2017 Distressed Investing Summit

RUNNING OUT OF STEAM: ENERGY SECTOR IN DISTRESS

Patricia B. Tomasco, Jackson Walker LLP, Moderator
The Honorable Tony M. Davis, U.S. Bankruptcy Court, Western District of Texas
Brian Lennon, Kirkland & Ellis LLP
Monty Kehl, Huron Consulting
Doug Fordyce, Lazard Freres & Co. LLC

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Discussion Outline

- Principles of energy commodity pricing
  - SEC rules versus market value
  - PDPs, PDNPs, PUDs, etc.
  - Commodity driven enterprise value/projection periods

- Contested Valuation
  - What valuation techniques work
  - How do Courts address timing of valuation/projection lengths

- Fulcrum Security
  - Effect on plan negotiations
  - Negotiation strategies
  - Out of the money constituencies
  - “Products” to address future fluctuations in value
Linn Energy

- INSERT CAPITAL CHART AND RECOVERIES HERE
Midstates Petroleum

- Insert Chart here
Asarco

- Price of copper at petition date
- Price of copper at confirmation
- Issues relating to litigation against parent
Principles of Commodity Pricing

- SEC pricing rules versus market valuations
- SEC impairments due to lack of capital
- Effect of SEC valuations on negotiations
  - Sale versus reorganization
  - Projecting access to capital
- Fluctuation of Enterprise Value
  - Relationship between commodity and TEV
  - Use of averages and points in time commodity prices
  - Liquidation values (assume capitalized buyer?)
Valuation Disputes

- Valuation methodologies
  - DCF
    - Projections vary with commodity prices
  - Comparables
    - Comparables differ play by play

- Impact of commodity price fluctuations on TEV
  - Percentage effect of commodity price on typical E&P

- Diminution claims under cash collateral orders
  - Should diminution include commodity price fluctuations

- Structural evidence of plan fairness
  - When higher classes accept less than par
Fulcrum Security

- Defined as highest impaired tranche in capital structure
- Lower tranches are out of the money
- Commodity fluctuations cause movement in fulcrum
- Projected future commodity prices and SEC-driven backward-looking valuations can affect negotiations
Products to Address Future Value

- Out of the money warrants
  - Priced at higher enterprise valuations during a specified future time period
  - Liquidity Event Protections
- Option to invest in capital raise
- Smaller allocations of equity
  - <10%
  - Used in simplified structures
- A Contingent Value Rights (CVR) is a type of option that can be issued by the buyer of a company to the sellers. It specifies an event, which, if triggered, lets the sellers acquire more shares in the target company
Option Protections

- Term of Options
  - What is typical term
  - How does strike price relate to assumed plan enterprise value

- Cash–Out Protections for Options
  - Liquidity event before end of term
  - Less than option strike value
  - Option pricing using Black–Scholes Model
  - Issues around calculation of volatility
Sabine Warrant Terms

- Tranche 1 Warrants
  - 10 year Tenor
  - 15% of Company Equity
  - $1 B TEV Strike with Cashless Exercise
  - Minority protections and certain covenants
  - Black Scholes Cash-Out Protections
    - Black-Scholes Merton Option Pricing Model
      - Knowing the (i) Current Price, (ii) Strike Price, (iii) Remaining Tenor (days until expiry), (iv) Riskless Rate, and (iv) Implied Volatility of the Security
    - Warrants provide that in the event of a Company Transaction:
      - Warrant holders get paid the Black-Scholes value of the warrant at the time of the transaction
    - Key Open Issue is Volatility
      - Agreement fell away and left open to bank to determine
      - Volatility is a key driver of value in the model
## Effect of Volatility on Recoveries

<table>
<thead>
<tr>
<th>Illustrative Second Lien Recoveries</th>
<th>Implied Volatility of Warrants</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>50%</td>
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<tr>
<td>Total Claim</td>
<td></td>
</tr>
<tr>
<td>Total Claim</td>
<td>$ 730.00</td>
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<tr>
<td>Primary Equity Value AP</td>
<td>20.00</td>
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<tr>
<td>Primary Equity Value Def.</td>
<td>2.70</td>
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<tr>
<td>Tranche 1 Warrant Value</td>
<td>30.40</td>
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<tr>
<td>Tranche 2 Warrant Value</td>
<td>6.00</td>
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<tr>
<td>Second Lien Recovery $$</td>
<td>59.10</td>
</tr>
<tr>
<td>Second Lien Recovery %</td>
<td>8.10%</td>
</tr>
</tbody>
</table>
Breitburn

- Doug to Add Warrant Protection deal terms here.
To cram down an immediately Junior Class or Complete a 363(x) Sale, the Plan or Sale must provide:

- ROV means the value of a hypothetical option to purchase the entire firm at a price equal to par plus accrued on the Senior
  - Paid to the immediately Junior Class only
- 3 year Option from Petition Date
- Value determined using Black-Scholes (or other)
- Form of option consideration determined by Seniors
  - Cash out at plan or sale
  - Debt or equity allocation
  - True exercisable option

Requirement could lead to earlier option based settlements

May shift disputes from Value to Volatility