THE M&A ADVISOR

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THE M&A ADVISOR SYMPOSIUM REPORT

Featuring

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JP Hanson
Head of E&P
Co-Head of Energy Practice
Houlihan Lokey

Keith Maib
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Pavle Sabic
Director, Credit Market
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STALWARTS ROUNDTABLE
RUNNING OUT OF STEAM: TROUBLE IN THE ENERGY SECTOR

Executive Summary

Despite a modest recovery in the first quarter, oil's sharp price decline in the second half of 2014 continues to send shockwaves through the energy sector and is likely to continue reverberating for quite some time.

In this session at the recent M&A Advisor 2015 Distressed Investing Summit in Palm Beach, Fla., five energy finance and restructuring experts shared their insights on the industry's current state of affairs and touched on several key issues:

- The implications of what is projected to be a long-term supply glut.
- What declining prices will mean for restructurings now, in the near future and in upcoming years.
- The challenges for energy services companies and leveraged E&P companies.
- Why changes in credit markets have made this cycle different from previous cycles.
- With resets looming, what may happen if borrowers cannot meet the terms of their loan covenants.

Presented by

Mackinac PARTNERS

HOULIHAN LOKEY

Vinson&Elkins LLP

From The M&A Advisor

The unexpected and severe collapse of oil prices last year has made energy Topic "A" among restructuring and distressed investing professionals. While the full ramifications of the industry's new economics have yet to unfold, the future of the energy business was a prominent part of conversations at our recent 2015 Distressed Investing Summit in Palm Beach, Fla.

Many of these conversations took place informally over breakfast and lunch — and, on the evening of Feb. 22, at a reception at the former Kennedy Winter House hosted by the home's current owner, John K. Castle, Chairman and CEO of Castle Harlan, Inc.

The formal discussion took place during our Stalwarts Roundtable on energy, the highlights of which are covered in this Symposium Report presented by Mackinac Partners, Houlihan Lokey, and Vinson & Elkins LLP.

After an insightful overview of the current energy scene by Pavle Sabic of S&P Capital IQ, our esteemed Stalwarts Roundtable panelists — Farley Dakan of Mackinac Partners, JP Hanson of Houlihan Lokey, and Bill Wallander of Vinson & Elkins LLP — led by moderator Keith Maib of Mackinac Partners, explored the challenges and stresses the energy industry will face in coming months and years.

Our energy session participants — like those in the Summit's eight other Conversations, Roundtables and a special Case Study on Detroit's restructuring — are the preeminent experts in their respective areas. The M&A Advisor greatly appreciates their contribution to the Summit and we are pleased to share their informed perspectives with you.

David Fergusson
President and Co-Chief Executive Officer
The M&A Advisor

Contents

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What's Happening in Energy

To set the stage for this Roundtable discussion, Pavle Sabic of S&P Capital IQ provided attendees with an overview of the current state of the energy industry.

"It's really about three questions: Where will prices go? Will they recoil to their highs? And have they reached the bottom?"

"It's really about three questions: Where will prices go? Will they recoil to their highs? And have they reached the bottom?"
– Pavle Sabic

Supply and demand imbalances are driving oil prices, he said. On the supply side, Sabic noted that U.S. production reached 9.2 million barrels per day at the end of 2014, up from approximately 7 million barrels per day at the end of 2012. Meanwhile, U.S. demand has remained a relatively unchanged from 2012, at about 15 million barrels a day. The increase in supply and unchanged demand has resulted in a repricing of credit risk.

"CDS spreads have blown up and have widened significantly," he said.

Looking ahead, Sabic said that S&P Capital IQ is not forecasting prices above $80 per barrel for Brent crude or $75 per barrel for West Texas Intermediate for the next year — and is not forecasting prices beyond 2017.

Against that backdrop, Sabic said he sees "an interesting" environment for mergers and acquisitions and restructuring throughout the industry.

