Recovery boost

In this article, the first in a new series of SCI CRT Case Studies, **Stelios Papadopoulos** explores the reasons that led to Weatherford International's restructuring and the high recoveries on its revolvers, as well as the company's future prospects. Weatherford entered a chapter 11 restructuring in 2019 and emerged from it in December of the same year with 100% recoveries on the revolvers. The latter was positive for the capital relief trades market, given that those revolvers were referenced in an SRT deal.

SCI can reveal that oil and gas firm Weatherford International is referenced in a capital relief trade, following the company's successful emergence from bankruptcy in December 2019. The revolvers that backed the significant risk transfer deal have fully recovered from the chapter 11 restructuring, although the factors that led the company into bankruptcy – including low oil prices and price competition – persist, as the coronavirus crisis renders the oil major's outlook negative once again.

High recoveries

According to Moody's data, the oil and gas industry was the largest contributor to corporate defaults over the 2018-2019 period. The number of oil and gas defaults climbed to 21 in 2019 from 15 in 2018.

Unlike in 2015-2016 when most of the oil and gas defaults were driven by a collapse in commodity prices, the 2019 defaults mainly stemmed from the defaulting companies' aggressive financing policies – they had taken on too much debt to fund development since the commodity downturn. Some of the defaulters also continued to struggle with the lingering credit effects of the 2015-2016 downturn.

Moody's notes that 11, or more than half, of the oil and gas defaulters in 2019 were re-defaulters that had distressed exchanges in prior years. Although commodity prices have recovered from the low levels in 2015-2016, they remained at moderate levels during most of the 2017-2019 period and were insufficient to help some companies turn around. When measured by dollar volume, oil and gas topped the list – accounting for 28% of the total – owing to the contribution of large defaults, such as those of Weatherford International, EP Energy and Chesapeake Energy Corporation.

The capital structures during the 2019 default wave were virtually the same for both exploration and production (E&P) firms and oil servicing firms. Julia Chursin, analyst at Moody's, remarks: "E&P firms tend to have more senior unsecured bonds on their balance sheets, when compared to other spec-grade companies, especially to those owned by private equity. But E&P companies' capital structures tend to be quite uniform. Senior unsecured bonds normally dominate the ▶

balance sheet, but reserve-based loans and first lien credit facilities are prioritised."

Sajjad Alam, vp and senior analyst at Moody's, adds: "As with other investment grade oil and gas firms, Weatherford's capital structure mainly consisted of unsecured debt and the company took on secured debt, such as a term loan, following a downgrade to speculative grade. The restructuring itself was nothing unusual; it was a typical chapter 11 restructuring with revolvers at the top, followed by unsecured bonds and equity."

Although the oil and gas industry has been responsible for the bulk of corporate defaults, recoveries for the revolvers in the capital structures tend to be extremely high. Moody's data state that the average recovery rate over a 32-year period (1987-2019) for reserve-based loans was 96%. First lien bank credit facilities benefit from an 80% average over the same timeframe.

Analysts qualify, however, that recoveries for oil servicing firms tend to be lower. "The recoveries of oil servicing firms tend to be weaker due to a highly depreciable asset base, such as pressure pumping assets, as well as intangibles. Exploration and production firms, on the other hand, have crude reserves," says Alam.

Exhibit 1: Corporate defaults 2018-2019

Industry Group	Percent by count		Percent by volume	
	2019	2018	2019	2018
Aerospace & Defence	1.0%	0.0%	0.7%	0.0%
Automotive	1.0%	1.3%	0.4%	3.1%
Banking	4.9%	1.3%	0.3%	0.0%
Beverage, Food & Tobacco	2.0%	2.5%	1.6%	0.5%
Capital Equipment	4.9%	0.0%	1.8%	0.0%
Chemicals, Plastics & Rubber	2.0%	0.0%	2.8%	0.0%
Construction & Building	4.9%	11.4%	4.9%	3.5%
Consumer goods: Durable	0.0%	3.8%	0.0%	2.7%
Consumer goods: Non-durable	2.9%	1.3%	1.2%	2.0%
Containers, Packaging & Glass	1.0%	0.0%	0.6%	0.0%
Electricity	0.0%	5.1%	0.0%	2.1%
Oil & Gas	20.6%	19.0%	28.2%	23.8%
Finance	2.0%	3.8%	1.2%	1.5%
Forest Products & Paper	0.0%	1.3%	0.0%	0.5%
Healthcare & Pharmaceuticals	4.9%	2.5%	3.7%	8.9%
High Tech Industries	1.0%	1.3%	0.1%	0.0%
Hotel, Gaming & Leisure	2.9%	0.0%	1.9%	0.0%
Advertising, Printing & Publishing	1.0%	3.8%	0.2%	1.7%
Broadcasting & Subscription	1.0%	1.3%	0.2%	20.4%
Diversified & Production	1.0%	0.0%	0.2%	0.0%
Metals & Mining	5.9%	3.8%	4.3%	1.9%
Retail	10.8%	20.3%	7.0%	14.3%

