2017 Distressed Investing Summit

RUNNING OUT OF STEAM:
ENERGY SECTOR IN DISTRESS

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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

Illustrative Second Lien Recoveries			
	Implied Volatility of Warrants		
	50%	**70%**	**100%**
Total Claim	$ 730.00	$ 730.00	$ 730.00
Primary Equity Value AP	$ 20.00	$ 20.00	$ 20.00
Primary Equity Value Def.	$ 2.70	$ 2.70	$ 2.70
Tranche 1 Warrant Value	**$ 30.40**	**$ 47.80**	**$ 65.90**
Tranche 2 Warrant Value	**$ 6.00**	**$ 10.00**	**$ 14.10**
Second Lien Recovery $$	**$ 59.10**	**$ 80.50**	**$ 102.70**
Second Lien Recovery %	**8.10%**	**11.03%**	**14.07%**

Breitburn

- Doug to Add Warrant Protection deal terms here.

363(x)

- 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