

Let's Talk Oil and Gas Loans: Financing the Energy Evolution (Part 2)



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

Highlights from this episode include:

- Breakdown of renewed interest in alternative financing structures and if they see those being a renewed focus for financing going forward.
- Predictions on interest rates and oil prices in the future and how companies can protect themselves from further increases.
- Their perspective on if there is room for further commodity price increases and where they see prices going in the future.

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Audio Transcript

Erin Webb: Welcome back to Winston & Strawn's Let's Talk Lending podcast. I am Erin Webb, a Finance Associate in the Houston office. This is part two of the Let's Talk Oil & Gas Loans: Financing the Energy Evolution featuring Ryan Hunsaker, a Finance Partner in the Houston office. We are joined again by guest speakers Brett Fenn, Managing Director at Texas Capital Bank, and Blake Kirshman, Senior Vice President at Independent Financial.

Ryan Hunsaker: Tying that back to commodity prices, you're saying, okay, so long term, you're thinking 60, 90 bucks, depending on where we are.

Blake Kirshman: I notice how I gave a really wide range.

Ryan Hunsaker: Well, I was going to say, depending on where we are on any given day, these days, I mean, it's down 9% today. You're in the triple digits not that long ago. So in order to get to that 60 to 90 bucks, you're clearly going to need more production. Right? OPEC has said, "We're tapped out. We can't turn on the plugs or spigots any more than we currently have at least for a foreseeable future." So if you've got US companies who are out there and now ramp up production because for the last few years, for the variety of reasons we talked about, they just haven't had the incentive to do so. Where does that capital come from?

Blake Kirshman: A lot of it's going to have to come from the equity side, to be honest. I think that's been the case. I know Brad and I were talking about S&P energy fund stats earlier and money's flowing back in. It's not flowing back in as quickly as I thought it would, obviously there's a hanging from our recession, but from a debt side, there's level that's needed from the commercial banks and corporate banks. You still have a lot of the deal activity that comes in from the A&D market and honestly, there's a lot of sellers and there's not a ton of buyers. There's a lot, if you're smart buy low, sell high. That's a genius way to do it. I wish I've done it more in my life. At the same time, there's only so much capital and a lot of the valuations on the public companies don't make economic sense to make that purchase.

If I paid 3X for something where your stock trading at 1X, just like, it's hard to use the currency when the equity markets, if they get back in line in terms of the valuations, they can start using that to deploy on the acquisition side. But if they do get in line having an empty war chest, as we've seen in the past, sometimes not the best thing. So

strategic acquisitions, I add the word strategic there, very key, but from a lending perspective, what's going to fill it? There's been some VPP stuff. I know you said you've worked on a few of those. I've heard it from family office things. We keep up with different pools of capital. It's challenged and that's the best way to put it.

There's the high yield and a lot of times I think there's been one or two, I think two EMP companies. Hilcorp and Earthstone. Earthstone has made a ton of acquisitions termed out revolvers. Hillcorp was terming out something else and so that made sense. Would they do it in that market? I bet they're glad they did with the rate rises. I think the energy issuance will be one of the lowest ever this year, and I'm not a high-yield energy guy so that's answers your question on where they are going to come from. Brett, you spent a lot of time in that world. What do you think?

Brett Fenn: I think it's so interesting... energy is so cyclical. I mean, we look at just the last 10 years, and here we were in 2013 and there was a new portfolio company announced every week, but always had an animal name and a color name. Then there was also a new regional bank. Like you mentioned, at one point, there were probably 70 to 80 banks and they were new. So these were privately held companies and they were buying off from the majors and all of a sudden you got the downturns. You couldn't do a lot and now you've got consolidation. Now can you access the capital markets and you got these little pockets being filled in between.

There was a VPP shop that popped up down the hallway from us last year with guys that used to be on a trading desk of a large firm. They get VPPs because you have to hedge a lot of that production, so they got the point. But at first they were doing up to 20 million and their view was it's 20% roughly. It's kind of smaller deals, but it's very binary. They can't get financing for these smaller deals because that doesn't exist as much anymore. So they either did it or they didn't. If they did it, they could do the project. If they didn't, take the VPP and the 20%, they didn't do it at all.

Then all of a sudden they just got inundated in the last seven months with deals, true story, to a point where now they upped it to like 50 and they were raising a fund for 300 million because the need was there to your point about where's it going to come from. Then you see people doing securitizations to fill another gap for a couple hundred thousand or a couple hundred million. And then you got the capital markets acting like they are. It's just EMP seems to evolve to some extent.

Blake Kirshman: I've used this line a lot with clients and other bankers or bank leadership over the years is there's a few things that have to occur for a healthy upstream environment. You must have a healthy environment. You can't have an over-tapped services industry. You can't get wells, you can't get sand, you can't get crews. It has to be a vibrant service industry to support the upstream industry. They are now having their time in the sun, but when it was negative oil and everything was being shut in and it was really bad times and you kind of look out and you're like, yeah, you're getting a lot of rig deals done right now. But at the same time, we know what's coming when prices go up. The second to that kind of tripod is the RBL space. If you don't have a healthy and vibrant RBL environment, you cannot have a upstream environment.

