

# Restructuring in the oil and gas sector:

What does the future hold?

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The market challenges facing many smaller and financially weaker companies in the service sector means that they will face existential challenges over the next 12 months, with pressures mounting as current backlog runs out. Businesses need to conserve cash, take actions to reduce costs and be competitive on price.

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# Restructuring in the oil and gas sector: what does the future hold?

## Synopsis

The oil and gas sector is no stranger to oil price cycles and for many the scars from the last downturn are still visible. However, capital structures are again under strain from the biggest oil price correction in decades and with most industry commentators forecasting a subdued outlook for the sector, many are predicting a further wave of restructurings.

There are a number of specific challenges facing the sector. Here, we explore the challenges facing exploration and production (E&P) and oil service sector companies, and what may lie ahead.



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### What is the current state of play?

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By and large, the oil and gas sector was recovering quite well from the last downturn and activity levels had increased through 2018 to 2019. However, recent events have hit the sector hard and we have started to see cost cutting and cash preservation measures such as deferral of capital expenditure projects, deferred maintenance and unfortunately a series of redundancy programmes across the industry. Companies are operating in crisis mode and taking steps to reduce costs, conserve cash and access liquidity.

For some E&P companies, there has been short-term revenue mitigation through oil price hedges. However, hedge benefits will recede as we enter Q4 2020 and will offer little protection in 2021. Another feature has been some players reducing or shutting-in production to preserve the hydrocarbons in the reservoirs for better times hopefully ahead.

The management teams of oil and gas companies are adept at managing their cost base well in tough times – they've been in a similar situation before – and the quirk with this commodity is that companies do not need to keep producing it if the price drops, they can just stop until the market begins to improve. But that does not mean challenges can be overcome easily.

Initially, the hardest hit have been the oil service companies, especially those that focus on exploration and development where work has dried up. Those with a project backlog, albeit reduced, through 2020 are looking at activity levels next year and beyond – particularly businesses across the supply chain that have had work stopped or put on hold. We know these businesses are already putting measures in place to address the issues they're facing, be that looking at headcount or deferring capital expenditure but, for some, the main concern is about their ability to win replacement work for next year and further ahead.

### How has the COVID-19 pandemic impacted the sector?

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Most crucially, the COVID-19 pandemic has prompted unprecedented operational and welfare issues, in some cases with employees and contractors stranded offshore. However, beyond these immediate welfare concerns, COVID-19 is weighing heavily on sector confidence and in particular long-term oil demand. This could impact long-term resilience within the sector, which may result in a higher risk profile for investor returns.

### How will these challenges impact restructuring activity in the market?

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In previous cycles, lenders have driven restructuring activity and have generally preferred to ride difficulties out in expectation of oil prices rebounding. Additionally, unlike many other industries, lenders have been unwilling to take equity control, especially for E&P companies, given various concerns over consolidation, PR, environmental risks and decommissioning liabilities.

As a result, the vintage of financial restructurings from the last downturn was typically 'amend and extend' type restructurings. Debt would be left in place but maturities would be deferred. Repayment obligations would be re-set based on a revised financial model predicated on increasing oil prices. Insolvencies were a rarity and most restructurings were implemented consensually. This has left a position today of many over-leveraged debt structures with unrealistic amortisation schedules at current oil pricing.

In most situations further financial restructurings would benefit businesses. Arguably the lenders' strategy may be the same as before. Anything else is likely to crystallise a large loss which may just be unpalatable. However, there are some signs that financial restructurings may look a bit different going forward.

### What might change in this cycle?

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In the UK restructuring and insolvency industry, partly as a response to COVID-19, there have been a number of recent changes. Firstly, the recent insolvency reforms in the Corporate Insolvency and Governance Bill 2020 have provided new tools, in particular a Restructuring Plan, which provides far greater scope than previous restructuring tools to compromise, or cramdown, liabilities or shareholders. This could mean that restructurings cut debt 'deeper' and/or tackle a wider range of stakeholders and possibly ownership structures. Lenders will want to see sustainable capital structures, either through equity injections or deleveraging financial restructurings.

Additionally, we have seen increased use of 'light touch' administrations, where administrators delegate certain responsibilities back to directors in order to achieve a more collaborative, effective and lower cost insolvency process. In a highly regulated sector such as the oil and gas industry – which faces operational, health and safety and environmental challenges – this approach could prove effective.

One feature of COVID-19 has been acceleration of change, and underlying trends away from hydrocarbons such as energy transition, agile working and greater use of technology may leave a permanent impact on long term oil demand. Combined with greater risk factors, this may undermine the economic rationale for more patient, supportive approach to oil sector restructurings.

## How do you think this will impact the future of the industry?

There may be further sector consolidation in a drive for scale and resulting cost and funding economies. The identity of the consolidators may be different to the last downturn, which saw significant private equity and distressed debt fund interest in the sector's restructurings. Many of those funds are now in harvest and exit mode and may not have the appetite for additional acquisitions. That said, there will undoubtedly continue to be appetite for good assets at realistic prices.

There is also a question mark over end of life assets. Good assets with large reserves of oil have the potential to make vast sums of money, but for those that are at the end of their life there is a need to decommission and that comes at a huge cost. We could see companies fail as a result of not being able to fund these decommissioning projects.

## Will the oil service sector trends mirror E&P?

Unfortunately, we expect further distress in the oil service sector. For many supply companies it must seem as though it has been a series of never-ending restructuring processes for the five years since the last oil price shock. Although E&P recovered somewhat, in many areas of the oil service sector conditions have remained depressed. Over capacity is at the root of the problem, meaning pricing levels have remained stagnant even if utilisation may have risen.

It is likely that we will see greater casualties of oil service companies in this cycle. We expect that the stronger players with newer technology, better quality fleets and well-regarded management teams will fare better – those that are no longer economically viable could end up with underutilised vessels and drilling rigs for long periods of time, with some tonnage exiting the market.

The market challenges facing many smaller and financially weaker companies in the service sector means that they will face existential challenges over the next 12 months, with pressures mounting as current backlog runs out. Businesses should focus on conserving cash, take actions to reduce costs and be competitive on price – it is better to have working assets that cover the costs than an idle ship that still needs to keep up payments for crew, insurance and storage. This is what all management teams are focused on, and they should continue to keep a close eye on operations.



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The number of E&P insolvencies since the last oil price shock

19.33

Oil price dropped to \$19.33 (per barrel) in April 2020

22

The number of services insolvencies in the last five years



## Conclusion

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Fundamentally, we expect deeper oil and gas restructurings and a higher level of oil service sector insolvencies in this cycle as we are starting from a far weaker base position than in 2015. Assets are now older so we expect to see more consolidation and a lower tolerance from lenders that they should just extend their debt terms – this will shake out second/third tier players leading to greater consolidation and it will take capacity out of the market. There will also be some companies that exit the market entirely – this wasn't a feature of the last oil cycle as most restructuring work centred around debt being restructured rather than the businesses' operations.

One thing is certain – management teams in this sector are aware of these issues and have been working hard to address them. Given the scale of the difficulties, an assessment of restructuring options is likely to be needed to help companies and their stakeholders address the challenges ahead.

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