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Petrofac Ltd's financial troubles compounded by legal woes

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On 30 August 2017, Petrofac Ltd, a leading service provider to the oil and gas production and processing industry, released its half-year results ended 30 June 2017 (1H 2017). The company reported a worsening in financial conditions, with net debt surging by 59.5% as compared to 6 months ago, and net cash flow from operating activities deteriorated from a net inflow in 1H 2016 to a net outflow in 1H 2017. Consequently, the company cut its full-year capital expenditure by around USD 100mn to less than USD 250mn, and slashed its dividends by almost half as compared to a year ago. Correspondingly, the RMI-CRI 1-Year Probability of Default (PD) for Petrofac rose sharply in May 2017, implying a weakening credit profile (see Figure 1).

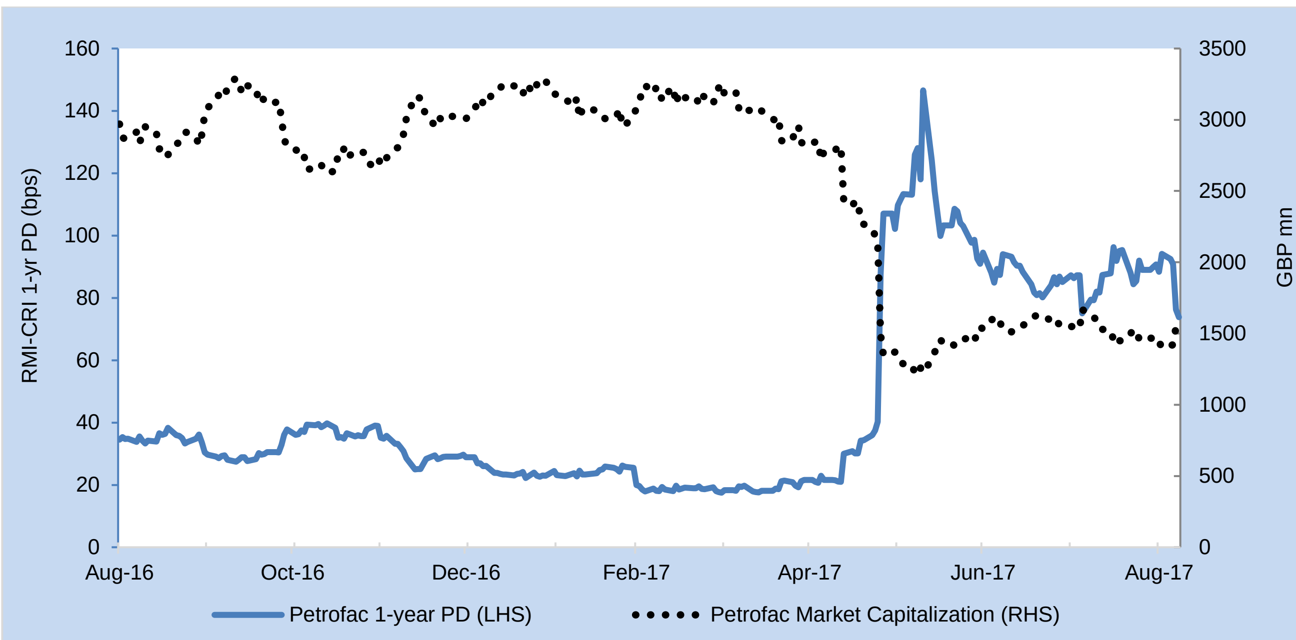

Figure 1: RMI-CRI 1-year PD (LHS) and Market Capitalization (RHS) of Petrofac Ltd. *Source: RMI-CRI, Bloomberg*

	2H 2015	1H 2016	2H 2016	1H 2017
Net debt/EBITDA	--	4.43	1.72	2.55
Cash ratio	0.22	0.25	0.23	0.20
Net Income (USD mn)	-167	12	-11	70
Free Cash Flow (USD mn)	480.0	82.0	435.0	-88.0

Table 1: Financial Data for Petrofac Ltd. *Source: Bloomberg*

In a press release on its 1H 2017 results, Petrofac attributed the deterioration in its financial conditions to the weak oil market and escalating legal woes faced by the company. Indeed, the oil market continued to face challenges, with the WTI crude oil price languishing near USD 50/bbl, which is far below the pre-crisis level of around USD 90/bbl in year 2014 (see Figure 2). This was despite efforts undertaken by the OPEC cartel and Russia to curb oil output until March 2018. This downturn in the oil market consequently led to a squeeze on spending on oil processing services, leading to a 24% tumble in Petrofac's first half revenues from USD 3.89bn in 1H 2016 to USD 3.13bn in 1H 2017, and a fall in net profit (before exceptional items) from USD 165mn in 1H 2016 to USD 158mn in 1H 2017.