Then the third of the tripod is the borrower, so the upstream company. You have to have those three. They're disproportionate in their value and whatnot. But if one of those three are struggling, then you've got a problem. That's a very high-level way to look at that space.

Ryan Hunsaker: So obviously there's been a lot of focus recently on returning to oil, returning to traditional energy sources. But I think we all know that ESG hasn't gone away and isn't really going away anytime soon. There's definitely a push for alternative energy, which I think people can debate about how that fits in with the overall energy capacity and production. Both in the US and abroad, but Brett, to your earlier point, this is all still in its infancy, right? So ESG is hot. It's new. It's up and coming, but it's still reliant to a certain extent on governmental incentives and things which can expose it potentially to risk factors that traditional oil and gas have just moved past because that's a much older, well-developed industry. When it comes to ESG, and I think Erin and I wanted to talk about that a little bit more. Where do you see capital coming for ESG and do you see it being a place where commercial banks are there in terms of actually being able to provide financing that's not kind of tax credit based, or project based? Or do you think that we're still to use a term we talked about earlier. Do you think we're still the first inning of the game?

Blake Kirshman: From a regional corporate banking, commercial banking standpoint, I think we're pretty far. I think the ones that are going to set the path are the JPs, the wells, the city, the big four. And then the other side of that is

our friends across the pond and our friends in Japan on the banking side are very interested in this. I came from BBBA, was there for 15 years. They spent a lot of time investing in the ESG side. There was a lot of meetings, a lot of pitches. I've yet to see a pitch where I was sitting there going, "Man, they're going to do this tomorrow." But the thought generation and leadership that the European and some of the broader US banks are pushing is great.

It's just, is it viable? I'm not going to debate that one way or the other. There is a place for it. In my opinion, it's an all energy kind of thing. I think nuclear, I think natural gas is a huge piece. And I think that's the change post-Ukraine, post-COVID, is I think pre-COVID, pre-Ukraine War, pre-that, the LNG was a good piece for gas, but I think the Europeans have adopted that as that's an acceptable piece. It didn't help that Putin shut off their gas pipeline that was funding all their stuff, but they realized energy security is national security. Energy security is that and that's where I've said this before. From an energy perspective, I think the industry needs to step back and be proud of what they've done.

We had some guys come in from Madrid for an offsite called 18. The Jeremiah presentation to them was I pulled up the Jimmy Carter 1973 all-embargo speech where we're going to ride all in 19, I forget the date, we'll call it 1990. I played it for them, and oil and gas stations were closed three days a week. A lot of listeners will remember these days. I wasn't born yet at the time, but I've gone back and appreciate the history of it. We don't want to go back there. I think if you could give me a green option versus that with equal cost, I'm going to take the green option. If you give me a green option and a traditional option, and it's 3% higher, I'm going to take the green option because I like being outdoors. I like clean air. If you're going to the green option at 120% of the cost, I'm not going to do it and neither can the economy or the average citizen. And so I think that's where it comes down. I think it is in the first inning and it's going to evolve a lot and our kids will benefit from the investment that they're doing today.

Brett Fenn: I go back last year, and I think about the environment. So there were days when I would talk to Ex-RBL bankers or current RBL bankers. And they'd be asking about what does diversified banking look like? I mean, you just go back and you think about how much has changed in nine to 12 months. And you had Ex-CEOs who sold their portfolio companies at a discount, who are now trying to raise money... Which by the way, like you said earlier is really hard to do when you don't have a background and some success level to build upon. And they were doing carbon capture, because that was kind of the sexy topic at the time. And then you kind of fast forward and part of the problem is it's somewhat of a moving goal post so I believe it also is the super early stage.

I just think it's really hard to pick winners. There's so many EMPs who have built additional arms, like take privately held funds who raise LP capital. Maybe it's from pensions, endowments, whatever. And they've also, many of whom have changed their names from whatever resources to just something generic because that was popular or needed to happen nine months ago to raise money. Now it's changed a little bit. From a banking standpoint, you've got project finance folks that have always been around. Solar and wind is nothing new. These are just larger projects that are always been hard for banks, commercial banks to finance, period. It's just is. And then now they've got these sustainable finance and alternative energy groups, but they're all in infancy stages. So just to answer your question, you said, "Where does the money come from?" I think it's equity risk. I don't think a bank is ready to pick winners when you've got all these people throwing pitch books at them, but nobody has a history. So if anybody comes at you and they're like, "I'm an expert in this." I don't really believe it unless they can somehow prove it. I think they were reformed upstream or something type of a person with some kind of engineering background.

