Standpoint

Upstream Finance: Stability Shifts the Balance

A period of relatively stable and gradually increasing oil prices in late 2016 and 2017 has led to a significant increase in the number, type and volume of financings in the upstream sector. Several significant acquisitions were signed, backed by underwritten bank finance; new borrowers raised debt for the first time; upstream development financings came to the market; and refinancings, postponed while the oil price was low, could be carried out successfully. 2018 looks likely to hold more of the same. Several years of oil price turmoil have stretched balance sheets to breaking point, but have also driven opportunistic investment and innovation, giving the upstream market variety, albeit coupled with significant complexity, in terms of its potential sources of finance.

Relative stability driving activity and variety in upstream debt finance

A higher and more stable oil price, relative to the last few years, increases market confidence and has helped to drive a significant amount of bank debt into the market. Although capital is still constrained compared to the years leading up to the latest price cycle, the turmoil of the last few years has seen a significant broadening of types of finance available in the sector with the involvement and innovation of traders, direct lenders, streaming providers and others. We expect that more complex capital structures will continue to be seen in the coming period.

Notwithstanding improving market conditions, banks will of course continue to apply conventional risk mitigants (such as price decks at a discount to market curve, cover ratios, reserve tails and discount rates) to their deals; this leaves room for an alternative finance provider to deploy funds in the gap between the debt quantum supportable in the senior bank market and performance expectations from an equity perspective. An RBL could be bolstered by a trader-backed prepayment, a stream or a sold call option. Confidence is also gradually returning to the debt capital markets in the sector, which will lead to more borrowers pairing RBL and other products with bond issuance.

All of these alternative sources of finance introduce intercreditor complexities and a need to address competing demands on potentially strained borrower cash flow.
Trade, vendor and contractor financing

Structured commodity trade finance will remain a useful weapon in the debt-raising armoury. The flexibility and speed offered by trader-backed financings, from multi-billion dollar central Asian prepayments to smaller but still meaningful prepayments in West Africa, will remain attractive to all parties involved. Large and well-supported Middle Eastern pre-export financings demonstrate both an asset-driven ability to raise finance and bank appetite to lend. An interesting challenge for the market will be to navigate the natural tension between such financings and more conventional, purely bank-provided, fundraising, since each of them looks to projected cashflows from offtake for debt service.

Vendor financing is likely to remain a tool, with asset sellers participating in the capital structure at various levels – as senior lender, mezzanine lender, royalty recipient or otherwise. Whether vendor financing will be seen to the same extent as in the past couple of years (driven by a desire to shore up balance sheets by disposing of assets, even if that required some seller assistance) is an open question, although a somewhat higher oil price may mean less need for this. Greater asset valuations will support greater debt-raising capacity – although asking prices will rise accordingly.

Contractor financing is also emerging. Through the downturn in oil price, significant pressure was put on contractors to reduce costs but also to defer payment. Contractors effectively became a source of financing for the sector. Contractors are now working with their relationship banks to structure financing products, linked to specific projects but leveraging the balance sheet of the contractor companies. This allows contractors to structure their involvement in the financing of upstream development more efficiently and pro-actively, rather than simply reacting to adverse conditions by negotiating deferred payment terms. As pressure on development financing increases, and as the challenge of financing decommissioning projects looms, creative financing and the involvement of contractors as stakeholders in the financing structure of a project and its returns seems likely to be an increasing trend.

Development finance and project finance

Single-asset development finance, which has increasingly been raised by way of hybrid structures blending an RBL approach with many of the features of project finance, is likely to increase in activity, having been subject to a lull in recent years. This is driven by the development of major new discoveries, often in emerging market jurisdictions, by sponsors who are significantly capital-constrained following the challenges of recent years. A recent trend, which shows signs of increasing, is for joint venture partners to finance developments on a whole-of-field basis, rather than each JV partner financing their own share independently. This is partly driven by bankability factors relating to the interdependence of the financial stability of all the partners. This trend is also driven by the types of participants involved in developments – whereas large developments often used to be led by IOCs with deep pockets in partnership with NOCs, the divestment of assets by majors, and challenges for the balance sheet of all players in the market, has led to more desire (and in the case of larger players a reluctant willingness) to participate in asset-level financing.

Large scale project financing of integrated projects should also see an uptick in activity, driven by the higher oil price and the need for greater capital investment. After several years in which capital investment in major projects was substantially reduced, particularly as part of cost-cutting efforts on the part of majors, a need to invest now to satisfy future demand will lead to an increase in the number and scale of hydrocarbon project financings.

Acquisition finance

The key driver of new debt financings, certainly in late 2016 and the first half of 2017, was underwritten bank financing for private equity-backed acquisitions. The development of this market involved working through some fundamental tensions between leveraged acquisition financing norms of certainty of funding, and sponsor-friendly terms for major PE players, and the RBL bank market’s background of financings involving regular adjustment to debt capacity, and a significant degree of interface between bank groups and their borrower clients, including requirements to involve the banks in a wide range of decisions. The bank market has coped very well with this challenge and a number of large-scale syndicated financings have been raised, providing buyers with significant certainty and the conditions required to complete leveraged acquisitions successfully.

The M&A market is still strong and we expect these precedent deals to be built upon with further acquisition financings in the sector this year.