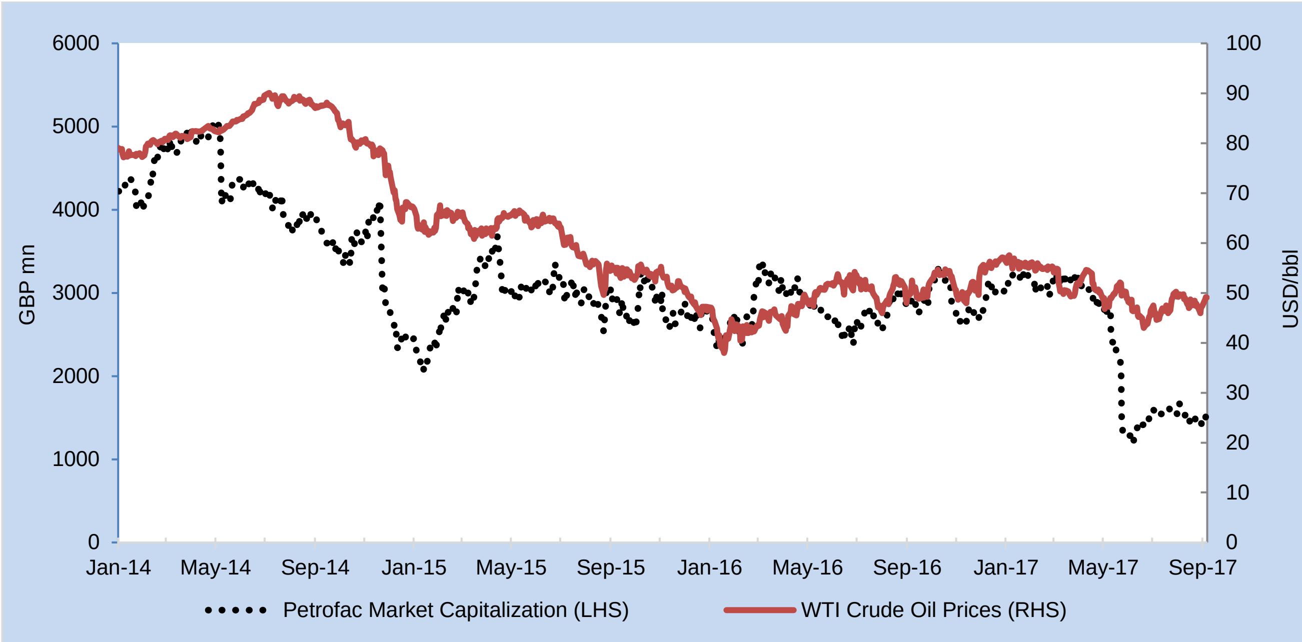

Figure 2: Market Capitalization of Petrofac Ltd (LHS) and WTI Crude Oil Prices (RHS). *Source: Bloomberg*

Challenging market conditions have in turn caused Petrofac's financial conditions to worsen, in particular its credit profile. Its net debt soared from US$617 million at the end 2H 2016 to US$984 million at the end of 1H 2017, while its net debt/EBITDA ratio rose from 1.72 to 2.55 in the same period (see Table 1). According to the company, the surge in net debt was primarily due to higher borrowings and increased working capital movements that led to lower cash holdings. A closer examination of Petrofac's financial statements suggests that a surge in accounts receivable from USD 1.377bn at the end of 2H 2016 to USD 2.038bn at the end of 1H 2017 caused cash flow to drop. Net cash outflow from operating activities was USD 43mn in 1H 2017, as compared to a USD 474mn net inflow in 2H 2016. In fact, Days Sales Outstanding (DSO) surged from 60.46 to 106.82 in the same period. This suggests that the company seems to be facing difficulties in collecting payments from clients, and this reversal from its formerly "strong performance on cash collection" in 2H 2016 as mentioned in Petrofac's Annual Report 2016 is worrying, as it signals that the deterioration in Petrofac's credit profile could continue even once the oil market stabilizes.

