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Responding to the Oil Industry Downturn: Challenges to Debt Restructuring in the UAE

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Introduction

Saeed Salim had spent another long day in 2017 at his father's engineering and construction firm, negotiating for temporary relief from suppliers and lenders owed payment, seeking buyers for the company's assets, and scrambling for ideas to come up with cash. Employees would have to suffer delayed payroll, again. The legal environment surrounding the treatment of bankruptcy was unclear and still evolving in a society in which going bankrupt had little precedent and had historically resulted in calling on a personal guarantee, having assets seized, or debtors choosing to leave the country before they defaulted on their debt.

His mind returned to a familiar source of stress: What was he doing wrong? How would he motivate the shareholders of his father's company to get serious about a financial restructuring? And given the market downturn and the United Arab Emirates' legal structure, how would he right its finances?

ABC Services

Salim's father and a handful of partners had founded ABC Services more than a decade earlier to provide engineering, procurement and construction services primarily to the UAE's oil industry. Salim worked there after earning an undergraduate degree in finance.

Under the engineering, procurement, and construction model, contractors took on the financial responsibility for designing and building a project, including materials and labor costs. Essentially, so-called EPC firms bet the contract's value would exceed these expenses, and that they would profit from the difference. They were typically paid out in installments only after

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completing certain construction milestones. Thus, lapses in execution could be costly. Uncertainty surrounding geological conditions at a project site, materials costs and other factors could present significant risks to EPC firms. The model was used widely in the oil-and-gas and power industries for the building of pipelines, generation plants, and other infrastructure.

ABC grew quickly from 2004 to 2011 amid easy energy-market conditions. Save for a sharp but brief downturn following the 2008 financial crisis, historically high prices and low volatility in oil markets supported robust exploration and production activity (see Exhibit 1). In turn, demand for engineering and construction services boomed. The company doubled in size in roughly five years following 2007, despite competition from large international players such as UK-based Petrofac, India's Punj Lloyd and South Korea's SK Engineering & Construction Company. Local enterprises like ABC occasionally enjoyed modest advantages in certain costs, but multinational EPCs' scale and access to capital generally gave them a leg up. Nevertheless, ABC was so successful that in 2013 it started preparing for an initial public offering, seeking capital to expand in to Saudi Arabia and Qatar.

Nearly all of ABC's business came from a handful of major clients in the oil services industry.

Economic Backdrop

ABC's prosperity reflected the UAE's bountiful natural resources. Fossil fuels, discovered in the mid-20th century, helped the country transform from an impoverished collection of small desert principalities to a modern nation state with per-capita income roughly equivalent to Western Europe's leading economies. The UAE had 98 billion barrels of proved crude reserves in 2017, the eighth-highest of any nation worldwide.[1] As of 2017, it boasted the fourth-largest economy in the Middle East, behind Saudi Arabia, with an estimated $691.9 billion in gross domestic product.[2]

In the latter part of the 20th century, the UAE took steps to diversify its economy, reducing the oil industry's share of its GDP to about one-third of output.[3] It invested in trade infrastructure, tourism, and industry. Dubai International Airport ranked third globally in total passenger traffic and number one in international passenger traffic in 2016.[4] Dubai's ports, including the massive Port of Jebel Ali, made it one of the world's busiest trade hubs. The city became known for opulent homes and hotels, thanks to audacious developments such as the Burj Khalifa, the world's tallest skyscraper, and the Palm Jumeirah hospitality and residential complex, built on an artificial island chain off the city's coast. Abu Dhabi Investment Authority, flush with the country's oil riches, became the third-largest sovereign wealth fund in the world, with $683 billion in assets.[5]

The UAE government, like those of other gulf states, took steps to privatize its energy sector, reducing state dependence on oil-and-gas and bolstering government budgets.[6] In December 2017, Abu Dhabi National Oil Company (ADNOC), the state-owned oil company of the UAE, took its gas station unit public on the local stock exchange, raising some $900 million. Kuwait Energy, Emirates Global Aluminium and Oman Oil Company likewise planned or announced public listings, according to The Wall Street Journal, spurred by Saudi Arabia's plan for an IPO of its giant state oil company, known as Saudi Aramco.

Meanwhile, non-governmental organizations ranked the UAE among the most user-friendly venues for international business and investment. As of 2018, the country ranked 21st on the World Bank's "ease of doing business" report, higher than France and Japan. The World Bank cited efficient tax and construction permitting systems and reliable access to electricity and other infrastructure. These statistics were matched by personal accounts. According to Salim, for example, ADNOC executives with whom he interacted worked efficiently and developed trusting relationships with their contractors.