Source: Moody's

Weatherford's restructuring is therefore noteworthy for the very high recoveries. According to bankruptcy filings, three types of facilities have been fully repaid.

The first facility is a first lien term loan ranked on top, followed by a second lien revolving credit facility and an unsecured revolver. An explanation of the high recoveries cannot necessarily be found in the capital structure.

Chapter 11 restructurings tend to lead to higher recoveries, given that they allow companies to continue as going concerns, while featuring revolvers that benefit from priority claims. However, this would still leave open the question of how an oil servicing firm can benefit from 100% recoveries when it lacks the advantages of exploration and production companies.

Price wars

As a result of the sustained decline in oil prices since 2014, oil and gas companies around the world have dramatically curtailed capital and operating expenditures dedicated to oil and gas exploration, development and production – which, in turn, has contributed to the financial distress of numerous oilfield services firms. As spending on exploration, development and production of oil and natural gas has decreased, so has demand for Weatherford's services and products.

Weatherford has long grappled with a very high debt burden resulting from its debt-funded growth and acquisition strategy. The company has fewer leading-edge technologies than its oil service competitors and the weaknesses became evident during the 2014 oil downturn.

The root of the problems goes back to the 1990s when the firm decided to pursue more debt leveraged acquisitions as a way to offset low margins and competition from larger competitors. "Acquisitions were considered less expensive rather than research and development and, as a result, the company was always more leveraged than its competitors," says Ed Hirs, energy economist at the University of Houston.

The acquisitions enabled the corporate to climb the ranks and become one of the largest oil field services firms in the world. However, it struggled to integrate the various companies it acquired.

The 2008 crisis and the fall in oil prices proved to be the first hurdle, but Weatherford managed to weather that storm relatively unscathed and continued acquiring other firms. Notable acquisitions in 2008 and 2009 included the purchasing of US-based International Logging and the oilfield services division of TNK-BP respectively.

Sajjad Alam, Moody's

As a result, the company's goodwill continued to rise from US$3bn in 2006 to US$4.4bn in 2011, but in 2Q12, it reported an US$849m net loss. Weatherford's operating profits ended up plunging by 406% between 2014-2015 as it had to service debt acquired over many years of aggressive growth and acquisitions.

Hirs remarks: "The 2008-2013 recovery was short-lived and driven primarily by the surge in shale oil and gas, but that all changed when the Saudis started a price war. At that point, Weatherford's activity in the sector was entirely domestic and the problems were compounded by price competition."

Price competition in the oil servicing sector was and remains a major bottleneck for the profitability of the industry, according to Vikas Mittal and Hari Sridhar, marketing professors at Rice and Texas A and M universities respectively.

Mittal explains: "The business model is based on very low bargaining power on the part of OFS firms. They try to compete on technological innovation and by trying to make a case to their clients that their products lower the total ownership costs. Yet there isn't a compelling value proposition for clients. Thus, even as they increase their fixed and variable costs by making acquisitions and investments in technology, they are unable to garner any pricing power."

Moreover, when there is a market downturn, all OFS companies are forced to lower prices. Thus, their business model is prone to margin erosion, lack of pricing power and virtually "no moat whatsoever."

Turning things around would require a focus on customer service. Mittal notes: "In practice, this means that a company should isolate two to three dominant value drivers for customers and build its strategy around it. Thus, Walmart builds its strategy around three value drivers – everyday lower price, high variety and convenient location. Because of this focus, it does not spend resources on in-person sales and support."

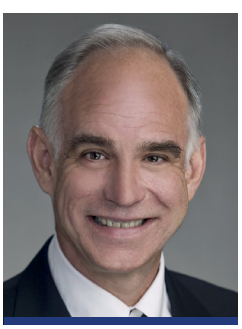
Exhibit 2: Brent crude oil spot prices (US$ per barrel) 2008-2020

Source: EIA

In contrast, OFS companies seek to be everything to every client, according to Mittal. "They want to be the safest, the most technologically advanced, the most sustainable, the best in ongoing service and support, the best sales team – and all that at the lowest price. Their leadership believes all this is possible through digital technologies – somehow remote monitoring and capturing digital data will magically accomplish all this. Unfortunately, they simply don't have the financial strength to make such large investments where the payoffs are in the distant future. By focusing more and more on technology and R&D, but not on basic customer needs, they are increasing fixed/variable costs, without increasing their pricing power."