Why Energy Is on Everyone's Radar

Keith Maib, Senior Managing Director and Co-Head Financial Restructuring Transaction Advisory & PE of Mackinac Partners, began the discussion by introducing panel members — Farley Dakan, Managing Director of Mackinac Partners; JP Hanson, Head of E&P and Co-Head of Energy Practice at Houlihan Lokey; and Bill Wallander, Parner and head of the Vinson & Elkins LLP restructuring practice in Dallas — and noting that the last seven years have been a lean period for those specializing in energy-related investment and advisory.

"How did we get to energy being on everyone's radar?" he asked the panel members.

The answer is two-fold, explained JP Hanson. First, the U.S. energy industry has been a fertile ground for investment for many years, largely because of the rise in commodity prices. Part two, of course, is a result of the recent decline in those prices.

"Now, the focus has shifted more toward distressed opportunities as commodity prices have fallen," he said, noting that today's seemingly sudden supply-demand imbalance stems, at least in part, from Libya coming back online with production of some 650,000 to 800,000 barrels per day.

"But stagnation in the European economy slowed demand a lot faster than expected, and the declining growth trajectory in Asia, particularly in China and Japan, has been more protracted and a lot more pervasive than initially expected," he said, adding that excess supply is now going

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Houlihan Lokey

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into storage, which is at all-time highs in the U.S. and around the world. That puts pressure on the marginal price of oil.

"So let's get to what may be the most important question in this room — is this going to be a ripple for restructuring or a tsunami?" Maib asked.

Ripple or Tsunami?

Hanson said he believes the industry is in the very early stage of its restructuring — "call it the bottom of the first inning."

"We're at the bottom of the first inning. The real industry restructuring activity could be yet to come."
– JP Hanson

The companies currently going through restructuring, he noted, were those "at the cliff's edge" before the current price drop because they had taken on too much debt. The decline in oil prices "was just the swift wind that pushed them over."

In the next wave, Hanson said, "you'll have a mix of companies with sub-par assets and those that have good assets with bad balance sheets." The issue, he noted, will be figuring out where to best invest and where to match the capital allocation.

Reporting on the mood at the recent NAPE Summit, a large meeting oriented to upstream producers, Farley Dakan said that attendees were "still putting on a smile and a façade that everything's going to be OK, hoping for that price bounce-back that could rescue them all."

But if pricing stays low for six months or a year longer, he said, "there's going to be some real trouble."

Answering Keith Maib's question about the industry's liquidity, Dakan noted press reports that some operators are out seeking capital to sustain them over what could be a period of trouble.

"Currently, it's all about what to do with acreage not currently held by production, what to do with work in progress that's effectively uneconomic today, how you allocate capital, and how you deal with your current debt and debt covenants," Dakan said.

A Matter of Hedges

Noting that companies facing the problems outlined by JP Hanson and Farley Dakan typically seek advice from their corporate attorney and bankruptcy experts, Keith Maib asked Bill Wallander about the advice he his giving his clients and what he believes lies ahead.

"People are in the reassessment phase right now, and to understand what's coming, you have to look at a company's credit facilities and their hedges, which supplement their revenue," he said. "The companies have to look at when their hedges roll off. In the meantime, they're actively trying to cut costs and expenses, which is having a direct and immediate impact on the service sector."

Wallander said that redeterminations — the periodic reassessment of equity interests in estimated energy reserves — that are coming in April probably won't be especially hard hitting. But subsequent redeterminations "will have a much more significant impact on liquidity," he predicted.

Energy services companies currently are under "tremendous pressure," Wallander said, in part because they have nothing to offset the decline in revenue. Many energy and production companies, on the other hand, have hedged their positions.

> "Some E&P companies went naked last fall and some did three-way hedges. Whether that's adequate, time will tell."
> – Bill Wallander

"A lot depends on where they're hedged," Wallander said. "Some E&P companies went naked last fall and some did three-way hedges where they get just a part of the fall. Whether that's adequate, time will tell."

He said that highly leveraged E&P companies with a shorter maturity hedge profile could face "issues."

