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Sizing and structuring matter in reserves-based oil and gas

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Despite difficult market conditions, reserves-based lending has reached its zenith in terms of liquidity and deal size. Banks have lent to oil and gas producers against oil reserves in the ground for over 30 years. The pioneers were small exploration and production firms in the US Midwest. Now bigger, bolder borrowers dominate the market, exemplified in recent, oversubscribed deals like Tullow Oils $3.5 billion loan and Swedish independent Lundins $2.5 billion borrowing base.

But reserves-based lending isnt just getting bigger. Banks are applying structures to unconventional assets at the smaller end of the spectrum, and are prepared to look at more challenging jurisdictions. Recent examples include Glencores $600 million seven-year loan for its Equatorial Guinea operations, the trading companys first RBL, financings, some with export credit agency support, for shale gas developments in the US, and even coal bed methane extraction in China. Reserves-based lending has grown up, serving new clients on new assets in riskier jurisdictions than ever before.

The allure of RBL

One explanation for the rude health of the market, split between London and Houston, is the growing number of independent exploration and production companies moving into new regions. Unlike oil majors, these younger producers lack capacious balance sheets, so their best option is the structured debt market. Borrowers like revolving reserves-based facilities because they give them flexibility in implementing spending plans, and portfolio deals allow them to add or remove borrowing base assets.

As these juniors grow, lenders know that frequent refinancings bring repeat business and fees. An oil and producer gas producer that repays its loan is no longer deemed to be in growth mode. It is actually quite rare when a mid-cap oil and gas company repays its loans according to their fixed amortisation schedules. Successful companies tend to refinance regularly, expanding their facilities to fund future growth, says William Stevens, global head of upstream oil and gas at HSBC. Although tenors go out to 7 years, most of the RBL commitments stay on banks books no more than 12 months with margins varying between 300bp and 600bp over Libor.

RBL structures suit other needs of growing corporates too, argues Jason Fox at law firm Herbert Smith Freehills. Typically a borrowing base will cover a handful of assets, but it can just as easily be secured on a single field or a very large number of fields. Lundins facility is available to 10 different borrowers within the Lundin group and sized off their assets in Indonesia, Norway, Sweden and France, and Tullows is sized against its whole portfolio, not just the Ghana assets that have been the focus of its recent development efforts. These are quasi-corporate reserves-based facilities suited to more mature producers like Tullow, where the covenants are relatively loose.

RBLs are also used to replace the bridge facilities that finance acquisitions. In this case the bridge financing is taken out by the RBL after acquisition work on the RBL deal may begin as soon as you close the acquisition, says Fox. Heritage Oil and Shoreline Power recently closed a $550 million bridge loan with Standard Bank, China Development Bank, Ecobank Nigeria and First City Monument Bank to support their $850 million acquisition of the OML 30 block in Nigeria, and are already at work on the long-term reserves-based refinancing of this debt.

New lenders, new markets

Just as reserves-based deals facilitate the entry of new operators into markets, there has been some turnover in the cast of lenders offering the product. The spike in dollar funding costs in the wake of the Eurozone crisis left European banks with less debt capacity and made them increasingly selective. French banks, which are particularly active in the upstream sector, looked wobbly earlier in 2012, though they have reported a reduction in funding costs in recent months and have been out in force on recent financings. Government-owned lenders like RBS and Lloyds now seek a UK component to deals rather than venturing into foreign jurisdictions. Both came in on the $430 million facility that Ithaca closed to finance development in the UKs continental shelf.

Reserves-based loans for popular borrowers also enjoy a reasonably liquid secondary market. Banks with constrained balance sheets can either sell down debt in a formal syndication or piecemeal in the secondary market, marketing the strongest names on their books to free up their balance sheets for new lending, while maintaining a lead arranger franchise. Performing RBL assets are liquid and popular and holding large tickets to maturity is costly. As long as clients have the money when they need it they are less sensitive to the lender mix, said one banker.

The growing choosiness of some lenders has created a gap others are keenly exploiting. HSBC has built up a strong franchise, and South African banks like Standard Bank and Nedbank increasingly appear in deals, as do lenders in countries that escaped the worst of the crisis and enjoy low funding costs, like Scotiabank and Commonwealth Bank of Australia. In Nigeria, local banks like UBA, Stanbic IBTC, Ecobank and Fidelity dived into the Exxon Mobil and Nigerias state oil company NNPCs $1.4 billion reserve-based financing facility at unprecedented levels. Reserve-based debt will fund the purchase by local oil groups, including Oando and Seplat, of ConocoPhillips onshore Nigerian assets, say local bankers.

