Driller killer

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The offshore rig financing market has been the most promising, lucrative, and robust of its kind in Latin America. It offered generous pricing, dollar revenues, and exposure to the best-regarded national oil company in Latin America – Petrobras. When Petrobras discovered huge deposits of oil in deep offshore formations, foreign lenders looked forward to a gush of business.
Petrobras has always been something of an anomaly among national oil companies. It has a reputation for solid management, has a US listing and prefers to be the operator of its own fields. Yet it can usually be pressed into service as an instrument of Brazilian economic policy, if not to the extent of Venezuela's PDVSA.

For drill-ship operators and their lenders, the isolation of Brazil's deposits from other production areas has meant historically that rig owners can charge Petrobras higher charter rates. In the last three years, Petrobras has responded by signing longer charters than the market norm, at slightly lower rates. Local operators and project finance bankers responded enthusiastically to the programme, part of the PROMIMP initiative.

The last game in town

Petrobras now accounts for 80% of the global market for long-term charters, in part because there is so little demand from other sources. Prices have collapsed, particularly for equipment in use in shallow waters. The market for deepwater vessels is much tighter, which is why Petrobras, surrounded by cancelled orders and struggling rig operators, is still scrambling to keep its procurement programme running.

Brazil's first round of bids, from 2007, involved six rigs, and local operators did well. Odebrecht, Schahin, Petroserv and Quieroz Galvao, each won one seven-year contract for 2,000m depth rigs, while Schahin and Quieroz Galvao also won five-year 2,400m contracts.

Quieroz Galvao closed an $810 million, 10-year deal with ING to finance its two rigs in 2007. That deal used an unusual tax-advantaged financing structure, though its documentation much more closely matched a shipping financing than a project financing. According to Mike Vernell, a partner specialising in shipping at Watson Farley & Williams, shipping deals tend to lean to a greater extent on the credit of the sponsor than the charter counterparty. "That said, in the market of November 2009, there are few enough deals that the distinction is hard to maintain."

Some deals for Petrobras vessels were signed in advance of their formally winning charters, leaving banks with a mortgage over the vessel, a hope that its value would hold up, and, usually, a promise from the sponsor to put up cash to collateralise any shortfall between debt amounts and a vessel's appraised value. While revenues from a charter would be dedicated towards debt repayment, banks often did not have security over the charter agreement, because they were signed after financing closed.

Odebrecht financed its rig, Norbe VI, though an eleven-bank $440 million financing, led by ABN Amro, which relied on the Petrobras charter, and Schahin followed with the Black Gold deal for its two rigs. Black Gold marked the high point of commercial bank interest in the Brazilian offshore sector – an $800 million ten-year financing, including a 3.5-year construction period, at terms just inside the lengths of the charters. Lead arrangers Mizuho, Standard Chartered, Unicredit/HVB and WestLB offered pricing of 237.5bp over Libor, for two rigs being constructed at an untested Chinese shipyard, Yantai Raffles.

Schahin's slow restructuring

Black Gold featured a number of piecemeal measures to mitigate this construction risk, including a 10% performance guarantee from Sinosure, 5% liquidated damages, an $80 million letter of credit, and a comfort letter from Schahin. All of them were needed when construction on the rigs began to slip behind schedule, though the benefits of these protections will not flow to lenders until the rigs are delivered. The debt is still undergoing an amendment and restatement, at sharply higher pricing, although getting approvals from all the banks has been, in the word of one banker close to the process, like "herding cats – though the higher pricing should help".

Schahin's difficulties have coincided with a drastic reduction in the number of banks willing to look at uncovered rig financings in emerging markets, and a reduction in the number of banks looking at rig financings at all. German and Nordic banks, which had expanded their shipping franchise into drill-ship financing, pulled in their balance sheet sharply. Several have received bail-outs, frequently because of their exposure to the volatile global shipping sector. HVB/Unicredit and HSH, which moved aggressively into the sector recently, are now holding back.

The difficulties with Black Gold, combined with banks' issues with the sector, have created a large backlog in financings. One of the casualties has been Schahin's own follow-up to Black Gold, called Black Diamond. Schahin has lined up around $800 million from Korean and Norwegian export credit agencies, but still has a $400 million hole to fill, and bankers familiar with the process say that there is no question of them seeking approvals for a commitment to the Diamond portfolio until the Gold vessels are restructured.

