Recent Developments in Oil & Gas Lease Markets

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Technological breakthroughs — hydraulic fracturing (commonly known as "fracking" or, to you aficionados in the industry, "fracing") and horizontal drilling — have enabled domestic oil production to replace imports at a historic pace. Output surged 14% in 2013 to 8.97 million barrels a day, the highest since the U.S. Energy Information Administration's weekly estimates began in 1982[1].

Brent crude reached its 2014 peak of $115.71 a barrel on June 19th, but then dropped like a rock beginning in the fourth quarter when Saudi Arabia cut prices for its biggest customers. The price dropped to $94.57 a barrel on Oct 1st and continued dropping to $45.13 a barrel on January 13, 2015, an astounding drop of 52.3% in a little over 90 days[2]. According to *The New York Times*[3], "the plunge … sent fear through global markets."

The short-term prospects for companies operating in the oil and gas industry (O&G) suffered a similar drop over this period. *The New York Times* went on to report that "the drop in prices led to a rising tide of oil company announcements of investment cuts for the coming months. Several Texas-based companies that have borrowed heavily in recent years to produce in new Texas and North Dakota shale fields are expected to announce steep investment and job cuts in the coming days." This information was especially significant as almost half of total U.S. oil production is now accounted for by Texas and North Dakota[4].

Companies involved in providing fracking services to exploration and production (E&P) companies found themselves a potential target of the announced reductions in capital expenditures.

The marginal cost of lifting additional oil and how that relates to the marginal revenue generated by the sale of this oil determines whether an existing well will continue to produce. Fracking is but one component of the marginal cost of stimulating an existing well. Every E&P company, and each of its wells, will have different marginal costs associated with stimulating additional production, making the analysis of which E&P companies will reduce their capital expenditures far from obvious. Therefore, it is difficult in the short term to predict which fracking companies will be winners, and which ones will be losers, knowing only their historical E&P customer base.

This analysis is further complicated by the fact that E&P companies typically do not contract for fracking services on a long-, or even medium-, term basis. Usually a fracking company learns of a new job 30-60 days out, and then fracks the well in "stages." A typical frack job can last up to 20 hours — one frack stage per hour — from start to finish.

Finally, since the revolution in shale oil production is relatively recent, most of the fracking companies tend to have been in business for relatively short periods of time, have grown extremely rapidly over this period, are thinly capitalized, and have taken on large amounts of debt and financial leverage to purchase the hugely expensive mobile pumping units (~$900,000 apiece) and sand delivery trailers (~$250,000 apiece) required to frack a well.

Despite the weakness in their balance sheets, fracking companies were routinely raising equipment lease and finance (ELF) capital from bank lessors directly, and indirectly through independent leasing companies that were syndicating ELF transactions to, or discounting just the rental streams with, bank lessors. Lease terms were typically 5-7 years and pricing was usually in the range of 250-350 bps over like term swaps (LTS).

This all changed in the fourth quarter as the ELF capital markets were not immune to the fear spreading through the global capital markets. Unable to any longer quantify credit risk, and alarmed by the potential damage to their existing O&G loan and lease portfolios, most of the ELF capital markets shut down to new O&G transactions in the fourth quarter 2014. This was especially true for the smaller fracking companies.

Representing various clients, Fairfield Capital Group is in the ELF market constantly but has recently been able to find but a single bank lessor that will even entertain new exposure to the O&G industry in general, and to a fracking company in particular. Part of this reluctance to consider new O&G exposure is no doubt related to the regulatory scrutiny that will move O&G loans and leases to the top of regulators' loan review list.

What has happened as a result of this vacuum is that any new ELF transaction activity has shifted to the non-bank lessor market — consisting of privately-held leasing companies, commercial finance companies and private equity-sponsored funds, all of whom operate on the high end of the risk reward spectrum.

This means that lease terms are now shorter (3 years preferred), structures are modified to reduce collateral exposure (advance rents, security deposits from lessee and/or vendor) and yields are higher. Whereas a bank lessor — if you can find one — would now require a spread of 550+ basis points over LTS, you more likely will be working with a non-bank lessor that will need a minimum 650-850 basis point spread to begin the conversation and fair market value end-of-term options that offer the likelihood for further yield upside.

In summary, fracking deals can still get done in the market but not under the same terms and conditions you may have been accustomed to. The good news is that a lot of the equipment used in fracking is manufactured for extreme duty, has a reasonably long useful life and maintains relatively strong residual values. Non-bank lessors will not be as focused on industry exposure and financial statements, and short lease terms will help mitigate their collateral risk. At least until oil markets recover to the $75/barrel level — and remain there — access to capital markets for small O&G service companies will come at a cost.

References

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Dana J. Pasternak, a 35+ year veteran of the equipment lease and finance industry, is managing director and founder of Fairfield Capital Group, LLC. Since 2004, FCG has been providing financial advisory and capital markets services primarily to small and mid-size equipment finance and leasing companies (i.e., Investors) and highly-leveraged and middle-market companies (i.e., Issuers) needing to raise lease capital to finance equipment acquisitions or to assist in the sale of products they manufacture. FCG has relationships with over 100 institutional investors active in domestic and international ELF markets. It maintains offices in the New York, Chicago, and Naples, FL metropolitan areas.