Blake Kirshman: And I think too, and you hit on a good point there. I covered a lot of the midstream, both investment grade and high yield at BVA prior to coming over to the independent financial. What I saw helping build out that midstream vertical there was a lot of the, especially the investment grade midstream guys and even the higher high yield midstream guys, they were printing a sustainability report because the stockholders want it or the institutional investors want it. They've been doing it for 20 years and whether that's in the community, how they operate on a safety basis and that's just how they did the business. That's a really cool thing to see. It's almost like they're bragging on the sustainability reports, but we talked to a lot of CFOs, treasurers, COs they're actually doing it. They've been doing it.

It's good to highlight that because I think, I don't know if it's the IPAA or whoever the main kind of lobby for the old business has done a poor job. Not to throw them out under the bus but if the energy security we offer, the things we've done from a green perspective as an industry and as a whole and advertising that to the public. I saw energy

transfer, we were watching the Astros game and they had a commercial that they played through the world series and they still play it. They said, "All this comes from oil and gas." It was more of an educational video and you're seeing that done by a public company versus a lobbying organization. I think that type of education is helpful when someone pulls up to a gas pump and is yelling about \$6 gas or... It just helps. It helps define it. Not to digress, but from an energy perspective, I think the advertising industry is spending dollars and from whether it's a lobbying or just a public information piece is helpful.

Erin Webb: Can we kind of go back to how companies hedge interest rate risk?

Brett Fenn: Yeah.

Erin Webb: A little bit about that. Look, my standpoint of having done both rates and energy for the last 20 years mainly is controls you can control. That is not a recommendation to lock prices, whether it's commodities or rates. Every borrower is a little different, but there is a reason why many boards of publicly traded companies, even privately held or even private equity sponsors, have some kind of mandate. You need to be hedged for this amount of time. Commodity is, of course, calendar years. And interest rates, it's usually fixed floating mix. So the stronger you are on the credit scale, so if you're publicly traded in your investment grade, they're going to be more floating than they are fixed. They can handle it. They probably have more cash on hand. They have access to capital markets.

But when you get to privately held borrowers across anything, you're technically lower on the credit scale, you don't have access to capital markets. Let's take the most simple capital structure. You got a revolver that's floating. Maybe it's seasonal, it's working capital up and down and you got a term loan. Maybe it's from an acquisition or maybe it's real estate, all the above. You generally see people fix the term debt, float the revolver, and have some kind of mix between fixed and floating. Alternatively, I cannot say how many meetings I've been in where CFO will say, "I don't take a view on rates. We're staying floating." Well, alternatively, we fix everything. Well, that's a total view on rates. That's why you see a lot of boards kind of target of a 50/50 mix. Goes back to controls you can control. If you have a two-year tenor, maybe you're less concerned. If you have a five or a 10 year maturity, you're probably a lot more concerned.

As I look back on the years, EMPs traditionally do not hedge interest rate risk. Why? Because that is such a small percentage of the risk compared to commodities. However, if I look back and I think back to the 15 years ago, you had privately held fund structures that were LP based, family office based, whatever, they were hedging calendar years kind of one, two and three years out. So I suspect you're going to see that a little bit more right now and we'll see what inflation comes out at tomorrow. You'll see the Fed on July 27th.

Ryan Hunsaker: So if you had, as we've come to the end here, if you had to guess about tomorrow, what do you think the number is?

Brett Fenn: Oh, I think the number comes out. I mean 8.6ish percent and it's going to be year over year. It's really what does the outlook look like? And personally, I'm going to pay attention to the VIX index just to throw that out there. The VIX is such an important aspect of what we're doing right now. Usually when a Fed enters a hiking cycle, the VIX is like at 17 and this time when they kicked it off, it was at 26 and there's all kind of empirical evidence that says when the VIX hits 34 to 36, that's a time that the stock market actually rallies. So if you look back this year, we hit our highs in January. We have three bear market rallies and we're kind of ending one. This week, we've seen a bunch of down, but coming into it, we were up 6%. So that's the third bear market rally we've had. What were the VIXs in the days leading up to all three bear market rallies, 34 to 36. So you had 11% jump that lasted about three weeks back in March. In May, it lasted about three weeks. It was 7%.

Brett Fenn: So those are kind of things that you really want to also pay attention to just outside of just inflation by itself.

Ryan Hunsaker: Blake, if you had to guess on oil prices where you see them landing?

Blake Kirshman: That's funny you ask, I just wrote down a number because I figured that was coming. I think for year 12/31/22, I'm going to take a 86-53 crude price. That's U.S. And then I think on natural gas, I'm going to go, I'm

going to 7.89. Brett, what do you with a major commodity background and I'm writing this down. So I'll remember.

Brett Fenn: I'm somewhat restrained from giving an opinion on that. But I will say that I think there's been talk over the last nine months about a commodity Supercycle. And if you're a student of history and you go back to the '70's very easily, you can convince yourself that we're at elevated prices for longer than most people are used to, which I would put myself in that camp.

Ryan Hunsaker: Well thank y'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 visiting the Winston Strong website for more insights on the latest market updates and trends in the finance practice area. So Brett, Blake, thank you again for joining us. Think this was very informative and hope everyone gets as much out of it as we did.

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