So what's the best way for outsiders to enter energy companies' capital structure? Wallander suggests looking at the companies' high-yield documents.

"There are a lot of baskets. Some are subject to caps. Some permit an unlimited amount of new secured debt to come into the equation," he said. So if some hard-pressed owners face a choice of keeping their equity — albeit at a somewhat lower value — and paying a higher coupon versus going through a restructuring, most owners would opt for the former over the latter, Wallander said.

He's also seeing increased efforts to raise equity, or at least see if that's possible, as well as more interest in exchange offers where existing debt can be swapped for more and/or better priced debt.

"There are exchange offers that people are trying to effectuate to see if they can swap their debt for new increased and/or better-priced debt," he said.

The Difference This Time: A Massive Investment

One major difference between this energy downturn and those of the past, Wallander said, is the massive amount of capital that has been invested in energy production.

"I don't know what the number is, but it starts with a 'T', and it's an incredible amount of capital that needs to get some yield back," he said.

At $50 or $60 a barrel, prices are inadequate to produce the expected return on that invested capital, Wallander said, leading him to believe that "there's going to be a lot of out-of-court work this time."

Both he and Keith Maib observed that commercial banks have been heavy lenders to the energy industry and are at the top of the capital structure at many companies.

"Will the banks be patient and manage through a recovery or will they be forced to do things more aggressively?" Maib asked rhetorically, noting that he tried to interest a bank in taking part in the session, but "nobody wanted to talk about this."

"Will the banks be patient and manage through a recovery?"
– Keith Maib

The problem today, noted JP Hanson, is that banks are operating under a much more stringent regulatory environment than in the past, which may make extending credit more problematic.

"That's why all this capital has been circling the industry on the distressed side because there's an opening to alternative lenders to step in and provide capital when regulated banks no longer are able to," he said.

As problems emerge and liquidity becomes precious, companies "have to take certain steps to protect the entire enterprise," said Wallander. "Often times that results in people not getting paid. A company that has to meet a payroll as opposed to timely paying a vendor…companies make those decisions all the time and they have to make those decisions to keep the enterprise going."

Sophistication in Distressed Debt and Bankruptcies

Responding to a question from an attendee concerning the possible impact of today's more sophisticated distressed debt market, JP Hanson observed that "there's now a voraciousness and a rapidity to which capital can get deployed, and there's been a wave of funds looking to raise dedicated capital in oil and gas. You don't see that in restructuring broadly."

When asked about the number of Chapter 11 filings expected in 2015, Hanson said he expects to see fewer than might be anticipated, but that may change in 2016, if commodity prices remain in this zip code.

"The majority of E&P upstream producers are significantly, if not majority, hedged. They'll live off those hedges. Ultimately, of course commodity prices matter, but in the short-term it isn't quite as pressing an issue for those that are significantly to majority hedged," he said.

Hanson predicted that companies will pull several levers: they'll go to service providers and squeeze down on them; they'll curtail capex and live off existing cash; they'll explore retaining assets where they have economies of scale and potentially sell off assets where they don't – which will generate liquidity and increase asset-level M&A activity. We're also seeing some new financings – long-term financing, developmental financing, well-head financing, working interest sales, and a re-emergence of over-riding royalty interest, sales and production and volumetric production payment-type financings.

"You're also seeing discussion around convertible or equity-like instruments to try to capture the upside as commodities rebound," he said, noting that much is being done to "extend the runway, which means that we probably won't see as many Chapter 11's in 2015 as you otherwise might expect. But if we're in this price environment in 2016 and beyond, that's when the real tidal wave will bound."

Bill Wallander added two points:

"If there's a liquidity crisis, some companies will get to a point where they have a large component of what I call 'stranded' debt – that is, debt they cannot deal with through negotiation or refinancing. If you couple that with the realization that the ownership of the company has to change hands, and depending on the debt structure, Chapter 11 can be a very effective tool to get a changing of hands on a very clean basis."