A quick turnaround from the current predicament is unlikely, as the outlook for the oil market remains bleak. While the agreement on curbs of oil output has so far observed high levels of compliance among OPEC producers and Russia, it is questionable whether such levels of compliance will be sustainable. This is because it may not be in the interests of oil companies to see prolonged lost revenues from keeping new oilfields on the shelf as part of the supply cuts agreement. Should cooperation between OPEC producers and Russia break down, global oil supply is likely to rise again, putting downward pressure on oil prices and reducing demand for oil services provided by companies like Petrofac. Moreover, , a rally in oil prices is even unlikely, if the cooperation is sustained, as oil prices above USD 50/barrel probably lead to a resurgence in oil production by U.S. shale drillers, which means global oil inventories will probably remain well above the level targeted by OPEC ministers. In fact, analysts at energy consultant Wood MacKenzie project that the extension of supply curbs by OPEC producers and Russia would help U.S. shale oil output accelerate to its fastest growth rate in years, causing global oil inventories to increase by an average of more than 500,000 barrels a day in year 2018. Hence, the OPEC producers are in a Catch-22 situation—regardless of whether they choose to comply with the agreement on curbing oil supplies, or violate the terms of agreement to gain market share and revenue, the oil market prospects look dull. Consequently, the possibility of Petrofac's revenue and profits rebounding is remote.

Further worsening these challenging market conditions are escalating legal woes faced by the company. On 12 May 2017, Ayman Asfari, Petrofac's Chief Executive Officer, and Marwan Chedid, Petrofac's Chief Operating Officer, were arrested and questioned by the Serious Fraud Office (SFO) as part of an ongoing probe into a global corruption scandal in the oil services industry, and in response, Moody's downgraded Petrofac's credit ratings from Baa3 to Ba1, which is in junk territory. In addition, on 24 August 2017, the Italian National Commission for Companies and the Stock Exchange (CONSOB), Italy's markets watchdog, had imposed sanctions on Mr Ayman Asfari, including a EUR 300,000 fine, in relation to allegations of insider trading in the shares of an Italian company. The effects of these mounting legal woes are twofold. Firstly, these legal woes could put further strain on Petrofac's cash flows, thus worsening its credit outlook. In fact, analysts warned that the fine imposed by SFO could be as much as USD 800mn, which would wipe out the savings from Petrofac's reduction in capital expenditures and slash in dividend payouts as mentioned earlier. Secondly, such legal woes might hurt the company's reputation and its ability to win new services contracts, thus further worsening the company's finances in an already tough business environment.

These challenges from the weak oil market and legal woes have in turn cast doubt on Petrofac's ability to service its debts. Petrofac has a USD 1.2bn 5-year committed revolving credit facility, maturing June 2020, with a syndicate of international banks, which is available for general corporate purposes. The facility is unsecured and subject to two financial covenants relating to leverage and interest coverage. While Petrofac is still in compliance with these covenants for the period ending 30 June 2017, continued deteriorating financial conditions might eventually cause Petrofac to breach these covenants, further limiting the amount of liquidity available through its revolving credit facility, which could be as little as USD 100mn, according to analysts at Bernstein.

Amid such deepening risks, Petrofac's prospects have recently improved by contract wins in Russia and Turkey. While such contract wins are welcoming news for Petrofac's investors, sustained contract wins and an improving oil market are required for a material improvement in Petrofac's credit profile to be realized.

Credit News

China's latest bond default is a cautionary tale for investors

Sep 11. Foreign investors remain cautious of Chinese bond market after the corporate default of Wuyang Construction Group in August. Bondholders protested against the non-disclosure of transgressions in sale documents for the bonds in previous exchange filings. Chinese defaults have risen by six folds since the end of 2015 after Beijing withdrew its implicit governmental support for troubled companies. Beijing's bailout record has made investors complacent as they overemphasized on the yields while downplaying the risks involved. The intentional non-disclosure of Wuyang on its previous loan defaults also raised doubts over the trustworthiness of bond documents in China. Foreign investors who are heavily dependent on paperwork might shun away from the Chinese bond market as a result. (Bloomberg)

