Financing Africa's Oil & Gas

Introduction

The fall in oil prices since mid-2014 has resulted in capex cuts across the Oil and Gas (O&G) industry. The intention of most of these cuts has been to increase the ability of companies to self-finance their operations. Wood Mackenzie the consultancy has estimated that over the past 2 years companies have cut approximately $400 billion in Capex investments (0.3% of Global GDP). According to the EIA Capex fell below 2009 levels and 2016 spending is likely to decline again.

Whilst line items such as Capex as well as general and administrative (G&A) costs have been sacrificed, unsurprisingly International Oil Companies (IOC's) have preserved their dividends, with a few such as Eni readjusting their dividends to meet their cash flows. This has been a clear sign from O&G companies that they intend on retaining the confidence of lenders and capital markets. Credit quality has been a top priority of global project finance debt since the fall in oil prices. The gradual recovery in oil price has lowered the likelihood of credit downgrades from credit rating agencies. However, if prices remain in the US$50 per barrel range for a sustained period or fall further than we expect, the outlook may prove problematic for projects with refinancing risk and market exposure.

Though there is a general mood of risk attached to the O&G industry currently we argue that a deeper analysis of the sector shows a more nuanced form of risk within the different sub-sectors of the industry value chain, with each sub-sector showing its own cash flow resilience against the drop in oil prices as well a unique opportunities of obtaining financing.

The Upstream sector has been impacted the most by the drop in oil price. According to the EIA US based Upstream O&G companies were able to raise about $100 billion by selling assets and accessing capital markets to supplement the decline in cash flow. The write-down in the value of proved Upstream reserves totalled $217 billion in 2015, the largest since at least 2007. Banks have also increased requirements for Upstream financing, IOC's with low gearing levels and better credit terms have been able to meet these requirements and also tap in bond funding encouraged by low interest rates that have resulted from liquidity injected into financial markets through Quantitative Easing (QE) in the US, Japan and Eurozone. However National Oil Companies (NOC's) in the Upstream sector, especially in emerging countries have had to rely more on bi-lateral and multi-lateral institutions to fund their operations as the sovereign ratings of their countries have impacted their access to bank lending.

The effects of current drop in oil price have been unusual when compared to previous low oil price environments. According to the IMF when an oil price fall transfers $1 of income, global consumption rises by 90 cents (the extra consumption of importers) less 80 cents (the consumption reduction by exporters) creating a net increase of 10 cents in global consumption is the result. This increase in consumption is meant to benefit oil importers and more specifically the Midstream and Downstream sectors. However though the Midstream and Downstream sectors have benefited from more demand, it has been less than forecasted. For example, China has experienced a drop in domestic (wholesale) petrol prices of only about 30% since June 2014, In the US, retail gasoline prices (including taxes) dropped from $3.8 to $1.9 per gallon (50% decrease) between June 2014 and February 2016 both decreases far below the 70% fall in the world prices. Though there has been an increase in demand for petroleum products which has benefited the Midstream and Downstream sector, the decline in investment in energy and mining in petroleum importing countries as well as general global decline in investment due to global economic headwinds has muted the expected increase in demand. The Midstream and Downstream sectors are traditionally financed through corporate and project finance. The economic uncertainty means that projects with good dynamics will go ahead whilst those without will have to go fallow until a period of more economic certainty.

Upstream Funding

Bank Lending

Credit rating agencies have reviewed their ratings of most Upstream O&G companies in view of the lower oil prices since mid-2014 and the reduced expectations for long-term prices. Lower ratings mean increased costs of debt; for oil and gas companies, this factor partly offsets the effect of the general supply of liquidity on interest rates. Agencies are closely watching managements' ability to reduce operating and project costs, and whether they are prioritizing stability of dividends and scaling back or deferring projects. Indeed in this low oil price environment companies will have demonstrate robust controls, tight cash management and good communication with investor and lenders as they compete for capital to be allocated to the sector over others.

As a result, high-cost and high-risk projects will be move down the priority list or be deferred. IOC's whose existence relies on such projects will have to re-consider their business models, for example, Statoil has had to reconsider its plans for expansion in the North Sea because of the high cost of deep-sea drilling. In Nigeria oil Majors, including Shell and Chevron Corp., are selling fields or putting them under strategic review as they scale back Nigerian operations following unrest, violence and crude theft in the Niger delta.

NOC's will also face the same challenges as IOC's as they are heavily impacted by the credit quality of their sovereign. Additional challenges for African NOC's include limited support from governments especially those heavily dependent on oil revenues. This means that NOC's engagements with Banks will be highly determined by their level of independence from governments.