US lenders like Bank of America Merrill Lynch, Citibank and JP Morgan are also new faces. They had steered clear of undeveloped oil and gas assets in international waters but are now lending upstream in riskier regions. They hope to nurture client relationships that could ultimately bear fruit in capital markets work. As borrowers grow and evolve they sometimes require commodity hedging products, investment banking services such as financial advice, and debt or equity underwriting. But these banks cost of capital is comparatively high, so they try to flip RBL exposures in the secondary market inside a 60-day window.

Non-bank lenders are also appearing, like Siemens, GE Energy Financial Services and BPs Britannic Strategies, the last two of which participated in the SG- and RBS-led $155 million loan for Xcite Energys Bentley field development in the UK North Sea.

ECAs are also looking at financing for strategic resource acquisitions. Koreas Kexim provided an RBL-based facility for a Samsung C&Ts acquisition of Parallel Petroleums 69 million barrels of reserves. JBIC has also financed onshore shale gas plays in the US and Canada, mostly because the buyers hope to export this gas to Japan. But ECA participation in the market isnt expected to grow much. ECAs tend to prefer funded commitments rather than unfunded revolving commitments and only Asian ECAs focus heavily on financings for resource imports.

Multilaterals are increasingly active in the market, though they need to be convinced that producers have incorporated sufficient environmental and social risk mitigation. The International Finance Corporation came in on the Tullow deal, participated in Southeast Asian-focused Salamander Energys $325 million reserves-based loan and made an equity investment in Latin American independent GeoPark, with Itau BBA providing GeoPark with $37.5 million in debt. These projects meet with our developmental angle of helping the growth of the private sector in developing countries, says Walid Labadi, chief counsel in the IFCs legal department. Although the IFC is looking at financings for liquefied natural gas projects in Mozambique that may feature some reserves risk, RBL gas deals could be trickier to get away, mostly because gas doesnt have a global transparent price like oil.

The old guard endures

Despite the emergence of new lenders, the barriers to entry are still high. Banks have to keep engineers and geologists on staff to properly measure reserves risk. Politics can get in the way, too. The Kenyan government is examining Cove Energys acquisition by Thailands PTT, saying that it may be due a tax payment on the transfer, and in Uganda Tullow is squabbling with the government over building a refinery.

But established upstream lenders are prepared to move into new jurisdictions. French-listed mid-size producer Maurel & Prom closed a $350 million five-year deal with Natixis, BNP Paribas, Credit Agricole and Standard Bank for its Gabonese subsidiary. But that debt had a parental guarantee and no reserves-based mechanism. It refinanced a four-year $255 million reserves-based deal that Maurel & Prom closed in 2009 and expanded to $330 million in 2010.

It is also much harder for lenders to juice returns on reserves-based deals by including a high-priced mezzanine tranche. These tranches often had higher margins and could be used to finance pre-development assets or exploration, but now are only available to the strongest sponsors like Tullow.

Basel III might make African onshore assets more difficult to finance, because assets, output and accounts that are more vulnerable to political interference may attract higher capital charges than offshore projects. In the event crude is shipped from offshore fields to international markets, and where accounts are offshore, there is less of a problem, says HSBCs Stevens. Onshore deals are going to find it harder to get done.

Basels higher cost of funding might force sponsors to turn to new investors like pension funds. Outside the US, and to a lesser extent the Nordics, a high yield bond market supporting international oil and gas developers has yet to emerge. Short-term unfunded commitments to borrowers with heavy commodity price exposure make poor bond market candidates.

But RBLs have suffered very few losses. The sector has seen technical defaults and loans rescheduled, but little else, says Herbert Smiths Fox. There have only been three or four cases where banks have actually lost money in the last 25 years. The pipeline is even relatively immune to oil price volatility. Banks participate in deals based on their in-house view of oil prices over the long-term. Borrowers tend to hedge their oil price risk and banks push to ensure they win that ancillary hedging business. If there is no hedging in place banks will use a lower oil price to support the borrowing base, said one observer. Regardless of the changing cast of lenders, banks will make sure theyre positioned to grab a slice of sponsors upside.