Second, he noted what he called a "synthetic plan sale," which does not involve a direct sales of assets (which can trigger lots of rights agreements), but rather pushes everything into the trust "that the buyer doesn't want and leave the remainder assets in the estate." New securities are reissued through a private exemption, Wallander said, and "then everything reinvests on a free-and-clear basis in the new entity."

Video Interviews

To watch exclusive M&A Advisor interviews with these energy industry experts, click on the following images:

Keith Maib

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Co-Head Financial Restructuring
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Farley Dakan

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JP Hanson

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Symposium Session Video

To watch the Stalwarts Roundtable – "Running Out of Steam: Trouble in the Energy Sector" click on the following image:

Running Out of Steam: Trouble in the Energy Sector

Presented by

Mackinac Partners

Houlihan Lokey

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Symposium Participant Profiles

Keith Maib
Senior Managing Director
Co-Head Financial Restructuring
Transaction Advisory & PE
Mackinac Partners

Keith Maib is a Senior Managing Director and Co-Head Financial Restructuring, Transaction Advisory & PE at Mackinac Partners. Keith plays a key role in the delivery of our service offerings across these areas including M&A/transaction services, Sell-side advisory, interim management, PE portfolio optimization, and PE subsidiary company performance improvement and restructuring. Keith has more than 25 years of diversified business experience including serving as a partner in two international accounting firms. He has extensive experience in leading companies through periods of pervasive change and turmoil and is nationally recognized as a leading turnaround executive. Keith's industry experience includes insurance (both P&C and Life), telecommunications, hospitality, retail, real estate, technology and manufacturing. Keith previously served as the interim Chief Executive Officer and Interim Chief Financial Officer for PlayPower Holdings, Inc. Keith previously served as the Interim Chief Operating and Marketing Officer for Sunterra Corporation, Interim Chief Financial Officer of Norwood Promotional Products, Chief Executive Officer of Worldnet Communications, Inc., Chief Executive Officer of Penncorp Financial Group, Inc., Chief Financial Officer of Acordia, Inc. and Chief Operating Officer of Borland International, Inc. Keith graduated from the University of Kansas in 1981 with a Bachelor's degree in business administration and an emphasis in accounting.

Pavle Sabic
Director, Credit Market
Development & Thought
Leadership
S&P Capital IQ

Pavle Sabic is Director, Market Development, at S&P Capital IQ. Pavle focuses on market development and thought leadership for S&P Capital IQ. He joined the firm's London office in 2011, where he covered business development in Europe, the Middle East and Africa. Pavle is an author of credit and M&A research which is featured in WSJ, Barron's, Financial Times and has extensive experience in risk management on both buy and sell side. He was also awarded the M&A Advisor '40 Under 40' award for M&A research and holds the FRM certification from GARP. Pavle completed his business school degree at the University of Edinburgh and was undergraduate Valedictorian at the Heriot-Watt University Edinburgh.

Farley Dakan
Managing Director
Mackinac Partners

Farley Dakan has over 15 years of diverse business experience including interim C-level management positions. His experience crosses various industry sectors including banking and financial services, oil and gas and real estate. His experience includes national, international, public and private organizations. Farley provides support to a number of the Mackinac's private equity clients on portfolio company restructurings, buy-side valuation and transaction advisory. Farley has advised a broad range of clients while at Mackinac Partners. He has completed valuation, advisory and asset management engagements on behalf of Diamond Resorts International, Lone Star Funds, Fortress Investment Group and Goldman Sachs on assets valued in excess of $5 billion. Asset types include non-performing loans, performing loans, REO, bank holding companies and several real estate operating companies. Farley served as an advisor for the strategic sale of a subsidiary of a publicly held insurance company. He has also been involved in the sale of oil and gas operating companies, non-operated working interests and as an advisor to multiple oil and gas service companies. Farley also has extensive hands-on operating experience with a range of real estate assets. He served as the asset manager of RE Loans during its Chapter 11 bankruptcy proceeding, which included a portfolio of $700 million in assets, located in 15 states. Farley has also managed day-to-day operations and acquisitions of an operating partnership with Fortress Investment Group and served as interim management of a large privately held timeshare developer. Farley began his career in the transaction advisory practice of Kenneth Leventhal in Dallas, Texas. At KL, he was involved in providing financial, transaction and M&A advisory to several Fortune 500 real estate companies. Former client engagements included KB Home, Lewis Homes, The Rouse Company, The Howard Hughes Corporation, Terrabrook (now Newland Communities), Westbrook Capital, Equity Office Properties and Centex (Homes and Commercial). Farley has also served as a third party advisor for several leading institutional investors including Fortress Investment Group and CalPERS. Farley received a BBA with a concentration in Finance from Baylor University. Farley is an active member of the American Enterprise Institute and is a frequent speaker at the University of Texas at Austin.

