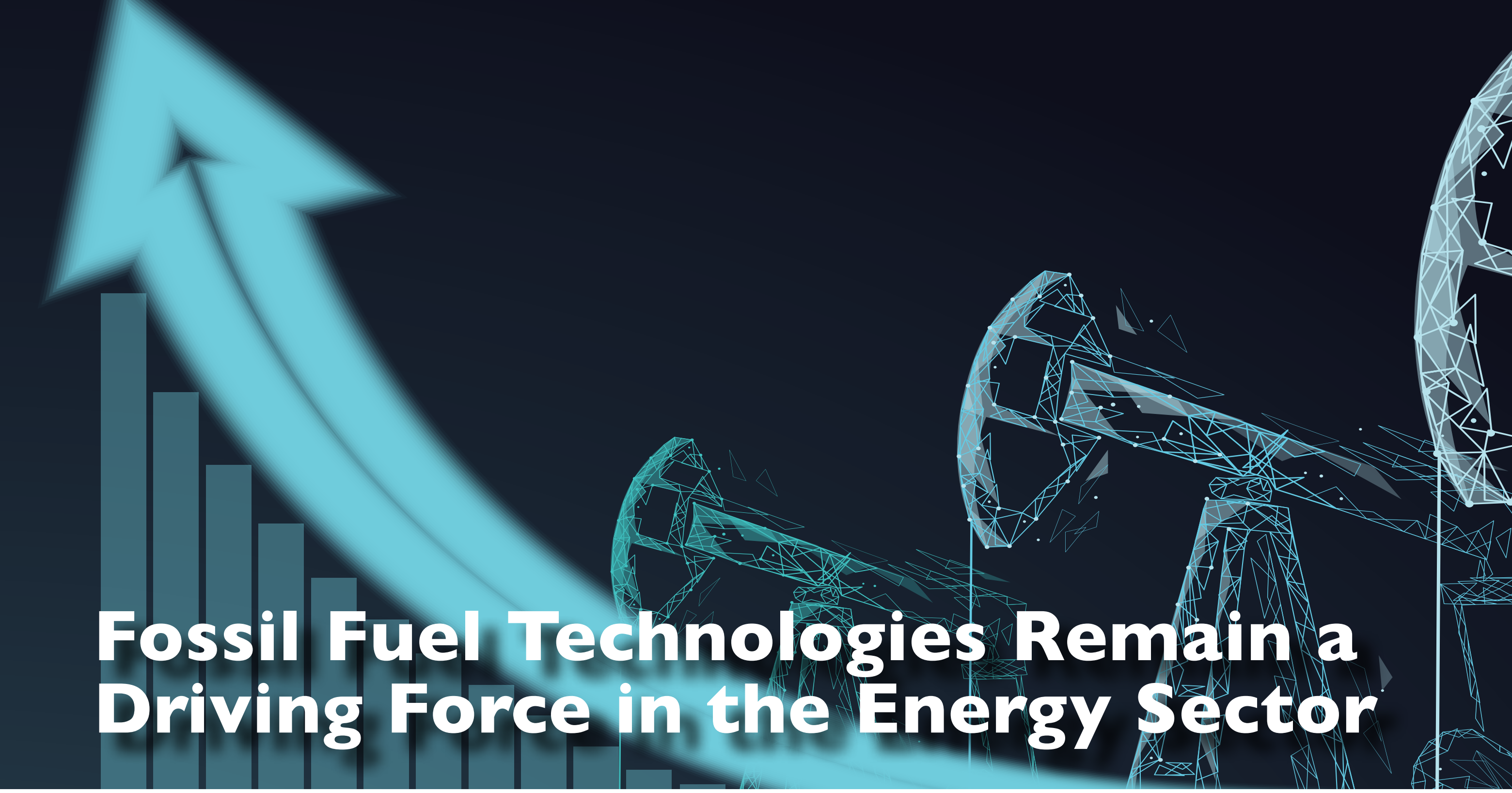

Fossil Fuel Technologies Remain a Driving Force in the Energy Sector

While clean energy sources may propel the future, continued financing for oil equipment makes sense for those companies that are established in the industry, explains Dan Spiller of Arboretum Commercial Finance.

By Dan Spiller

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The ever-increasing awareness and movement toward cleaner energy might lead one to expect that companies seeking financing in the energy sector are looking to fund technological advancements and projects focused predominantly on harnessing the power of solar, wind and water sources. Or at least it's a shift that I expected: increased financing requests from energy producers involving equipment more akin to panels and turbines and fewer on drills and pumps. That is, new investments that would be part of the transition away from oil and gas.