While some Upstream projects may have oil price risk pressure during the low oil price environment, the best structured projects will be able to weather the decline. For Instance

the Coral Floating LNG project by ENI in Area 4, is likely to go ahead with FID expected this year as a result of strong project dynamics that include a BP offtake for the full 3.4 mtpa of LNG.

Bonds

According to Wood Mackenzie in the first quarter of 2015, US E&P companies raised US$7.9 billion from bonds and US$11.7 billion from syndicated loans. In February 2016 Exxon Mobil Corp. raised $12 billion in its largest bond sale on record. Exxon said proceeds from the sale may be used toward "funding for working capital, acquisitions, capital expenditures, refinancing a portion of our existing commercial paper borrowings and other business opportunities," according to a Monday regulatory filing.

Whilst there have been successes on the international bond market for low risk borrowers challenges still exist for less credit worthy entities. Yields in the O&G sector are sensitive to O&G prices, O&G companies need to increase yields to attract capital, especially if they are planning high-cost, technically risky projects with high “above ground” risks. For Africa the re-emergence of political risk on the risk radar, with uneasiness around unrest in Nigeria (attacks that have cut the production of the countries and shut several key export terminals), South Sudan and Renamo violence in Mozambique. Poor management, corruption, heavy taxation and costs with regards to local procurement and content have also increased the risk assessment around countries such as Angola and Nigeria.

As a result in Africa bond funding is still quite challenging and not seeing enough upside in O&G yet vs the risk of oil prices drifting again. Share prices and yields of bonds for E&P companies operating in Africa have however improved since the lows of Jan / Feb showing that the market might be turning subject to oil prices remaining stable.

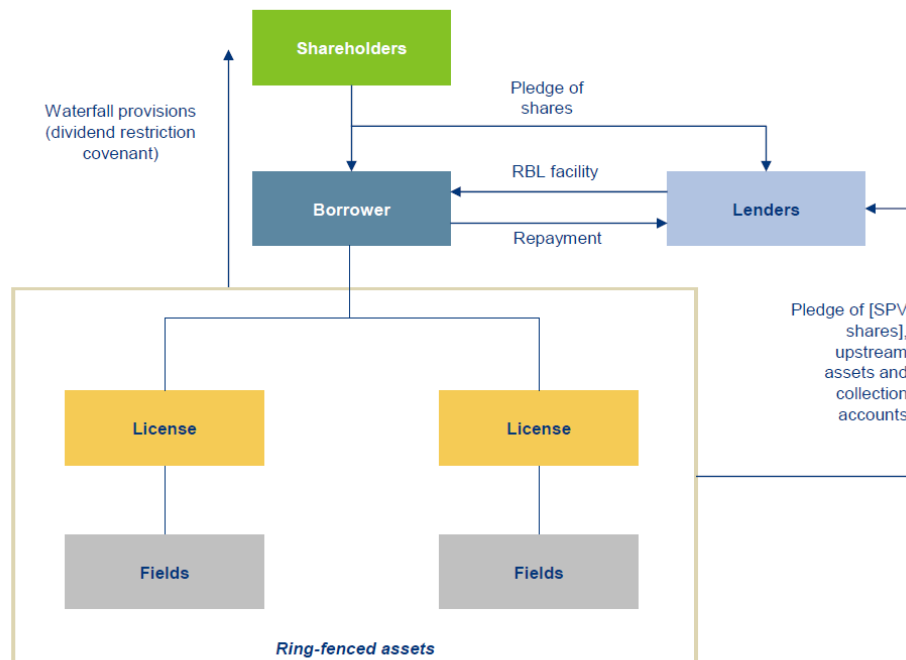
Reserve Based Lending

Reserve-based Lending (RBL) provides companies with a facility, drawn down as necessary, to fund development capital expenditure. Below investment grade companies often use loans primarily secured by the borrower’s oil and gas reserves. RBL’s allow banks to support small to medium-sized independent upstream companies. The borrower is not required to have a strong balance sheet or a good profit track-record, as the loan is sized on forward looking cash flows. It also benefits large corporates as they are able to ring fence assets in difficult jurisdictions and raise money against them. Generally, NOC’s cannot access RBL’s for they cannot offer recourse to ownership of their reserves.

RBL’s offer cheaper financing costs for mostly field development than would normally be available to a company with a limited balance sheet, because of this RBL’s are popular facilities for clients. Unequally so, RBL’s have proven to be unpopular with some of the biggest banks; the Financial Times in February reported that some of the largest US banks had signalled that they were preparing to cut RBL facilities across the board as they enter the next round of semi-annual reviews in the spring. This was after banks had cut limits for most customers by 10-20% in the previous round of redeterminations. In the same month BNP Paribus pulled out of the RBL business citing reasons of a poor outlook for future fundamentals in the short to medium term for the O&G sector.

