

HOW TO MAKE A LOAN WHEN THE INVENTORY'S UNDERGROUND

From
deep in the earth, crude oil becomes collateral

FirstCapital Bank's Ken Burgess and Jay Isaacs don't typically visit oil wells in their daily work these days, but they know more about the oil business--and the oil lending business--than bankers from other parts of the country. Read about how cash turns into gasoline.

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By Steve Cocheo, executive editor & digital content manager

This article is a companion to the February 2013 cover story about Ken Burgess, ABA Community Bankers Council chairman, and chairman at \$650.1 million-assets FirstCapital Bank of Midland, N.A., Texas. Also see "A Visit to 'The Beast': Exploring A Working Oil Rig."

A borrower comes to you with technical reports indicating that there's a good chance he'll hit oil if he drills on his property, or, at least as likely, on property he's leasing. But he needs money to drill the well and begin pumping the oil. Would you lend him the money on the strength of what he says awaits below ground?

Midland, Texas' Ken Burgess wouldn't. And he's a veteran oil-field banker.

"The Permian Basin oil field is littered with dry wells," says Burgess, chairman of \$650.1 million-assets FirstCapital Bank of Midland, N.A. Today's oil lender has to be a skeptic. And a cautious approach to energy lending can only pay off when boom times come again to the oil fields in Texas and elsewhere.

Collateral, capital, and experience

Sinking a hole into the basin, even with the best of current science and engineering, is no guarantee of a producing well. Even with new methods such as hydraulic fracturing--"fracking"--there is a finite amount of oil beneath the earth, so even the richest find isn't forever.

And the history of oil-patch lending is also strewn with its share of failed or once-troubled banks.

Burgess and many other bankers in oil country have worked for energy lenders that ran into big trouble when the price per barrel went far south. Even when you've got a producing well, success isn't assured, no more than a farmer raising corn necessarily gets richer with every bushel harvested.

Recognizing all this, bankers like Burgess have a certain conservatism when it comes to oilfield lending, even though their institutions make many such loans.

Take the hypothetical opportunity mentioned at the start of this article. Burgess explains that you can't put a collateral value on a well until it begins producing. Until then, it can have all the potential in the world, but that's not oil in a barrel.

Instead, the would-be borrower "has to be able to give us some existing production as collateral," says Burgess.

In addition, oilfield lenders want

to see two things in the borrower's operation: experience and capital. As with other bank business lending, credit does not substitute for capital, from principals or investors taking a risk with their own money in the deal. And a bank lender won't take a flyer on a borrower with no experience trying to make it in the complicated world of oil exploration and production.

"We lend to companies that have been through multiple cycles," says Jay Isaacs, president of the bank. FirstCapital also avoids producers who have overleveraged themselves.

After the oil's flowing ...

Once the well begins producing, this gives the bank more collateral to rely on. In this way the borrower can access additional funds.

However, recognizing that oil prices fluctuate, sometimes dramatically, the bank at most will lend at 60% of the net present value of existing production. In weighing the credit request, the bank also considers whether the well's output has been steady, increasing, or decreasing.

The net present value is based on the estimated future income stream of the well, discounted at a stated rate. FirstCapital typically applies a discount rate of between 8% and 10%. Such "discounted cash flow analysis" is the accepted means of appraising wells. If the future payment were \$1 million and the bank used a discount rate of 10%, then the maximum it would lend on that well would be \$540,000.

Burgess says that a 50%-60% ratio of loan to discounted cash flow is the standard today.

Loan decisions can also hinge on the size of a prospective borrower's operation. For argument's sake, let's say a producer has a well run dry. For the oil company that has 100 wells, that's perhaps 1% of its production. But for a firm with only two wells, that could be a major blow, not only for the borrower, but for the bank that has taken that producer's anticipated production as collateral.

Checking up on the borrower

No matter how much documentation a borrower brings in, the bank doesn't just assume it's getting the whole picture.

In a sense, once the well is producing, a production loan becomes something like an ag crop loan or an asset-based credit, where inventory or stored commodities backing up a loan are subject to observation or measurement by a representative of the lender. In the case of an oil production loan, that representative typically is a petroleum engineer. FirstCapital has an engineer on staff in Midland.

Delivery of quarterly financial statements is also mandatory, so the lender can keep tabs on the producer's financial condition. Also expected is delivery of copies of the producer's "run checks" and supporting documents. Run checks are simply the payments the producer is receiving as it sells oil. The documents show payments both gross and net of such deductions as taxes and related expenses of delivery. Also recorded is the number of barrels delivered.

"Production lending, done right, is pretty safe," says Burgess. "We've been in the business for 15 years, and we've never really had to charge off much of anything."

Oilfield credit beyond the production loan

Many players beyond the producers make the oilfields run and there are other types of credit utilized beyond production loans.

"If you are a commercial lender in Midland, Texas, you'll learn to be an energy lender," says Isaacs. "Or you won't be making many loans."

Equipment leasing--including everything up to the rigs themselves--is a form of credit offered, though

FirstCapital doesn't get involved in this.

Oilfield service companies assist producers with supplies or expertise that they need and FirstCapital does lend to such companies.

But management realizes that lending to service companies remains part of an oilfield concentration. It's not diversification. So the bank's involvement is restrained.

Isaacs points out that service companies' success hinges on the success, or, at least, the business, of producers.

"When people quit drilling," says Isaacs, "some service companies may have to turn out their lights."

Ed O'Leary's Oil & Gas Series

If you found this article interesting or useful, you may also like to read a 2012 series that "Talking Credit" blogger Ed O'Leary wrote about energy lending. You'll find the first installment, "Banking The Oil Field: Looking Back And Looking Forward." Among other episodes O'Leary describes are the days of crisis at First National Bank of Midland--something he shared with Ken Burgess. They both worked for that bank at the time.