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2020: The Year of the Oil Bankruptcies

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A bankruptcy boom has hit the oil and gas industry, and it's just getting started. Investors have lost their appetite for shale, and energy debt has become among the least desirable in the market.

The industry has been teetering on the verge of mass hysteria for much of 2019 as a record number of energy companies folded.

According to Energy and Restructuring law firm Hayes and Boone's, a grand total of 50 energy companies filed for bankruptcy during the first nine months of the year, including 33 oil and gas producers, 15 oilfield services companies and two midstream companies.

In contrast, 43 oil and gas companies filed for bankruptcy for the whole of 2018.

The biggest oil and gas bankruptcy of the year–indeed, the biggest since 2016–was EP Energy, which filed for bankruptcy in October, unable to pay back some $5 billion in debt.

Now, some observers are warning that the shakeout will pick up serious momentum in 2020.

Bingeing on Debt

During the latest shale boom, the putative class valedictorian of the modern energy industry, American drillers binged on mountains of readily available debt as they capitalized on investors and financiers willing to gamble on the premise that fracking operations could be significantly cheaper and more efficient than conventional drillers.

Before long, oil markets were flooded with a deluge of the commodity far outstripping demand. In what few could have foreseen, the US became the world's largest oil producer, with its nearly 13 million b/d output turning it from a net importer to a net exporter of crude. Predictably, prices tanked by a sizable margin, dropping to levels well below the breakeven points of many drillers.

Suddenly, investors became wary of the shale industry and energy debt became anathema.

They have good reason to be scared.

Companies with junk-rated bonds have been defaulting on interest payments at record levels, while dozens of smaller drillers that had saddled themselves with too much debt have been dropping like flies.

Now analysts see this taking an even sharper turn, with more mergers and more debt restructurings required to get the industry back in shape.

As Ken Monaghan, Amundi Pioneer co-director of high yield, has told CNBC:

> “We’re at the early stages [of the shakeout]. The problem is some of these companies still have a bit of rope to go. they don’t have [debt] maturities that are coming up in 2020 and 2021. They’re going to try to outrun the clock and hope that oil prices move higher.”

Michael Bradley, energy strategist with Tudor, Pickering, Holt, has expressed a similar sentiment, saying that the market is no longer rewarding energy companies with aggressive expansion schemes, preferring instead to see profits and money returned to shareholders.

> “Most people are saying we don’t want you to spend money on growth. We want you to give the money back because you guys are dummies.”

Monaghan says there are more distressed companies in the energy sector than in any other, with energy bonds only recently moving to the green after remaining in losing territory for much of the year thanks to the latest oil price mini-rally.

Bradley estimates that about $30 billion- $40 billion of high-yield energy debt [bonds] is now at risk. These companies have little choice but to seek bankruptcy protection and restructure if they hope to live to see another oil boom.

Catch 22

Shale drillers face a catch 22 situation because of the very nature of their business. Young shale wells decline at notoriously fast clips, with many depleting 70 percent to 75 percent of their reserves in the first year, thus forcing shale drillers to continue drilling new wells to replace lost supply. But with a freeze-out in debt and oil prices still low, they are bound to find it increasingly hard to keep up production.

Bradley sees many mid-cap oil companies resorting to mergers in order to survive with an estimated $2B-$7B in M&A deals over the next two years.

These won’t be the usual gilt-edged mergers with fat premiums, though, as the tie-up between **WPX Energy** and **Felix Energy** has proved. This was a smart and sober $2.5-billion tie-up that reflects the fact that investors have soured on the sector.

In other words, the consolidation wave that everyone seems to expect is going to focus on smart deals, or none at all.

This also means that large-cap independent players such as **Concho Resources Inc**. (NYSE:CXO) and **Diamondback Energy Inc.** (NASDAQ:FANG) are likely to see their market shares grow.

Ultimately, the ongoing shakeout is likely to leave the industry in a much better patch, though not so much for the consumer who will have to contend with higher oil prices thanks to higher levels of production discipline.

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