

# Bank Loan

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## REPORT

### Gulf Oil Catastrophe Spills Into HY

One of the failed attempts at stopping the oil spewing from **BP's** Deepwater Horizon well included a “junk shot” of debris. Now, as oil continues to pour into the Gulf of Mexico at a rate of as many as 5,000 barrels per day, junk-rated companies in the oil and gas space have begun to suffer the consequences of this catastrophic spill.

“[The oil spill] will affect relative value for existing E&P names within the high yield indices and portfolios,” said **Eric Needleman**, head of high yield with **Sterne Agee**. “High yield investors will look to reduce exposure in credits with offshore Gulf of Mexico E&P projects. To some extent this is already happening. Short version: Gulf of Mexico-exposed bonds aren’t bouncing back anytime soon.”

Market observers note that bonds in the oil and gas space have traded down consistently since the April 20 fire that started the spill. While **BP** and **Transocean** are investment-grade companies and the U.S. government’s moratorium on deep water drilling, which is working its way through the court system, affects mostly investment-grade companies, the incident will make business more difficult for the industry’s junk-rated companies, even though they are mostly shallow water drillers.

“It’s not just affecting those in deep water, it’s affecting those in shallow water as well,” said **Kenneth Austin**, an analyst with **Moody’s Investors Service**. “While there’s no formal moratorium [on shallow- water drilling], the industry is still grappling with and trying to interpret what the new rules are and how to deal with them.” He noted that even companies with shallow-water drilling permits prior to the disaster may still be required to reapply for permits under new rules and regulations. And companies are going to be delayed in returning to these projects, as government turnaround time, even on shallow-water drilling projects, is probably not going to be as fast as it was pre-April 20.

Austin also points out that speculative- grade companies affected by the spill and certain regulatory changes include those that support the industry: shipping companies, supply and equipment companies, even helicopter and other transportation companies.

High yield investors are now on alert when it comes to oil and gas and related companies. The disaster in the Gulf of Mexico is so severe that insuring these companies is going to be more difficult. “Now people realize that if something goes wrong, it can be catastrophic, and if you don’t have the balance sheet to withstand a catastrophic event, it increases risk and increases your cost of capital,” said **Mathew Van Alstyne**, head of research for the **Odeon Capital Group**. One of the big changes that may come as a result of the BP spill is an increase to the \$75 million liability cap. “With the risk of the liability cap being raised, it’s going to affect every company that’s in the oil business, either deep water or shallow water,” Van Alstyne said.

This increase in risk has been reflected in credit default swap prices. While CDS movement among oil and gas companies mostly affects investment-grade companies, as junk-rated companies already have wider spreads, widening CDS prices illustrate a sense of risk being factored into the capital markets industry wide. “CDS for

oil and gas companies have been widening out in the last couple of months since the oil spill,” said **Diana Allmendinger**, a director with **Fitch Solutions**. “The market has definitely been signaling credit deterioration for these names.” Fitch Managing Director **Jonathan Di Giambattista** noted in a report that while CDS liquidity rebounded earlier in June, smaller oil and gas companies are currently under serious pressure.

## Deep Water Downgrades

The spill has also spurred ratings downgrades for oil and gas companies, affecting even those without a tie to the spill.

**Fitch Ratings** downgraded BP in a big way, dropping the company seven notches, to BBB from AA, the rating agency announced June 15. Moody’s Investors Service dropped the company four pegs on its ratings scale to A2 from Aa1. And **Standard & Poor’s** downgraded the company three notches, to A from AA, over the course of two weeks in June.

Meanwhile, BP partner company **Anadarko** joined the ranks of junkrated companies following the disaster. Moody’s lowered the company’s ratings to Ba1 from Baa3, citing its potential liability for 25% of the Gulf cleanup costs. S&P revised the company’s outlook to negative but maintains an investment-grade BBB rating on the company.

Downgraded speculative-grade companies in the oil and gas space include **Hercules Offshore**, which S&P downgraded to B- from B; **Helix Energy**, which S&P downgraded to BB- from BB; and **ATP Oil & Gas**, which had its outlook changed to negative from positive by Moody’s.

Even companies without assets in the Gulf of Mexico have been negatively affected. For example, Moody’s changed the outlook of Cyprus-based oilfield services company **Songa Offshore** to negative from stable. “The negative outlook reflects Moody’s view that the consequences of the Macondo oil spill and the moratorium imposed by the U.S. government on deepwater drilling through November 2010, will negatively impact Songa’s operations,” Moody’s analysts said in their report. “Although Songa has no vessels operating in the Gulf of Mexico, it is not immune from what will be lasting consequences for the global oil drilling industry.”

Up until this point, oil companies had done well on the leveraged loan and high yield bond markets. Oil and gas sector loan volume was up 41% so far for the year through mid-June, according to a June 23 report issued by **Dealogic**. Global oil and gas sector borrowing stands at \$83.3 billion year-to-date. Companies such as **Trident Exploration**, **Sheridan Production** and **Big West Oil** have closed leveraged loans this year. On the high yield bond side, **American Petroleum**, **ATP Oil & Gas** and **NFR Energy** are among the companies that have issued new notes since early April.

Oil and gas companies, especially with business in the Gulf of Mexico, will find it harder to come back to the high yield market. Houston-based **Willbros**, a contractor that serves the oil industry, pulled its \$250 million bond deal in mid-June, and banks are pursuing a \$300 million term loan B and \$175 million revolver.

“Generally I expect to see consolidation in the space, with smaller high yield names selling down interests or joining with larger, better-capitalized names,” said Fitch analyst **Mark Sadeghian**. “The key question going forward is what the future appetite of banks is to lend to high yield names in the space, given the new risks that have come to light.”

Even if the junk bond market comes back in a big way, affected oil companies could be left out in the cold. “From the debt perspective, investors will be very cautious towards companies that have assets in the Gulf of Mexico until this is all sorted out,” said Austin. “I’m not sure the bond market is ready to jump back in with both feet.” — *MS*