The Black Diamond rigs were awarded in 2008, two of 12 contracts that Petrobras awarded in June 2008 and which suffered from very bad timing. Petrobras never released a full list of the contract winners, but it is believed to include Etesco with one, Odebrecht, with two, Schahin with two, Delba with four, Petroserv with one, and two foreign operators, Scorpion and MPF, with one each.

The 2008 round of tenders featured even longer contracts, as well as low day rates, and were designed to maintain the interest of domestic operators at a time when global opportunities were plentiful. The high proportion of Brazilian winners validated the strategy, though finding sufficient equity to roll out the slate of ships, even with the 80% leverage that operators expected, was always likely to be a challenge.

Brazilian operators have the limited patience of Brazil's relatively healthy banks to depend on. Both Odebrecht, which recently put together a long-term financing, and Petroserv, last heard talking to WestLB about a deal, have made use of domestic bridge financing. Foreign players have suffered hardest. Scorpion, after failing in November 2008 to find any financing for its semi-submersible rig, decided to cancel its contract with Keppel to build the rig. MPF filed for bankruptcy protection in September, after failing to sell or refinance its debut project, and exhausting the patience of its bondholders.

The most spectacular casualties among potential sources of equity are the German KG funds. These retail-focused, tax-advantaged funds were popular among German professionals for assets such as wind farms and ships. At least one Brazilian rig operator, Delba, financed a rig with equity provided by KG manager MPC. The $488 million financing, led by WestLB, complemented $130 million of equity, initially from MPC, but later sold down to a dedicated fund. This fund has a duration of 17 years and promised investors a 328% pre-tax total return, and is not thought to have suffered any losses. Construction on the vessel, courtesy of Single Buoy Moorings, is scheduled to be complete in 2010.

The KG funds, however, have absorbed large losses in their conventional shipping investments, even larger than Germany's shipping banks. Adding insult to injury, KG partners have been asked to contribute additional equity to staunch fund losses. By one recent estimate, seven out of every ten idle ships are owned by a German financial investor. With many German investors complaining bitterly about the means by which they were sold on KG funds, the market is closed even for projects with better-quality charters.

The green and yellow shoots

But there have been financings in 2009. In March, Mitsui, Mitsubishi and Modec closed a $428 million JBIC financing for a floating production, storage and offloading vessel, relying on Japanese relationships rather than a still-frozen project finance market to raise the necessary funding. This project was not one of the 2008 slate of rig charters, but provided an early indication of how important to the health of the Brazilian rig financing market Japanese participants would be.

Japanese sponsors provided most of the equity for the first of the 2008 rigs to close. Etesco, the operator of a drillship capable of working at depths of 3,000m, closed an $820 million financing for the ship on 12 June, but only put up 11.76% of the deal's equity. Japanese sponsors Nippon Yusen KK (with 33.7%), Mitsui (with 21.78%), Kawasaki Kisen Kaisha (with 20%) and Japan Drilling (with 1%), put up most of the remainder, as well as Mike Mullen Energy Equipment Resource (with 11.76%).

Petrobras has struggled for ten years to diversify away from dependence upon Japanese trading companies and sponsors, but the downturn in credit markets leaves Japanese sponsors as the strongest available sources of equity. Etesco, however, did not go to JBIC for financing, raising $270 million of its $650 million debt requirement with a GIEK-covered loan from Eksportfinans. It closed the remainder with commercial banks ING, Mizuho, SMBC, BTM-UFJ, SG and Standard Chartered.

According to TC Høiseth, a partner in the corporate finance group at Arctic Securities, which structured the Etesco VIII deal, the financing illustrates how central the Norwegian export credit component has become. "A small number of Norwegian companies dominate the market for high-value drill-ship components, including Aker, National Oilwell Varco, and Kongsberg. Even if Petrobras does manage to spur the development of a local drillship industry, this content, and GIEK coverage, will still be a part of future deals."