Chapter 11

Weatherford decided to turn a page in 2017 as management, led by a new ceo, assessed the structure and operations in order to determine where key cost savings could be implemented. The "transformation plan", as the effort was called, targeted cost savings from organisation restructurings and asset sales. Notable sales included the US$430m divestment of the US pressure pumping business to competitor Schlumberger in December 2017.



Ed Hirs, University of Houston

Nevertheless, despite these initiatives, Weatherford continued to face declining revenues and rising debts and in 3Q18, it reported that it had missed cashflow projections, having generated negative free cashflow. Extensions of its liquidity runway in order to realise the benefits of the transformation plan became necessary.

Bankruptcy filings state that in early 2019 the company was "determined" that it would need to pursue a restructuring option – although the initial thoughts were for out-of-court settlements, including maturity extensions of the revolving credit facilities and first lien term loan, debt-for-up-tiered-debt and/or debt-for-cash exchanges, the issuance of convertible debt instruments and debt equitisation transactions. The same filings note that by mid-April 2019, Weatherford and its advisors began negotiations with unsecured noteholders to first explore such out-of-court alternatives, along with a credit facility maturity extension on terms proposed by the company's existing bank group. Despite the parties' best efforts to achieve an out-of-court solution, it became clear that an in-court process would be required to accomplish the comprehensive balance sheet restructuring that the firm needed.

On 10 May 2019, Weatherford and its creditors reached a pre-packaged chapter 11 restructuring agreement that aimed to reduce long-term debt, provide access to additional financing and establish a more sustainable capital structure. According to the terms of the agreement, the company's unsecured noteholders exchanged approximately US$7.4bn of senior unsecured notes for approximately 99% of equity and US$1.25bn of new tranche B senior unsecured notes.

Second, Weatherford received commitments for approximately US$1.75bn in the form of debtor-in-possession (DIP) financing, comprised of an approximately US$1bn DIP term loan that would be fully backstopped by senior unsecured noteholders and an undrawn US$750m revolving credit facility provided by the corporate's bank lenders. The restructuring agreement also contemplated a commitment of up to US$1.25bn in new tranche A senior unsecured notes that would be funded at an emergency in order to repay the DIP financing, the revolving credit debt, case costs and to recapitalise the company at exit. Weatherford emerged from bankruptcy in December 2019, having reduced approximately US$6.2bn of outstanding funded debt and secured US$2.6bn in exit financing facilities.

Low oil prices, weak pricing power, depreciable assets and problems integrating newly bought firms imply that the company-level decisions that led to Weatherford's restructuring may offer a better explanation for the high recoveries.

"A COMPANY SHOULD ISOLATE TWO TO THREE DOMINANT VALUE DRIVERS FOR CUSTOMERS AND BUILD ITS STRATEGY AROUND IT"

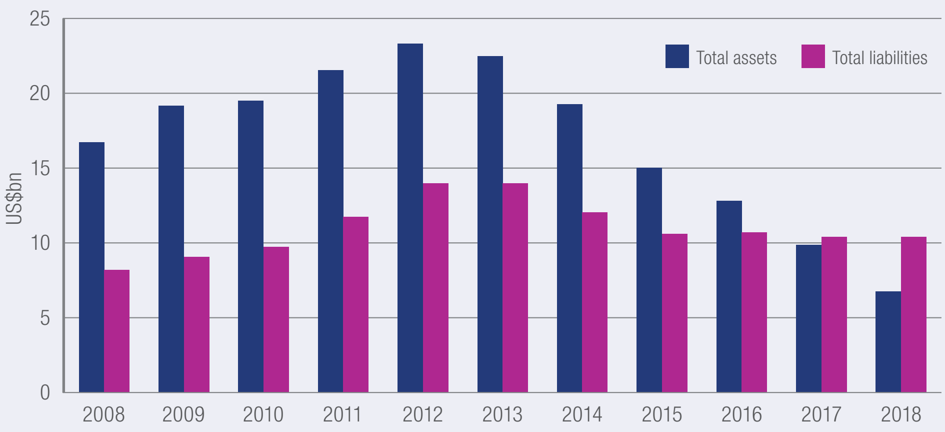
The firm essentially arrested any further value erosions by engaging early with creditors and skilfully managing the timing of its chapter 11 announcement.

