get out of the space to internal policies via ESG, be it societal pressures of just, oil being perceived as not something that's desirable given climate change, or just because they took losses in the last downturn. So, as you've seen fewer of the commercial banks continue to provide that financing, are you seeing more of, at least from what we've seen, you're not really seeing borrowers pushing covenant levels like you used to at the height of the prior peak, you're not seeing the increased labor ratio. You're not seeing the looser covenants.

Blake Kirshman: In the prior cycles, you had 60 to 80 banks, depending on if you include the European investment banks or the small regionals that step in. Honestly, being one of the active banks in the space since 19', when this group came over to independent financial, it's 20, maybe 30, all the big guys, they pick and choose what they're doing. They're leading the right deals. But when you only have that many banks to fill out a significant amount of RBLs, it's on the lender's terms and they get to pick and choose and one thing we've done and think we mentioned them 17 or 18 deals we've done so far this year was it's been on deals where we know the management team, we know the sponsor, we know the family office or whoever we're doing it with.

There's a deep relationship and it's through multiple cycles, so Blake and Brett and Ryan get their oil and gas and go out tomorrow and try to raise the thing like, all right, what have you done? Well nothing, we did a podcast once and it was wildly successful, know something like that. So, the market is very much constrained. If you talk to the major syndication of wealth, they're going to tell you, it's hard to raise the dollars. And it's like a two to \$400 million RBL can get done. It's no problem. It's the five to \$1 billion RBL. When you go from, like I said, 60 to 80 to 20 to 30 normal participants falls apart-

Ryan Hunsaker: Squeeze in the market.

Blake Kirshman: ...and not only that, they all learn their lessons. Wait, if I take a 100 million of an RBL and it goes bad, that's a big Hickey. But if I take 30 million of our RBL, I can manage through that. And so amendment levels are down. There's just a lot of lessons have learned. And unfortunately it's guilty by association. So, whether you're a great company or this, the lessons of the past are going to be applied to you. Like I said, in five years, I hope not, but there's going to be something that's like, man, we really should have thought about that. We've got the science dialed in, but there's always going to be something. Something's going to shift. Something's going to break that you're like, wow, we should have thought about that.

Ryan Hunsaker: Thank you all again so much for joining Erin and I today. And thank everyone for listening to our Let's Talk Lending Podcast. You can subscribe to the podcast via Apple, iTunes, or Google, or by visit the Winston & Strawn website for more insights on the latest market updates and trends in the finance practice area.

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