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The Bank Loan Market: Practical Advice for Energy Companies

January 23, 2009

Volatile commodity prices, dysfunctional credit markets, political and regulatory uncertainty, escalating project costs, and the on-going recession continue to generate turmoil in the energy sector. So it comes as no surprise that many companies in the energy industry are focused on building and maintaining liquidity. As access to the capital markets remains spotty, energy companies are building liquidity by selling assets and reducing cash outflows (e.g., deferring or curtailing capital expenditures, cutting dividends, terminating share purchase programs, and reducing or unwinding obligations that require margin or collateral postings). Many energy companies also are turning to a source that has long provided, at least until recently, a liquidity safety net: the bank loan market.

Beyond drawing funds available under existing credit lines, many energy companies are entering the bank market to amend loan terms, extend maturities, arrange new facilities, and replace lenders and letter of credit providers whose creditworthiness has deteriorated. While tapping the bank market is easier said than done in the current environment, advance planning to deal with recent market issues and trends can facilitate the process.

Expect More Pain. Commercial lending has for many banks taken a backseat to activities designed to shore up their balance sheets and capital ratios. When loans have been extended, lender concerns have translated into greater risk premiums, higher fees, and wider interest rate spreads. Banks are questioning whether credit ratings are reliable indicators of creditworthiness, are worried about the proverbial shoe that has not yet dropped, and are concerned about accepting or increasing their exposure to other financial institutions. Until the credit markets stabilize, borrowers can expect the pain to continue. Aside from less favorable pricing, for example, companies should expect a longer and more difficult credit process, ranging from more rigorous due diligence by banks and their counsel to increased scrutiny by bank credit committees, as well as more lender-friendly terms in general. In addition, borrowers should not be surprised by other lender-favorable actions that buck prior trends, including smaller commitment levels and collateral demands for loans that may have been structured as unsecured cash flow loans before the credit crisis.

Anticipate Lender Issues. Until recently, borrowers routinely negotiated loan provisions based on the assumption that their banks would be willing and able to fund their commitments. Borrowers also paid little attention to market disruption clauses relating to LIBOR price options based on the assumption that prevailing LIBOR rates would fairly reflect a bank's cost of financing Eurodollar loans.[1] Recent market events, however, serve as a reminder that even the most stalwart financial institutions are susceptible to failure, and that LIBOR may not adequately reflect a bank's cost of funding Eurodollar loans. Companies should be mindful of these events when negotiating interest rate, default, assignment, remedy, and other loan provisions. Among other things, this means considering provisions that (i) allow a borrower to replace defaulting lenders, as well as non-defaulting lenders that have indicated they will not honor their funding obligations, have been downgraded to certain ratings levels, and the like (so-called "yank-a-bank" provisions); (ii) permit a borrower to terminate a defaulting lender's commitment and loans without finding a replacement lender; (iii) terminate or suspend a borrower's obligation to pay commitment fees and interest to a defaulting lender; and (iv) establish procedures designed to reduce a bank's need to invoke Eurodollar market disruption clauses, such as establishing a procedure to negotiate a LIBOR floor, using an alternative cost of funds in lieu of prevailing LIBOR rates, or limiting the available LIBOR interest period options to those readily available in the market.

Discount Precedent. The bank market is a lenders' market today, and the meaning of "market standard" is changing rapidly while borrowers and lenders learn to cope with new realities in the financial markets and energy sector. Tougher terms and higher pricing are becoming the norm – banks are, for example, requiring stricter monitoring covenants (including financial covenants, such as net worth tests, that often fell by the wayside when capital was readily available) or more restrictions on a borrower's use of cash for acquisitions, dividends, and other activities. Consequently, attempts by borrowers to negotiate new deals based on the terms of borrower-friendly deals struck before the credit crisis frequently elicit a "that was then, this is now" response. Companies must be prepared to negotiate fresh terms in an environment of heightened sensitivity, which includes understanding when negotiating tactics grounded in a "but that's the way it has always been done" rationale should be abandoned in order to timely compete a deal.

Plan Accordingly. In a commercial loan transaction, the borrower assumes the risk of being unable to satisfy its financial covenants and other loan provisions (and potentially being held hostage by its banks for any amendments or waivers necessary to avoid a loan default). As the downside risk of non-compliance is particularly daunting in tight lending markets, companies pursuing amendments, extensions, or new credit in the bank market may be well served to act conservatively. In preparing financial projections for its banks, for instance, a company might consider revising downward the financial projections on the basis that its forecasts may erode more than expected while the economy navigates the current recession. At the same time, companies might consider "paying up" for greater commercial flexibility, especially in terms of financial or negative covenant packages that could limit or prevent actions designed to further improve liquidity, such as asset sales or the shuttering of a cash-hungry business line.

Despite many challenges, the bank loan market remains an important funding source for companies in the capital-intensive energy sector. But the market has changed, and the practical lessons discussed above are worth remembering as companies look to amend terms, extend maturities, refinance debt, and access new credit.

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Footnote

[1] In most commercial loan transactions, a borrower's interest rate consists of two main components: a reference rate and a margin. The reference rate is intended to reflect a bank's financing cost, and the margin is intended to compensate the bank for taking on risk (e.g., risks of extending credit to the borrower). For U.S. companies, LIBOR is the principal reference rate for Eurodollar loans. Because LIBOR is calculated based on data provided by a sampling of banks, LIBOR is generally assumed to reflect the rates at which banks borrow funds from each other and, therefore, an average cost of bank financing.

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Please contact Jim Goettsch of our Energy Industry Team if you have questions regarding this topic or would like additional information.