Alam explains: "At the time of default, Weatherford had US$7.7bn of unsecured debt and US$615m of secured debt. It could have operated for another year, but it engaged unsecured creditors early and the revolvers were fully repaid. Effectively, it preserved value through an early bankruptcy filing."

Negative outlook

Nevertheless, the macroeconomic and industry challenges that drove Weatherford to chapter 11 remain and will be further compounded by the coronavirus crisis. At the same time, novel strategies to tackle the challenges are wanting as the

Exhibit 3: Weatherford's total assets and liabilities (US$bn) 2008-2018



Source: company reports

"AT THE TIME OF DEFAULT, WEATHERFORD HAD US$7.7BN OF UNSECURED DEBT AND US$615M OF SECURED DEBT"

corporate adheres to the same strategy of asset sales and organisational restructurings.

"The logic of the transformation plan is still there. This means centralisation of procurement and asset sales, but the company can now do it with less debt," says Alam.

On 30 March, Moody's downgraded the firm from B1 to B2 and changed the outlook from stable to negative. "These negative actions reflect an expected sharp deterioration in oilfield services industry conditions, following the oil price collapse in early-2020 and the severe negative implications it will have on Weatherford's earnings, cashflow and liquidity," comments Alam.

Moody's notes that the outlook had been shifted to negative, despite the company expanding its cost-savings targets, significantly lowering cash interest in 2020 and having good liquidity to meet covenants through 2021.

Vikas Mittal, Rice University

S&P followed on 2 April by lowering Weatherford's issuer credit and senior unsecured ratings to triple-C plus from single-B minus and senior secured rating to single-B from single-B plus. The rating agency states: "The coronavirus and market share war between Saudi Arabia and Russia have led to a steep fall in crude oil prices and resulting demand for oilfield services and equipment. Under these assumptions, we expect exploration and production spending to significantly fall, resulting in weak market conditions across the oilfield services industry. We expect the financial performance of Weatherford International to weaken significantly in 2020 and 2021 versus previous expectations."

On 15 April, Weatherford announced that it would delist from the New York Stock Exchange. According to the press release: "The impact of the Covid-19 pandemic and recent actions by certain producing nations have had an unprecedented disruption on the supply/demand equation for oil, resulting in a precipitous decline in commodity prices and substantial reductions to the capital spending plans of exploration and production companies. In response, Weatherford supplemented its cost reduction initiatives with a number of actions."

The actions include temporary pay reductions of 20% for management, total headcount reductions across North American operations and the global support structure of 38% and 25% respectively and reducing planned capital expenditures by approximately 50% in 2020 versus 2019 levels.

The press release continues: "Currently, Weatherford has adequate liquidity and is compliant with its financial covenants. However, the emerging operating environment has led to the inability to predict the depth and length of the industry's weakness. In this backdrop, the company's debt levels are too high. Management and the board of directors are evaluating options to improve liquidity and address the company's long-term capital structure."

Following the release, S&P further downgraded the company's issuer credit and senior unsecured ratings to triple-C and senior secured ratings to single-B minus. Looking ahead, the rating agency warns that the latest announcement "could lead to a debt transaction we would view as distressed, given current market conditions. The outlook is negative, reflecting the potential for a distressed refinancing transaction over the next six to 12 months."

Conclusion

UK outsourcing firm Carillion grabbed headlines two years ago when it was discovered in a significant risk transfer transaction. However, what made Carillion's case noteworthy for the SRT market was the near zero recoveries on the company's loans, thanks to large amounts of goodwill and no fixed assets, in a market where average 30-year corporate recoveries can range anywhere between 60% to 80%.

Consequently, Carillion's default clarified the importance of forensically analysing company reports and looking for early-warning signals in the equities market. In other words, relying on investment grade ratings for disclosed and concentrated corporate portfolios was and is still not enough.

Weatherford's case though seems to be the mirror opposite; the recoveries were not too low, but too high – and driven not necessarily by the quality of the company's assets, but company-level decisions over the timing of a chapter 11 announcement. If a lesson therefore can be drawn for SRT investors, it is that the drivers of recoveries are not necessarily buried in company reports. Indeed, how firms manage the expectations and perceptions of their creditors and investors through skillful public communications may be equally important.

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