Noble shortlists bidders for USD 1bn oil business

Sep 10. Commodity merchants Vitol and Mercuria have been shortlisted to buy Noble Group's USD 1bn Americas-focused oil business as the debt-laden trading company tries to pay down its debt to avoid bankruptcy. Once Asia's biggest commodity trader, Noble is fighting for survival because of a crisis of confidence triggered by concerns about its accounting standards. Following the sale of its US gas and power business to Mercuria, Noble put the oil business up for sale in July to continue the shrink-to-survive strategy. Noble wants to return to its roots in Asia and trading hard commodities such as coal. (FT)

Venezuela asks to restructure Russian debt

Sep 8. Venezuela has requested Russia to restructure its debt due to difficulties in fulfilling the debt. Rosneft, controlled by Russia, extended US 1bn in additional credit to PDVSA earlier this year, stating that PDVSA had total outstanding debt amounting to USD 5.7bn, plus USD 300mn in unpaid accrued interest. Venezuela's economic plight has been mounting for years and became acute after oil prices plunged in year 2014. Under the pressure of international bond defaults and foreign seizure of oil export revenues, Venezuelan authorities conserved dollars by dramatically crimping imports of basic goods. While Russia has engaged in bilateral contacts in order to work out a mechanism to restructure Venezuela's debt, debt restructuring might not be feasible due to US financial sanctions on Venezuela. (FT)

EnQuest receives waiver ahead of test on loan covenants

Sep 7. Heavily indebted EnQuest received a waiver on the test of its loan covenants that was due at the end of September from its banks. The company's liquidity position became under strain after its new Kraken oil field reported a low-level production, sparking concerns that EnQuest may fail to meet the loan covenants of net debt to EBITDA ratio. EnQuest's net debt to EBITDA ratio stands at 3.2 times at the end of first half and will have to go down to 2.25 times by the end of the year if the company is to meet its December covenant test. If productions at Kraken field fail to improve, EnQuest is likely to request for further waivers. (FT)

Toys R Us restructuring debt, with bankruptcy filing an option

Sep 7. Toys R Us Inc has hired law firm Kirkland & Ellis LLP to help weigh restructuring options ranging from a bankruptcy filing to raise financing, as bricks and mortar retail goes through a major downturn and steep competition from e-commerce and discounters. The company reported a net loss of USD 164mn in the fiscal first quarter of 2017, widening from USD 126mn a year earlier, and a drop in its same-store sales by 4.1%. Until April 29, Toys R Us has approximately USD 5bn in debt, of which roughly USD 400mn is due next year and roughly USD 301mn in cash on its balance sheet. However, on a positive note, a large portion of Toys R Us' debt is secured by real estate, which could help the company's refinancing prospects. An update on a plan to deal with the debt would be announced on September 26 when the company announced its second quarter earnings. (Straits Times)

Australian banks sitting on A$500 billion of 'Liar Loans,' UBS says (Bloomberg)

European private banks suffer first profits drop since 2009 (FT)

Pacific Radiance begins talks with banks with view to debt restructuring (Straits Times)

Regulatory Updates

Ghana triples minimum capital requirements for banks

Sep 8. The Bank of Ghana more than trebled minimum capital requirements for lenders as part of reforms to strengthen the industry, expecting the increasing capital requirements will spur mergers and acquisitions that will result in few stronger lenders. Compared with GHS 120mn to meet license obligations previously, lenders now need to set aside at least GHS 400mn in capital. The people asked not to be identified said lenders will be given until December 2018 to meet the requirement. As a result the GSE Composite Index fell 2.8% on September 8, accounting for the largest plunge since 2011, together with some share declines in Standard Chartered Bank Ghana Ltd. and Ghana Commercial Bank Ltd. (Bloomberg)

India market regulator proposes tighter ratings agency rules

Sep 8. Several months after the regulator set tougher rules, Securities and Exchange Board of India (SEBI) proposed additional changes to credit ratings agencies on September 8, including a restriction on cross-holdings and spinning off non-ratings business. For example, SEBI requested a rating agency to hive off any other business it does and suggested that an appeal by a company against a rating assigned to it should be reviewed by a different panel. It also said that a rating organization should maintain a minimum net capital of INR 500mn, an increase from INR 50mn, before it is accredited as a credit rating agency. (Reuters)

China's trillions remain out of reach of foreign funds (FT)

Regulators descend on booming ETF market (FT)

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