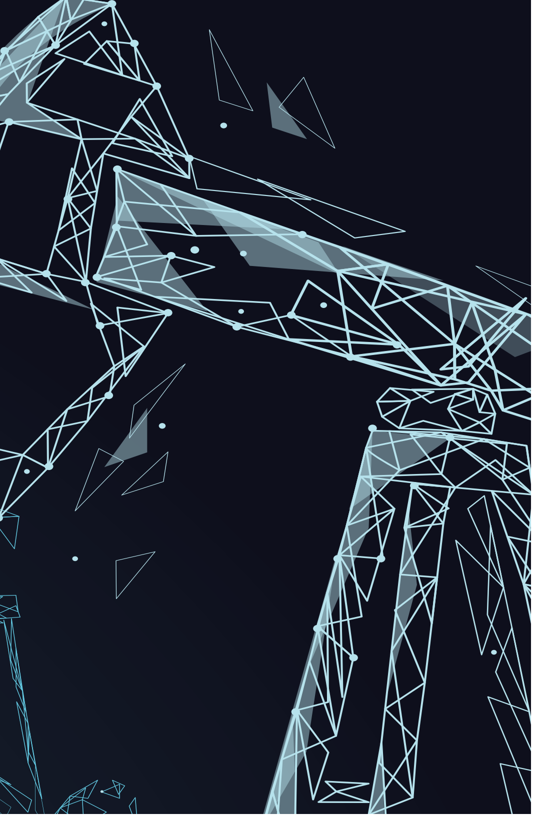
But that's not what we're seeing – at least not in the U.S. middle market. Most of the energy deals we see range from $1 million to $10 million in transaction size and are collateralized with new assets to be used specifically in oil and gas production. Oil companies are investing in pumps, centrifuges, transportation and even new rigs to support and enhance their operations.

So, how do these actions and business decisions fit in with the modern paradigm of clean and renewable energy? In that context, investment into fossil-fuel technologies might sound outdated, but from a less-insular and more macro view, continued financing for oil equipment makes sense for those companies that are established in the industry and have been savvy enough to handle price volatility.

After oil prices crashed in 2014, the oil producers that survived the downturn utilized that same resiliency and adaptability to capitalize on the recovering demand in the market. By staying lean and finding new efficiencies over the subsequent years, oil companies were able to generate strong revenues and increases in cash flow despite oil prices never again reaching the level of pre-2014 highs. That increase in cash flow and revenues for these producers signaled the potential for growth and opportunity for investment, and some have started to capitalize on this by financing new assets that enhance or are complementary to their established infrastructures.

The business opportunities for oil companies are all the more appealing when considering the subsidies in place. While the discussion over subsidies and other governmental support for renewable energy sources has earned increasing awareness and national attention, the longstanding and continued subsidizing of the oil industry still plays a major role in benefiting the economics of oil production. According to a recent report from Oil Change International, direct production subsidies for fossil fuels in the U.S. exceed $20 billion annually, with 80 percent of these subsidies going to oil and gas. With tax cuts and benefits helping to pave the way for better margins and profitability, oil companies are incentivized not only to stay the course on their business model, but even increase production.

Beyond just the subsidies, other factors have influenced and promoted domestic oil production, including the movement toward energy independence as well as innovations in



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extraction methods such as horizontal drilling and fracking. The reliance on importing energy from foreign sources has drastically declined over the past decade, thus increasing the need for production here at home. And with the advancements in directional drilling and fracking, oil companies are able to implement new methods and technologies without restructuring their entire foundations or changing their core ways of doing business.

One more element to consider in our analysis is the component that drives the entire energy sector: demand. Unlike some industries, the demand for energy is almost never in a decline, and certainly not over the long term. Fluctuations occur throughout the year, but on an annualized basis the need for energy holds steady. According to the Energy Information Administration, energy consumption in the U.S. has remained relatively consistent over the past 20 years, with consumption in 2000 hitting approximately 98.8 quadrillion BTUs and reaching 101 quadrillion BTUs in 2018. This reliable domestic demand gives producers the opportunity to make strategic business decisions without feeling encumbered by the uncertainty of need.

When all of the elements we’ve listed are taken into consideration – established-but-adaptive companies, governmental assistance and subsidies, and technological improvements – it starts to become more apparent why financing is an attractive option for oil producers. These are the companies that made keen internal managerial decisions five years ago to become leaner – surviving the crashing prices and understanding that a profitable future meant investing in technology that would increase efficiencies and establish the new breakeven price for oil.

In the same vein, these companies have become increasingly attractive to lenders through these internal efforts by effectively de-risking themselves. The new technology that is helping to make the companies more efficient and profitable is the exact kind of equipment that lenders and lessors want to finance. It’s a good match bringing together companies that were compelled into smarter decision-making through the use of high-value equipment that requires financial backing. The equipment itself becomes integral to the new way of doing business because it’s what drives the new efficiencies in operations; therefore, the likelihood of delinquencies and defaults from these companies is greatly reduced because the investments have become mission-critical to the business and staying competitive.

Staying competitive is what brings us full circle back to renewable energy. Despite current circumstances providing a favorable environment for oil and gas producers, none of this is to say that cleaner energy isn’t also on the rise and finding a foothold as an alternative solution and positioning itself to become more competitive in the future. Renewable energy deals are certainly happening, but on a different scale in a different space – venture capital funding for younger companies with emerging technologies, large-scale funding for heavily-established energy producers and investments overseas in places where support for renewable energy is more prominent.

The current state of the energy sector has created a viable environment for middle-market oil producers, but the future is uncertain. The lack of supply from renewable sources should ensure some stability over the next few years, but as the clean-energy producers evolve and the public demand for renewable resources continues to gain momentum, the same savvy oil companies that survived previous threats may once again be challenged to adapt in a whole new way.

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