Specialized Assets Lending in the Nigerian Upstream Oil and Gas Sector

Proem

The oil and gas business is an extensive, complex, worldwide industry with extremely diverse risks; especially in relation to the upstream sector, where operations are very capital intensive. Indeed, conventional lending options do not readily provide the necessary financial backing in some cases, and commercial lenders may not always be keen to finance upstream activities. For companies with less cash to fund their projects, securing financing that are not accompanied by high interest rates for loan servicing, becomes a key concern.

Given these accumulated issues, it becomes obvious that the high amount of risk in petroleum investment leads oil and gas exploration project sponsors to seek other ways to finance their operations.

This article seeks to discuss the concept of specialized assets lending as a viable financing feature for players in the upstream oil and gas industry, alongside important factors to be considered by the lender and the borrower, when choosing specialized asset lending as a business financing option.

Introduction to Specialised Assets Lending

A common means through which companies access finances is through cash flow-based lending, where lenders rely on past and projected cash flows of an entity, in determining loans granted to borrowers. However, unlike such conventional lending, specialized assets lending (SAL) (also known as asset-based lending), is a rather non-traditional means of financing, where loan issued to a borrower is secured by leveraging the cost of a specific asset or assets of the borrower, as opposed to the borrowing entity itself.

This would generally see the borrower use its assets as collateral for obtaining the required loan. As such, SAL is a great option for borrowers in the industry who have assets or require finance to purchase assets with great loan to value ratios. Under this arrangement, the lender's primary focus becomes the existing and future value of the asset, which would typically be evaluated through a field examination or third-party appraisal. In more complex arrangements, the borrower may incorporate a special purpose vehicle (SPV) to hold the collaterised asset of the borrower.

Accordingly, the SPV would act as the actual borrower of the loan from the lender and secure the loan with cash flows generated from the secured asset.

However, what are the specialized assets in the upstream petroleum industry? They include Petroleum Exploration Licenses, Petroleum Prospecting License and Petroleum Mining Leases (OML), alongside their associated infrastructure such as oil rigs, gas plants, pipelines, property and equipment (PPE), inventory, marketable securities, account receivables, intellectual property rights, brand names, as well as real property.

Characteristics of Specialized Assets Lending

Some of the major characteristics of SAL are:

a. The purpose of the loan is usually to acquire or finance an asset, which will serve as the collateral for the loan.

b. The cash flow generated by the asset becomes the sole exclusive source of repayment of the loan.

c. The lender assumes control over the asset and the income it generates.

d. Loans are typically underwritten with a limited number of financial covenants which creates lender risks that mitigated by conservative advance rates against liquid collateral, strong collateral controls, and frequent monitoring.

Types of Specialized Assets Lending

SAL may be undertaken in varying forms which include:

Project Finance: Here, the loan funds the infrastructure required for a particular project, which could be an oil field, power plant, or transportation infrastructure, with repayments made from the revenue generated from the operation of the completed project.

Object Finance: Here, the loan funds the acquisition of equipment, for example, a drilling rig, with the repayment of the loan being dependent on the cash flows generated by the bought assets that become pledged to the lender.

1. Ayodele Oni, 'Understanding Petroleum (Oil & Gas) Transactions and the Nigerian Market' (2021), CIPLUS Limited, p199.

2. Section 4 of the Petroleum Industry Act (PIA), 2021.

3. Section 53 of the PIA, 2021.

4. Issued by the Central Bank of Nigeria in 2014.

Commodities Finance: Here, commodities such as crude oil are purchased or produced with the loan, with repayments based on inventories or receivables from the sale of the commodity.

Advantages and Disadvantages of Specialized Assets Lending

Potential candidates for SAL are producers, manufacturers, distributors, or retailers with a rich asset base, who may have variations in cash flow but need significant capital for larger scale business operations.