Odebrecht comes back strong

The largest of the Brazilian sponsors – Odebrecht – has provided the most convincing evidence of a return to health in the market. Its ODN VIII and ODN IX financing, for the Norbe VIII and IX rigs, was delayed by roughly a year. "Originally we had RBS and Santander as financial advisers for the rigs, with a roadshow scheduled for the week after Lehman Brothers happened," notes Odebrecht Oil & Gas chief financial officer Marco Rabello.

The two rigs are to be built at a South Korean yard belonging to Daewoo, and Odebrecht was able to attract support from Kexim, unlike Etesco, whose rig is being built at a Samsung shipyard. Both Eksportfinans, with GIEK cover, and Kexim were able to go out to 12 years for Odebrecht. But Rabello sat down individually with 24 commercial lenders, twice the number that came in on Norbe VI.

Banks, working through a three strong group of advisers – now BNP Paribas, Societe Generale and Santander – fought hard during the middle of the year for the uncovered debt to have a tenor of eight years, and for the sponsor to contribute greater amounts of equity. Odebrecht held out – successfully – for 10 years and 80% debt. According to sources close to the deal, the substitution of Santander's credit committee for that of ABN Amro, following the former's acquisition of the latter's Brazilian operations, was keenly felt. Santander is accustomed in credit to being very strict with non-Spanish corporates.

The final financing package consisted of $335 million in sponsor equity, a $274 million loan covered by GIEK, a direct loan from Kexim of $165 million, a Kexim-covered loan of $135 million and a $770 million commercial bank tranche. The deal is comfortably the largest ever to close in the sector, though Odebrecht's size and heft mean that the Schahin restructuring and follow-up are likely to provide the purest evidence of banks' interest in the sector.

The bookrunners on the commercial debt, priced at 340bp over Libor initially, rising to 415bp over term, were Banco do Brasil, Banco Espirito Santo, BNP Paribas, Calyon, HSBC, Santander, and Societe Generale. Participants included CIC, Caixa Geral de Depósitos, ING, NIBC and WestLB. The relatively low-level participation of ING and WestLB, which have dominated the market in recent years, gives an idea of the internal pressures on banks' exposures to Brazilian offshore risk.

Schahin's travails directly affected one aspect of the Odebrecht financing – how the participants approached construction risk. The end result was decidedly sponsor-friendly. According to Stephen Hood, a partner at Mayer Brown, which advised Odebrecht on the deal, the financing started from the structure used in Norbe VI. "There were, however, key structural differences that required the allocation of risk between the sponsor, the lenders and the project counterparties to be revisited. For example, the underlying principle that the two drillships were fully cross-collateralised and cross-defaulted required careful analysis. Odebrecht wanted to ensure that any critical delay in completion of the second drillship could not default the first drillship, if at that time the first drillship was up and running. Carve-outs to the events of default were included so as to give Odebrecht some flexibility if this occurs."

The NOC takes charge

Petrobras, despite the unsettled state of financial markets, is determined to press on with a new round of charters for the exploration of the pre-salt fields. In September, it said it would procure 28 rigs for delivery between 2013 and 2018, but wants them to be built in Brazil, and feature roughly 60% Brazilian content. A first round of nine rigs would include seven to be built in single shipyard, to assure the putative new shipyard a steady stream of business, with Petrobras as the buyer. The remainder would be awarded in lots of up to four to established operators, on the condition that they build them in Brazilian shipyards.

There is widespread market scepticism that Brazil will be able to build a domestic drillship industry from scratch so quickly, although Petrobras' willingness to step up and fill the gap left by operator and lender weakness has won plaudits. If Petrobras does decide to buy domestically-built rigs directly from shipyards, it has been mooted that it might sell these back to operators, providing a lucrative source of business for lenders, without exposing them to construction risk. It may, however, stick to its existing practice of simply leasing rigs back to operators.

The Brazilian government's Guarantee Fund for Naval Construction would set aside R4 billion to support the construction of this slate of rigs, though foreign lender willingness to rely on this commitment is untested. Brazils' national development bank, BNDES, would for the first time have a role in lending to offshore oil projects, essentially as an export finance bank, since the special purpose vehicles used to own the rigs are likely to be based outside Brazil. BNDES recently closed a R$528 million bridge financing with a Petrobras-owned special-purpose vehicle to finance the Mexilhão 1 Platform.

