Bleak Times Ahead For The Oil & Gas Industry

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By Barry Samria

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In a recently published Audere Partners article, "Consolidations and Bankruptcies Ahead for the Oil & Gas Industry," on April 6, we painted a bleak outlook for the Oil & Gas sector through 2020 and beyond. Looking back at how events have unfolded in the three weeks since the article was published, it is apparent that we were not bleak enough! Many research bodies and news sources agreed on an aggressively bearish outlook on oil markets. Still, we are not sure that any of those sources could possibly have foreseen an outcome in which the buyer was being paid by the seller to take the product! Negative price on an oil contract is something that has never happened in the history of the oil markets. Admittedly, it was a short-term phenomenon, limited to the day before May contracts expired. The question we should all be asking ourselves: was this a one-time event, or could we see similar scenarios play out for contracts expiring in June or beyond?

In the same article, we put forward a myriad of compelling reasons why oil markets are in for turbulent times and a likely sustained low oil price. Some will say that it is not all doom and gloom. A counter-argument is that OPEC+ finally came to an agreement to reduce output by just under 10 million barrels per day. However, it is important to note that this reduction is being phased-in and is not immediate. Counter that with the fact that demand has been reduced by as much as 25% during the last couple of months, so this reduction is not really going to stave off the inevitability of filling viable storage capacity. Globally, we have less than 10% remaining crude storage capacity, and of that, what little onshore capacity is remaining is located mainly in the U.S.

The most immediate challenge for producers is viable crude storage capacity. Even with the OPEC+ cuts, the supply continues to exceed demand by a considerable margin. This will be a significant headache in the short-term, considering the continuing pandemic lockdowns throughout the U.S and Europe. At this juncture, we can only hope for a gradual easing of the lockdowns throughout June, and potentially July. What does this mean for the oil markets in the U.S? Without drastic reductions in production, we will see a repeat of May's negative contract prices.

At the time of writing, oil has seen healthy double-digit gains for the past two days following reports of lower than expected inventory build-up in the United States. Production has also fallen by 100,000 barrels per day week ending April 24 to 12.1 million barrels per day, one million barrels below the record set a few weeks prior in the week ending March 13. At a macro level, we are seeing other positive events play out, with some states partially opening up their economies and easing stay-at-home guidelines. There is an indication of early positive results from the Gilead Coronavirus drug trial. This is all good news at a time when such news is in short supply, but we are not getting carried away with this mini-rally. If anything, our skepticism remains high as industry fundamentals do not evidence this mini-rally continuing. The harsh reality is that markets are reacting to any and all news in the vain hope of getting ahead of a trend. We will continue to see tremendous volatility in the oil markets with swings north and south. Not only are we seeing volatility from one day to the next, but we also see wild intraday swings.

HOW BAD CAN IT GET?

Moody's issued guidance of WTI averaging $30 in 2020, and $40 for 2021. Our estimates for 2020 are slightly lower but not radically so. We believe that fully ramping-up the economy still has numerous hurdles and will take longer than the more optimistic estimates predict. We also believe that the aforementioned storage and supply issues will keep oil prices in check for the short and medium-term. Of course, these assumptions will be tested by the speed and pace of demand recovery as global economies reopen for business.

Another factor at play the independents in particular, are the historic level of corporate debt and the inability to potentially service that debt in the current scenario. To service the debt, Shale producers have to keep the wells flowing, which rapidly fills crude storage capacity, driving lower prices and thus making it all the more difficult to service the debt. It is a vicious cycle that will drive an increasing number of bankruptcies; this was the central thesis in our preceding article. Not only will we see an increasing number of companies filing for Chapter 11 protection, Merger & Acquisition activity will be on the upswing as well. We will likely see lenders getting more actively involved and driving their agenda more forcibly, especially the PE firms. Given that the primary challenge in the short-term will be to maintain the ability to pay down debt, capital projects will either have to be deferred or scrapped alto-gether. Sadly, this also means that recovering from this pandemic is going to be all the more difficult. The industry will look very different when the crisis has abated.

Through this pandemic, the independents are already scrambling to ensure access to adequate working capital. Luckily there are numerous strategies available to operators to maintain operations and stave off Chapter 11 or worse.

SURVIVING 2020

Thus for many independent Shale operators, survival is at stake, and the first priority will be to ensure access to sufficient working capital; read our recent article. For many, there is little choice but to retrench and live to fight another day.

Operators should be taking a good hard look at all available cash sources, including debt and borrowing, divestiture, third-party financing, financial investments, securitization, creditors, inventory, and receivables, to name just a few.

The more enlightened operators will realize that ensuring sufficient working capital is only one strand in a more complete strategy necessary to survive to fight another day. Looking at every cost line item becomes a critical task. We have already mentioned that most independent Shale Operators have significantly reduced capital budgets. The drilling rig count in the U.S. was down to 465 on April 24, from 991 a year earlier. A few months from now, we are going to think that today's number was the '*good old days*'! Operators will have to rapidly optimize every facet of the Supply Chain, with special attention paid to sourcing and network optimization. Organizational constructs in their current form must be challenged along with the current operating model and philosophy. Operators will rapidly have to execute actions to optimize all assets - human, tangible, and intangible. Basically, doing what they are doing with a whole lot less.

Operators have to turn to technology and innovation, creating its own unique set of challenges, requiring a very different type of organizational construct, one that can more effectively and efficiently execute remote operations strategies. Organizational structures are different, as are roles & responsibilities, processes, and operating philosophies. Several organizations have transitioned to new ways of working over the past few years. The technology is tried and tested, as are the organizational constructs. We see the incredible value of driving "out-of-the-box" operational improvements through A.I./IoT, rapidly driving significant efficiencies. Sadly, A.I./IoT is vastly underutilized by the majority of independents; read our recent article.

Our O&G team at Audere Partners has been developing and executing operational strategies with our clients to address challenges much like these for decades. In a sustained low oil price environment, it is going to take bold, daring, and decisive actions from committed executives to see the other side of this downturn successfully.

We are here to help in any way we can. We need a strong Oil and Gas sector in the U.S. since millions of jobs, both direct and indirect, are at stake. As a nation, we cannot strategically afford to go back to becoming a net oil importer. Actions will need to be meaningful and rapid. Are you ready?

REFERENCED ARTICLES

Consolidations and Bankruptcies Ahead for the Oil & Gas Industry

By Barry Samria

Sources and Uses: Working Capital Reserves

By Frank Buckman

Operators Slow in Adopting Game-Changing AI

By Barry Samria