Some of the advantages of SAL are that:

a. Borrowing terms generally provide more flexibility to fit into the borrower's specific business needs;

b. It provides ready cash to support liquidity needs, eliminating the need to wait for the collection of receivables; and

c. It provides important funding for companies in cyclical or seasonal industries by providing liquidity during slow sales periods and periods of inventory build-up.

Some of the disadvantages of SAL are that:

a. For the borrower, the loan agreements typically allow the lender to take control of the borrower's cash or more readily seize the collateralised asset in the event of default; and

b. For the lender, the administration and monitoring of SAL can be financially and time consuming, and it can also be susceptible to borrower fraud.

In all, the key point to note is that SAL can be more flexible, but likely cost additional fees and create the risk of loss of asset in the event of default.

Warning Signals and Risks

Considering the quantum of exposure in the upstream oil and gas sector, and the risk management deficiencies which may exist in the system, the need to proactively guard against a crystallization of such risks becomes apparent. The following are some of the issues usually considered to protect lenders:

a. **Financial Strength**: In considering the financial strength of the borrower, the lender weighs the borrower's creditworthiness, share in the income generated by the asset, tenor of licence/lease, cash flow predictability/-decline in revenue that may significantly increase the risk of default, other isolated activities of the borrower, loan to value ratio and history of contract non-compliance, amongst others.

b. **Transaction and/or Asset Characteristics:** This includes the market value/resale value of the asset, high operational cost, susceptibility to damage and exposure to market/cycle risk. The existence of maintenance contracts.

c. **Regulatory Legal Risks**: The upstream sector is highly regulated in Nigeria, and changes in government policies can affect the industry. Upstream companies need large areas of land to develop and operate wells. upstream carries environmental risks, and there is extensive state and federal regulation of access and environmental remediation. Additionally, government restrictions .

d. **Security Risk:** The lender considers the capability to remarket the asset(s), lender's right to assignment of asset, lender's right to assignment of rents/income, risk of losing control of asset, limited ability to monitor location and condition of asset, weak insurance coverage and limited control over cash flows, amongst others.

e. **Operational Risks:** Once the project or asset is completed/purchased, it must be operated and maintained in such a manner that the borrower can comply with its obligations under the loan agreement. To ensure that the project operates at the level required to generate the revenues forecasted and needed to repay the loans, the borrower must engage the use of maintenance contracts, obtain insurance, and agree to extensive reporting obligations and inspection by the lender.

f. **Reservoir risk:** This relates to the uncertainty in development and production of hydrocarbon in commercial quantities, in the light of geological, economic and technological uncertainties. Usually, a reserves consultant will prepare reserves report as a financing condition precedent to establish the nature of the recoverable hydrocarbons and verify the production projections and reasonableness of the proposed production costs.

g. **Price risk:** Volatile market prices are a major repayment risk for upstream borrowers, due to weather, changes in supply and demand, and geopolitical events or conflicts. Commodity swaps, call options, put options, futures contracts, and forward contracts are the most common derivatives used to hedge against such occurrences. Upstream companies also use future and forward contracts to lock in oil and gas at a future sell price. [1]

h. **Credit Risk:** Credit risk arises from the ability or inability of the borrower to repay debt with operating cash flow generated from the asset. Borrowers can mitigate many of these risks by obtaining insurance coverage, employing hedging and structured finance strategies, and taking ownership of service companies or equipment.

Management and Assessment

In addressing the aforementioned risks, lenders, especially banks, deploy the use of risk rating systems which, although varying in their approach, seek to determine all or one of financial objective benchmarks, stress testing, and credit ratings.

