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Energy lending narrative is probably a slow-moving one

By Jeff K. Davis

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The narrative around the energy revolution in the U.S. changed dramatically in the past month due to falling oil prices. Stories that had a sense of awe about American engineering and a stick-it-to-OPEC attitude have been replaced by the downside of lower oil and gas prices for producers. Energy stocks not only have been hit hard, but tertiary energy players such as banks that lend into the sector have been hit. Trading was particularly brutal on Nov. 28 when the price of West Texas Intermediate fell more than 10% to $65.99 per barrel. Banks that are based in the oil patch such as BOK Financial Corp., Comerica Inc., Cullen/Frost Bankers Inc., Hancock Holding Co., International Bancshares Corp., MidSouth Bancorp Inc., Texas Capital Bancshares Inc. and ViewPoint Financial Group Inc. had their shares hammered for losses of 4% or more.

The U.S. economy seems to be doing OK, and it is hard to see how lower gas prices are not going to benefit broad swaths of the economy — especially the transport, manufacturing and retail sectors. Maybe even companies with challenged borrowers such as subprime auto lender Santander Consumer USA Holdings Inc. will get a break through improved credit performance. Still, the move lower in oil prices from around $100 a barrel in June to $65.99 on Nov. 28 combined with a drop in the yield on the 10-year U.S. Treasury to 2.18% from around 2.60% in June should raise eyebrows among investors.

Regardless of what lower oil prices and higher bond prices may imply about the economy, investors are right to ask a few questions about what lower oil prices mean for lenders and high-yield bond investors. The shale energy revolution has required a lot of capital to build the infrastructure. Energy companies have accounted for over 15% of high-yield issuances in 2014, up from over 10% in 2012 and 2013. Banks such as BB&T Corp., Associated Banc-Corp, First Horizon National Corp., and Mutual of Omaha Bank among many others have made a push in the sector in recent years.

The market, of course, anticipates and usually is good at doing so. When Ben Bernanke offered that subprime mortgage issues were "likely to be contained" on March 28, 2007, to the Joint Economic Committee of Congress, subprime lending was in the process of blowing up and the broader housing market was beginning to show cracks.

Maybe it is the speed at which prices have fallen that has caused investors to be jittery about lenders; however, oil and natural gas are commodities — albeit really important commodities for global commerce. They are no different from other commodities in that their prices can swing dramatically with supply and demand. Oil prices approximated $2 per barrel from 1948 until the very early 1970s. Then, a series of oil shocks in the 1970s combined with a weak U.S. dollar (oil is a global commodity that is priced in U.S. dollars) caused the price to peak around the upper $30s per barrel in 1981. Markets have a tendency to overshoot and then reverse, however. A resurgent dollar, deregulation in the energy sector and perhaps a more pliant OPEC caused oil to crash to around $10 per barrel in March 1986.

The move during the 1980s caused significant pain in Louisiana, Texas and Oklahoma. Many "oil-patch" banks were crushed because a broad spectrum of assets — notably real estate — had been supported directly and indirectly by the 1970s oil boom. In 1986 I was a corporate credit analyst in Mobile, Ala., at AmSouth Bank (now part of Regions Financial Corp.) I remember driving into work during the spring of 1986 — five years after oil prices peaked — and seeing a growing number of rigs that had been pulled from the Gulf and moved to Mobile for storage awaiting a recovery in prices.

At the 2008 Gulf South Bank Conference, I heard MidSouth CEO Rusty Cloutier refer to how a paradigm shift can take a long time to play out when he compared the then-emerging real estate crisis to the crash in oil prices during the 1980s. He noted that in 1984 Louisiana bankers were hopeful that the crisis was peaking and that things would get better next year (1985). He went on to note that it was not until the early 1990s, or about a decade after oil peaked, that the bottom emerged for banks in the oil patch. (As a side note, housing peaked in 2006 and bottomed in most markets in 2010 or 2011. The quicker turn was a function of radical Fed interest rate policies, in my view.)

Given the move in oil prices, investors should not be surprised if a number of banks report incremental provisioning during the fourth quarter of 2014 and first quarter of 2015 for their energy books, as energy-related credits may be subject to downgrading. However, I would not expect anything more dramatic unless oil really dives — say to $50. If it does, then the 10-year yield may have fallen below 2% and we will have to revisit our narrative regarding the economy and credit quality beyond energy portfolios.

In October, Comerica management commented on the bank's $3.4 billion energy portfolio. Comerica's chief credit officer noted that a drop in price into the $70s would cause activity to slow, and slow a lot if it fell into the $60s. He also opined that it would take two to three years for oil in the $60s to cause "some credit issues." At the time of the post, oil was above $80.

WTI crude has fallen to the mid-$60s, so activity will slow a lot if he is right, though it will take a couple of years before portfolio losses presumably begin to emerge. My experience with Comerica has been that they generally have been spot-on with credit since incurring an outsized loss in 2002, other than overlooking one smallish California builder portfolio in 2007-2008 when scrubbing their balance sheet for ties to the unfolding subprime disaster. Other banks may have looser (or tighter) lending standards for energy-related borrowers, but Comerica's comments are probably a good starting point for investors when thinking about the impact on banks with exposure to the sector.

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