Opportunities in Special Situations/Post-Bankruptcy Reorganizations

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Post-Bankruptcy Reorganizations

With a wave of energy companies turning over a new leaf, we kicked off the New Year digging into a number of post-bankruptcy reorganizations ("post-reorgs"). We would like to share our perspective on some recent post-reorgs, which we believe suffer from a stigma with investors that landed them in the universe of mispriced stocks. In our view, these stocks are inefficiently followed by Wall Street and often trade at steep discounts to intrinsic value, while often bearing fewer fundamental risks than their peers.

When companies get their groove back

Cash flow is the lifeblood of every business. Companies often borrow excessively when times are good and there's nothing but sunshine on the horizon. If the music stops and cash flow becomes insufficient to service the debt and maintain ongoing operations, management must find a way to resuscitate or save the patient. Companies that can be described as "good business, bad balance sheet" may need to file for bankruptcy protection when times get tough.

Similar to paramedics performing CPR, a distressed company may sell assets to raise cash and/or ask bondholders to convert their holdings to equity. If a public company survives and emerges from the bankruptcy process, the new stock may be an interesting candidate for our portfolio.

Inefficient Market Hypothesis

Academics argue the stock market is "efficient." In other words, prices reflect all available information and stocks are always properly priced. While this may be true in certain sectors of the market (i.e. mega-cap stocks), we think the market for post-reorgs is very *inefficient*. Information flows are often sporadic and incomplete during the bankruptcy and subsequent emergence phases.

During bankruptcy, companies often make drastic changes. CEOs are replaced, assets are sold, debts are renegotiated, capital is raised and shares are issued. Wall Street analysts typically stop covering companies when they go bankrupt. The new company that emerges usually has too little market capitalization or institutional interest for analysts to invest the time and energy to pick-up coverage. During this period of inefficiency, stock pickers can be rewarded for rolling up their sleeves and doing the digging Wall Street won't do.

Buy when there's blood in the streets

Boom and bust periods are painful to watch, but can create great investment opportunities. We think the old adage, "one man's trash is another man's treasure," is true, particularly with post-reorgs.

Over the past 3 years, crude oil traded down from over $100 in mid-2014 to $26 in early 2016. In the US alone, a quarter million workers in the energy sector were displaced and a staggering 114 oil producers filed for bankruptcy protection between 2015 and 2016. This tidal wave of bankruptcies brought a plethora of potentially interesting investment prospects to our shores. Bankruptcy washed out companies with weak prospects, while allowing companies with strong prospects to survive. These survivors lived to benefit from a more rational supply and demand environment, with crude oil now hovering over $50.

Calm after the storm

There are 2 key risks for any business, business risk and financial risk. Business risk is the possibility a company's operations will generate lower than anticipated profits or a loss. Financial risk is the possibility a company's cash flow in insufficient to meet its financial obligations. Post-reorgs often have attractive risk versus reward characteristics after bankruptcy forces management to "right-size" the company's operations and balance sheet.

Companies that are able to survive an extended period of operational distress typically have lower business risk. During a crisis, management streamlines operations and pulls every lever possible to make ends meet. They reduce headcount, try to increase revenue and push on suppliers for lower prices.

Companies that survive bankruptcy also typically have lower financial risk. During the bankruptcy process, companies renegotiate their debts to a more manageable level by discounting the amount of debt owed and/or exchanging debt for equity in the reorganized company. Bankruptcies may also include a lender stepping in with debtor-in-possession financing or a new equity investor injecting cash. With less debt owed and more cash in hand, financial risks are usually lower.

Our favorite post-reorgs

Over the past few months, we have evaluated a number of post-reorgs in the energy sector, two of which we purchased for our Small-Cap Value strategy, Key Energy Services (KEG) and Sandridge Energy (SD).

Key Energy Services (KEG) - Freshly Loaded Powder KEG

Key Energy Services is a market leader in North American energy production services. KEG is the largest onshore well servicing contractor in the country, with 840 rigs and 3,000 employees. Extracting oil and gas from wells is a dirty business and KEG does the heavy lifting for major energy producers.

KEG filed for Chapter 11 bankruptcy protection on October 24, 2016 and emerged on December 15, 2016. KEG emerged from bankruptcy with $132 million of net debt, after eliminating $694 million owed to creditors prior to entering bankruptcy protection. With a clean balance sheet and powder KEG of liquidity, we expect management to acquire many bargain assets from struggling peers.

We have faith in management. CEO Robert Drummond joined in June 2015 from industry giant Schlumberger (SLB). Drummond has already cut nearly $100 million in annual overhead. KEG's management is also working closely with its largest holder, Platinum Equity, which owns 49% of KEG and is well regarded in the industry not only as a prudent acquirer but also as an operator.

We find KEG's stock price very attractive as it is trading below the replacement cost of its assets. KEG's enterprise value is below $900 million, but we believe its 840 rigs and other heavy equipment alone would cost well in excess of $1 billion to replace. We believe KEG is worth $56/share, which is 10x our 2018 estimate of KEG's earnings before interest, tax, depreciation and amortization ("EBITDA").

Sandridge Energy (SD) - Stocking up on cheap gas

Sandridge Energy ("SD") is the leading producer of oil and gas in the mid-continent oil province. With plenty of cash liquidity, half of this year's production hedged at favorable prices and low production costs, we think SD is a very attractive investment.

SD controls 458,000 acres in Oklahoma and Kansas and another 133,000 acres in Colorado. As of September 30, 2016, SD had proved reserves of 138 million barrels of oil equivalent ("BOE"), of which 28% was oil and 72% natural gas. SD also produced 50,000 BOE per day during that quarter.

SD filed for Chapter 11 bankruptcy protection on May 16, 2016 and emerged on October 4, 2016. SD emerged with no debt, $110 million of cash and a credit facility allowing it to borrow $425 million until 2020. The bankruptcy process eliminated a whopping $3.7 billion of debt, which dramatically reduces SD's financial risk.

The largest business risk for any oil and gas producer in recent years has been volatility of commodity prices. SD has substantially mitigated this risk by hedging, locking-in prices for approximately half of this year's production at $51.45 per barrel of oil and $3.19 per MCF of natural gas.

Further mitigating business risk, SD is low cost producer of oil and gas. For each BOE produced, SD spends $21. Land is leased for $9, production costs $8 and $4 is spent for overhead.

We think SD's current price of $21.50 represents outstanding value. We estimate the liquidation value of SD's attractive low cost reserves at $25 per share, making SD some of the cheapest gas you can buy! At a 14% discount to estimated liquidation value and with lower business and financial risk than its competitors, we think SD is a very attractive risk versus reward proposition. We believe SD is worth $32, which is 6x our 2017 estimate for SD's EBITDA.

Sources:
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