These management processes are used within the context of the following summarized criteria:

a. **Government Regulations and Control:** Considering the complexities and risks involved, and the strategic importance of the oil and gas industry to the Nigerian economy, the industry is highly regulated by the government. Over the years, regulations and guidelines have been issued that require certain approvals and consents to be obtained as conditions precedent to consummating transactions in the industry. The foremost industry regulation is currently the Petroleum Industry Act, 2021, which provides for a new regulator called the Nigerian Upstream Petroleum Regulatory Commission,[2] while the government participates in the oil and gas industry through the national oil company, NNPC Limited.[3] Importantly, the PIA provides for the ownership of petroleum within Nigeria, the requirements for obtaining industry licenses; such as the Petroleum Exploration Licence, Petroleum Prospecting Licence and Petroleum Mining Lease. Oil and Gas Industry Credit Risk Mitigation Framework (the "Framework"), issued as a guide for the purpose of financing of the specialized assets.[4]

Importantly, the Framework provides that:

i. Banks ensure that the projections of volumes of crude oil sales for upstream obligors are backed by independent and professionally prepared reserves estimation reports.

ii. Adequate technical data is provided by the obligor for the management of obligor credit risk, including a copy of the feasibility study of the project being financed.

iii. Collateral documentations are perfected, and copies placed in the obligor's credit file

iv. There is a documented improvement in their monitoring activities of Oil and Gas Exploration and Production exposures.

v. Oil and Gas Customers have a robust and effective enterprise risk management policy and system. Of key importance is a price risk hedging policy.

vi. Adequate training in credit appraisal is provided for the marketing, and credit risk management units, amongst others.

b. Financial Strength/Flexibility

i. Debt Service Coverage Ratio (DSCR) - The ratio between an asset's cash flow and its debt service requirement is a strong predictor of its financial capacity. The DSCR thresholds or ranges developed by the lender reflects the results of stress testing and/or modelling projects with similar characteristics.

ii. Leverage or Loan to Value (LTV) - The ratio between an asset's indebtedness and its market value is a strong predictor of its level of credit risk. An asset's LTV is closely related to its DSCR. Due to the relationship between a project's DSCR and its LTV, these two assessments are combined to identify segments of the portfolio that are deteriorating and improving.

iii. Tenor of Transaction Compared to Useful Life of the Asset: This rating assessment incorporates an estimate of the useful life of the asset or the period it will require limited capital expenditures that are supported by the economics of the project. The risk is deemed lower when the transaction's tenor is shorter, compared to the asset's useful life, but deemed higher when the tenor is longer compared to the asset or project's useful life.

c. Stability of Supply & Demand/Marketability/Resale Value

i. Competing sources of supply (both existing and planned), estimates of demand and growth in demand, and analysis of buyers' willingness and ability to pay for project output.

ii. The quality of the asset being financed, particularly with respect to its design, configuration, maintenance requirements and overall condition.

d. Collateral Control: Such as

i. Controls over the disbursement of funds, including the use of escrow accounts to control construction advances and the requirement that independent engineers certify that work has been completed prior to disbursing additional funds.

ii. The adequacy of the laws and regulations, with regards to the enforceability of security contracts, bankruptcy laws, licensing procedures, and tax regimes in the location of the project or asset.

iii. The extent to which financial covenants ensure that the lender has first claim on the asset and its cash flows.

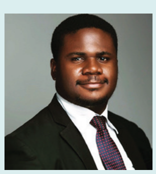
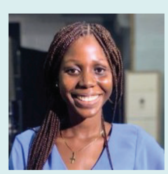
iv. The use of escrow accounts or lock-box arrangements to enable the lender to control cash receipts generated by the asset.

e. Strength of Management: The experience, reliability, and financial strength of the borrower.

Conclusion

Having considered the nature of SAL in the Nigerian oil and gas industry, it is important to note that although lenders may be reluctant to grant loans for the financing of specialized assets due to the high risk associated, the key to the bankability of such transactions lie in proper due diligence by the lender in respect of the financial indexes, title to assets and other forms of regulatory compliance regarding the borrower and the project/asset, and the level of control shared in respect of the transaction. Considering that capital investment is a continuous need of the sector, it is also pertinent that the regulatory climate facilitates the enforceability of contracts and security by lenders.

For more information please contact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