Lenders active in the sector say that if domestic sponsors want to win any of the latest round of 28 rigs, it will be by combining BNDES debt with established sources of export credit debt such as GIEK, JBIC and Kexim. According to Paul Clifford, a director at Standard Chartered bank, "BNDES financing does look attractive, though achieving long-dated tenors for US dollar funding could be challenging, as might the use of Reais, because dollar revenues predominate on rig financings."

The Petrobras credit experienced a brief wobble in late 2008, but it has since recovered in the eyes of capital markets investors. On 30 October it sold $4 billion of bonds through Citi, HSBC, JP Morgan and Santander. Petrobras noted that the issue was the largest ever on the dollar bond market by a Brazilian corporate and was 2.9x oversubscribed. The issue broke down into $2.5 billion in 2020 bonds that priced at 238.5bp over the ten-year treasury for a coupon of 5.75%, and $1.5 billion of 2040 bonds that priced at 270.6bp over the 30-year treasury for a coupon of 6.875%.

On 4 November, Petrobras closed a $10 billion, 10-year loan with the China Development Bank, which signed alongside a ten-year agreement for Petrobras to sell 200,000 barrels of oil per year (150,000 barrels in the first year) to Sinopec. The financing reduces, but not eliminates, its dependence on government lenders. Its closing of loans in 2008 with Banco do Brasil and Caixa Econômica Federal was widely interpreted as a sign of weakness, and it has refinanced, and extended the maturities on, these loans in 2009 rather than repaying them.

A Petrobras-owned future

"When you add up the remaining sources of project finance for drill ships, the shipping finance, and the export finance capacity, it is still very challenging to identify whether there is sufficient capital to construct the number of assets which are needed to develop the Brazilian reserves," suggests Dan Bartfeld, a partner at Milbank familiar with the sector.

Bartfeld is alive to the possibility of greater cooperation between lenders such as BNDES and export credit agencies in order to fill this need for capital. Several bankers believe that Petrobras, as its September statement of intent on rig procurement suggests, will need to step up in some way to help get the drill ships, semi-submersibles and FPSOs in operation on schedule.

Petrobras has scrambled to sublease rigs under short-term charters from oil majors, and diverted a rig that it had chartered from Sevan Marine in the Gulf of Mexico to Brazilian waters. Sevan has now mandated ING to arrange a $525 million loan for a second ship on charter to Petrobras, this time with cover from Norwegian and Chinese export credit agencies. Brazil's national oil company may also bring together Japanese trading companies with struggling rig operators in a shotgun marriage.

The project banks' greatest fear is that Petrobras simply takes drill-ship construction contracts, which represent a small, if significant, portion of its pre-salt spending, back on its own balance sheet. Grounds for this fear come from the willingness of bondholders and export credit agencies to lend to Petrobras on a corporate basis. In this scenario, Chinese, Korean and Japanese funding supports both oil and gas imports from Brazil and their own struggling shipbuilding industries. Independent operators say this funding is likely to depress charter day rates for several years.

In the last 18 months Petrobras, the last game in town for long-term charters, and the small number of shipyards capable of building deepwater rigs have eyed each other warily over the heads of struggling ship operators. Petrobras might be tempted to bypass the operators altogether, but its local content ambitions will make any accommodation temporary at best.

ODN VIII and ODN IX
Status: Signed 29 September
Size: $1.68 billion
Location: Brazil
Description: Financing for two drillships capable of operating at 3,000m
Sponsor: Odebrecht
Equity: $335 million
Charter: Petrobras, 10 years
Debt: $274 million GIEK-covered Eksportfinans direct loan, $165 million direct Kexim loan, $135 million Kexim-covered loan and $770 million commercial bank loan
Tenor: 12 years (covered and ECA), 10 years (commercial bank)
Financial advisers: BNP, Santander, Societe Generale
Bookrunners: Banco do Brasil, Banco Espirito Santo, BNP Paribas, Calyon, HSBC, Santander, and Societe Generale
Accounts bank: JP Morgan
Sponsor legal: Mayer Brown
SPC legal: Akerman Senterfitt (Delaware), Maples and Calder (Cayman Islands), Gus Constantakis Chambers (Bahamas)
Lender legal: White & Case (US), Souza Cescon (Brazil)
Accounts bank legal: Clifford Chance
Kexim legal: Yulchon