Financing an Oil and Gas Project*

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Abstract

Traditional ways of financing for a typical private or public company include loans, venture capital, common and preferred stocks, and debt instruments. An oil or gas project can be financed using traditional financial instruments, as well as instruments that are more appropriate for the industry, such as project financing, private equity, joint venture, and in situations that involve sovereign states, oil loans, and multilateral lending through international organizations.

Challenges and opportunities that can potentially have great financial impact include:

- The new oil boom for the next 20 to 50 years
- Projects getting larger and require more capital
- Political risk at historical highs due to the public and a portion of investors becoming more “socially conscious”
- More capital available, but tougher competition
- Business risk with potential break-through in the alternative energy industry

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By

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Brief Overview

- Common capital sources for a typical business project
  - Features, pros and cons of each capital source
- Capital sources for the oil and gas industry
- The challenges of financing an oil and gas project

Common capital sources

- Sources of capital for a typical small business
  - Personal funds, including those from family and friends
  - Commercial loans
  - SBA loans
- Sources of capital for a typical (tech) start-up
  - Angel capital
  - Venture capital, including private equity

Common capital sources - debt

- Sources of capital for a typical public company
  - Debt: most common form of debt is corporate bond
    - No ownership claims
    - Fixed claim on corporate cash flows (coupon rate), hence the name "fixed income product"
    - In a bankruptcy proceeding, debt holders get paid before preferred stock holders and common stock holders
    - Suppliers → government → collateralized debt → senior debt → general debt → subordinate debt → preferred → common

Common capital sources - equity

- Equity (common stock)
  - Each share represents a proportional claim of ownership
  - Claim on cash flow is residual – “whatever left by the others”
  - Stand last in line to get paid when a company go bankrupt
    - How much do you think the equity holders will usually get paid?

Common capital sources - preferred

- Preferred stock
  - Has some equity features – claim on cash flow is not guaranteed, but usually enjoys cumulative rights
  - Has some bond features
    - an stated interest rate (even though payment is NOT guaranteed each year)
    - no ownership claims, hence no voting rights
  - Some called it cheap equity, some called it expensive debt

Comparison of common capital source

- Risk-wise: common > preferred > debt
- Reward-wise: common > preferred > debt
- Bankruptcy payment priority: debt > preferred > common
- Some notes:
  - No 100% equity financed company can be forced to go bankrupt
  - Leverage (meaning borrowing debt) can improve the bottom line to a certain extent
  - More leverage, more financial distress

Some notes - continued

- Investors will require different rate of return based on their assessment of your company's credit worthiness and riskiness of the project
- Different companies doing similar projects may have to pay very different rates

The Oil and Gas Industry (1)

- Traditional corporate finance through debt and equity
  - Against firm's overall credit worthiness
  - Investment banking process costly and time-consuming
  - May not fit the needs of large projects, which can be as large as, or even larger, than the company itself
  - EFN may be carried out for smaller projects and other internal needs as the company grows
  - Many companies choose to form joint ventures to share the financing responsibility

The Oil and Gas Industry (2)

- IPOs
  - Heavily dependent on oil and gas prices
  - Heavily dependent on economic and financial market conditions
  - May not be very receptive to new IPOs at a time when your company needs the capital
    - Recent IPS slump
    - American Energy Partners

The Oil and Gas Industry (3)

- Private equity
  - Attracting private investors with the potential of your projects
  - A major source of funding for many small upstream adventures that exhibit technological advantages but lack sufficient funding to realize its profit potentials
  - Some private equity funds
    - Energy Trust Partners – mainly invest with experienced management
    - 3i – global partner in the upstream oil and gas industry that started in the early 1970s.

Private equity examples (2)

  - HitecVision – European-based and exclusively invests in the assets side, such as drilling rigs, supply vessels and subsea construction vessels.

- Private equity has offered tremendous support to a substantial portion of the independent producers, which represent 90% of the petroleum produced in North America.

- Private equity's support of the oil and gas industry is also heavily influenced by oil and gas prices

The oil and gas industry (4)

- Venture capital
  - In the early 1980s, represented 20% of all venture capitals
  - Today, about 1%
  - Reason for decline
    - Investment horizon too long, capital commitment too intensive, break-through technology too few and far between
    - High-tech firms offer much better risk-reward ratio

The oil and gas industry (5)

- Debt
  - Small upstream firms may have a hard time raising debt
    - Debt investors are mostly concerned about stable cash flows
    - By nature, small upstream firms do not have such stable cash flows (yet)
    - Having proven reserves will increase your risk profile significantly
    - Having diversified line of business, e.g. both exploration and production, will increase your chance to successfully raise debt AND lower your rate of borrowing

The oil and gas industry (6)

- Project finance
  - Different from corporate finance in that lending is solely based on and secured by the assets and cash flows of a particular project, which is separate from the sponsor (the parent company)
  - Usually used for large, long-term, high (but manageable) risk projects; cash flow is usually the only target for investors
  - All the usual financing tools may be used, but most such projects are financed using high leverage where debt accounts for more than 60% of total financing
  - Many are large, government financed projects

The oil and gas industry (7)

- Other financing terms and jargons
  - Multilateral lending: World Bank, International Bank for Reconstruction and Development (IRBD), International Development Agency (IDA), International Financing Corporation
  - State interests and state-run companies
  - Oil loans

The oil and gas industry (8)

- Challenges and opportunities in the oil and gas industry
  - The new oil boom for the next 20 to 50 years
  - Projects getting larger and require more capital
  - Political risk at historical highs due to the public and a portion of investors becoming more “socially conscious”
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