JP Hanson
Head of E&P
Co-Head of Energy Practice
Houlihan Lokey

JP Hanson is Head of E&P and Co-Head of Energy Practice at Houlihan Lokey, where he is a senior banker in the firm's Financial Restructuring Group, Head of Houlihan Lokey's E&P Practice and Co-Head of the firm's Energy and Power Group. Mr. Hanson is based in the New York office. During his career, Mr. Hanson has worked on numerous financing, M&A and restructuring engagements; he has advised companies, secured and unsecured creditors and other stakeholders in both out-of-court and in-court restructurings, including "pre-packaged," "pre-arranged" and "free-fall" chapter 11 bankruptcy cases. In addition to domestic transactions, he has been involved in transactions for several Latin American, European and South African based companies advising companies and stakeholders regarding the structuring and implementation of financings, M&A transactions; out-of-court exchange offers and "pre-arranged" reorganizations in local jurisdictions. Before joining Houlihan Lokey, Mr. Hanson was a manager of alternative lending at Commonfund Mortgage Corp. Earlier in his career he held a similar position at Moneyline Lending Corp. Mr. Hanson began his career in finance trading fixed income securities at NNJ, a private family wealth fund formerly based in San Francisco. Mr. Hanson currently serves on the Board of Directors of Bennu Oil & Gas, LLC. He earned a dual B.A. degree, cum laude, in Italian and international finance from Brigham Young University and his M.B.A., with a concentration in finance, from the University of Maryland's Robert H. Smith School of Business.

Bill Wallander
Partner
Vinson & Elkins LLP

Bill Wallander is a Partner and the Practice Group Leader of the Restructuring & Reorganization Practice Group of Vinson & Elkins L.L.P. Bill has over 20 years of complex restructuring and reorganization experience across a broad spectrum of clients and industry lines. Bill represents debtors, agents and lending groups, bondholder and noteholder groups, funds and committees. Bill has also served as an expert witness in Bankruptcy Court. Bill's industry experience includes aerospace, agriculture, chemicals, commodities, construction, defense, energy (upstream, mid-stream, downstream, renewables), derivatives, financial services, healthcare, hotel, legal, manufacturing, mining, mortgage finance, power, public finance, commercial real estate, retail, shipping, technology, and transportation. Bill is a member of the American Bar Association; State Bar of Texas; New York Bar Association; Dallas Bar Association; State Bar of Texas Bankruptcy Section; Dallas Bar Association Bankruptcy and Commercial Law Section; American Bankruptcy Institute; Texas Bank Association, Texas Bar College; Turnaround Management Association. Bill is authorized to practice before the Supreme Court of the United States, Texas Supreme Court; Supreme Court of the State of New York; U.S. Court of Appeals for the Fifth and Tenth Circuits; U.S. District Courts for the Northern, Eastern, Western and Southern Districts of Texas, and the U.S. District Court of Arizona. Bill received his B.A. in Economics and Political Science with minors in Mathematics and Latin from the University of Pittsburgh in 1981. Bill received his J.D. from the University of Texas School of Law in 1984. While practicing law full time, Bill earned an MBA in 1998-2001 from the University of Phoenix.

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International Financial Forum - London, UK - December, 2015
Distressed Investing Summit - Palm Beach, FL - January 27, 2016

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