




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
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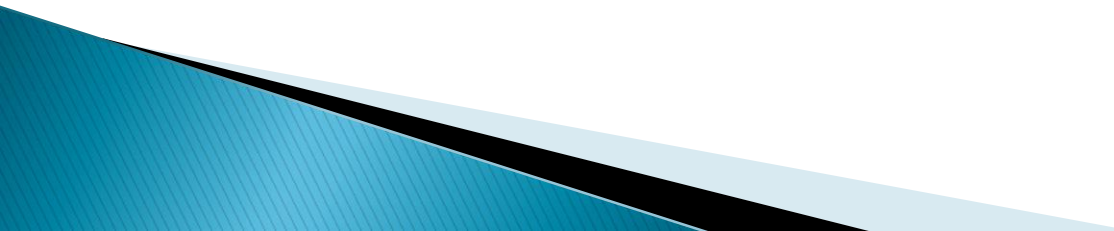
Linn Energy

- ▶ 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
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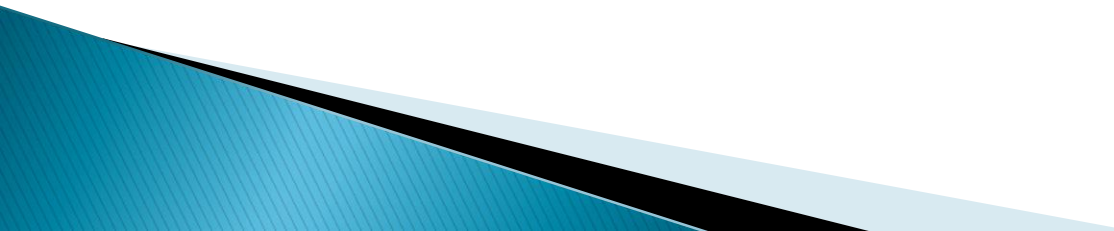
Principles of Commodity Pricing

- ▶ 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

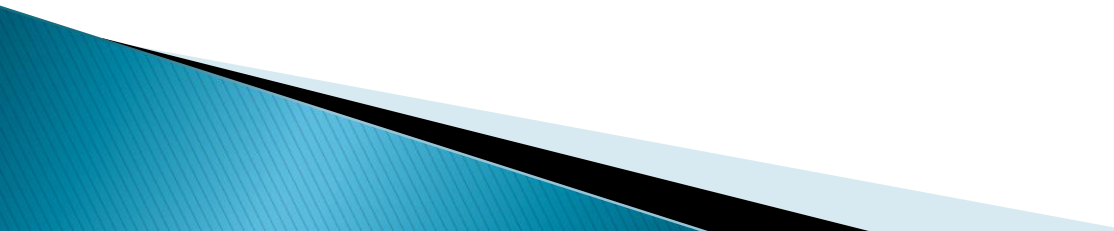
Fulcrum Security

- ▶ 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
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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
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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