The current low oil price environment will prove testing for RBL structures, especially so for structure negotiated in the $100 oil price region. The oil price that is used to calculate the borrowing base is mostly conservative, but most RBL's would have been calculated at higher prices challenging the conservative assumptions used in a higher oil price environment. The current low oil price environment will likely lead to stricter terms for RBL borrowers, limit their access and use by Upstream players.

Figure 1: RBL Structure



Advance sales of oil or gas

Angola funded the development of its O&G sector through advance sales of oil to China, following a trend that had been seen in Iraq, Kazakhstan, Russia and Venezuela. Advance oil sales are considerably a simple avenue to raise funds, as they do not result in a surrender of reserves as security. In 2014, a consortium of banks bought USD1.56 billion of Nigerian oil in forward sales from the Nigerian National Petroleum Corporation (NNPC), in order to settle debts. Traders such as Glencore have successfully invested in both oil production (to secure physical barrels and thus reduce exposure to market volatility) and advance purchases in the past few years. During the previous price drop in 2008, forward sales of oil were used successfully by many companies to fund their operations whilst the fundamentals of a recovery improved. Though this oil price is more protracted than the last, this strategy could equally prove successful for companies.

Midstream and Downstream

Project financing is widely used for pipelines, LNG terminals, refineries and storage terminals. As stated earlier the Midstream and Downstream is largely negatively unaffected by low oil prices but more affected by the sovereign factors. These types of infrastructure projects also garner the support of Export Credit Agencies (ECA's) and Development

Finance Institutions (DFI's) in their implementation. This is usually in the form of partial risk guarantees, long-term financing and political risk insurance.

It is in this area that we see the most activity on the African continent. President Museveni announced in April that Uganda had chosen the Tanzanian route to Tanga for its oil export pipeline, preferring it to another route through South Lokichar in northern Kenya ending in the Kenyan port of Lamu. The route is stated to secure first oil export by mid-2020E with pipeline availability of 99%, being also the least cost ($12/bbl transit fee vs. $16/bbl through Kenya) and more secure route. The route has flatter terrain; it also has existing roads and a railway along the project right of way. The route has minimal environmental impact, including only a 33km through the Biharamulo Game reserve. Other considerations favouring the route to Tanga also included easier land acquisition, total project costs as well as weather challenges at the port. We estimate that the projects breakeven price will be USD49/bbl. Though delayed, we expect the financing of the pipeline to face minimal challenges given the strong project dynamics explained above.

Standard Bank has also participated in the refinancing of the ROMPCO pipeline between Mozambique and South Africa which carries natural between the two countries and is operated by Sasol. Because of the strong demand dynamics and the quality of the offtake this transaction was a success.

With the rise of export refineries in the Middle East and the flat rate of increase in refining capacity in Africa over the past 20 years, we expect an increase in storage terminals. Standard Bank has participated in the R500 million financing of Burgan Cape Terminals in Cape Town. VTTI is the major shareholder in the Burgan Cape Terminals company, and this project that has been granted 'phakisa' (accelerated) status by the Government. This strategically important asset will offer 118,000 m³ capacity, with a product portfolio including diesel, petrol, fame & ethanol for blending.

Conclusion

Financing O&G activities will vary across the value chain, very few financing has been executed over the past 18 months given uncertainty on oil prices, almost no new projects sanctioned and there has been very limited Mergers & Acquisitions activity. In the next few months we expect that most of the deal flow will come from the refinancing/restructuring space with clients extending maturities and relaxing financial covenants to protect liquidity.

For existing projects there is a pool of private equity money waiting for the right deals, however not many have been done in Africa so far due to an increase in political risk (Nigeria) and struggling to find the right returns.

In the loan market going forward the key driver will be the lack of liquidity/appetite from international banks that are either managing their exposure to natural resources or are reducing their business in Africa due to concerns on compliance and from African banks: Nigeria banks short of US dollars and overexposed to O&G. In this regard liquidity from China becomes critical on large debt transactions and is likely to change the market.

In the midterm we would see appetite of the market rebuilding on the back of stable oil prices and global economic certainty. In this market it becomes critical for a borrower to have the ability to tap multiple sources of liquidity and for the borrower to recognise that upstream O&G is seen as riskier by banks so will need tighter structures, more equity support and higher pricing.