Energy Downturn of 2014

ABC's fortunes shifted along with those of much of the region in the second half of 2014, when crude oil prices fell by more than half.

Experts attributed the price weakness to a combination of factors. Prices were pressured by tepid global demand, burgeoning supply extracted from underground shale rock formations in the United States and the growth of alternative fuels. Geopolitical unrest in Iraq and Libya failed to curb the countries' production the way traders expected, and easy credit market conditions in much of the world delayed a reckoning for drillers and producers. Moreover, market participants expected the Organization of the Petroleum Exporting Countries (OPEC), which controlled a third of the world's crude, to bolster prices by curbing production. But the cartel declined to do so until two years after prices collapsed, in part because of a willingness of Saudi Arabia, a low-cost producer and key player in OPEC, to protect its market share at the expense of margins.[7]

Such shocks hit service providers especially hard. When prices fell, energy producers cut output, drying up oilfield service providers' backlogs. With less new business coming in, these service providers were left with little margin for error in executing existing contracts and keeping up with financing commitments. For example, in 2014, ADNOC's production growth slowed to 0.5%, down from 5.1% a year earlier (see Exhibit 2).

"From ADNOC's point of view we are trying to bring down operating expenditures and also on [capital expenditures] in the range of 25 percent," the group's head of strategy and coordination, Ali Khalifa Al Shamsi, said at a conference in 2015.[8]

ABC Navigates the Downturn

Such was the environment in 2015 when Salim returned to ABC after some years overseas. He found the business in rougher shape than he had left it. New business had dried up amid the tougher commodity market. The oil-and-gas downturn was well underway and the company was reeling from an accounting error by its chief financial officer, which led to the restatement of financial results for earlier years. Plans for the IPO had been scrapped, and ABC's owners turned their efforts to hoarding cash and finding capital to shore up the business.

The slowdown exposed problems with ABC's financing. The company relied on credit lines from local and regional banks, which were meant for short-term uses related to working capital and day-to-day expenses. In practice, ABC had been using these loans to finance myriad aspects of its business, including equipment purchases and the construction of facilities to house workers while a project was underway. When times were good, ABC always had new projects coming in and easily secured new debt capital to repay earlier borrowings. In late 2015 new work stopped coming in and the company started struggling to find the money to keep up with project deadlines.

As of 2015, ABC had 14 EPC projects under contract, financed by a complex arrangement of loans from local and regional banks. Its liquidity suddenly came into question. In October 2015, ABC found itself facing a loan principal payment it couldn't afford. "Until 2014, we were just revolving our debt and staying out of problems," Salim said in an interview. "The company was growing fast enough that there was always more coming in than what we had to pay the banks. No one was noticing that, wait, you're using short-term debt to buy long-term assets."

At the same time, ABC was over budget on a project it had taken on years earlier, its largest ever. In preparing its bid for the job, ABC had relied on an engineering study known as a front-end engineering analysis. Such studies were meant to be preliminary and somewhat crude, but market participants expected them to be reasonably precise, predicting project costs that deviated little from the more detailed engineering work ultimately undertaken by an EPC firm. In this case, the front-end engineering analysis had vastly understated the cost and complexity of the project. ABC's largest ever project was projected to cost 30% more than what the firm had budgeted.

In response, ABC sought a fee adjustment from its customer to compensate for the faulty engineering analysis. The claim stood to provide ABC with much needed breathing room, but it remained unclear when the customer would pay the claim. ABC's deteriorating liquidity gave it little time to wait for the claim process to play out.

Doing Business in the UAE

Navigating the UAE's legal and cultural landscape proved challenging for ABC during this stressful period. The law that was in effect until December 2016 considered a company's insolvency to be a criminal offense that could land its executives to prison. The new law outlined alternative courses of action, calling for a company to initiate insolvency procedures for debts over 30 days due. Failure to do so would result in a "disqualification order against the debtor in certain circumstances," but would not be considered a criminal offense.[9] Prior to this ruling, Salim worked to resolve the company's liquidity problems under the looming threat that one of ABC's banks or suppliers would call a default and have the company's shareholders—including his father—arrested.

As is the case in many emerging markets, the capital markets environment differed from that of the West. In Middle Eastern countries like the UAE, a portion of market participants adhered to Islamic rules that prohibit debt financing. Companies and investors had come up with sophisticated financial products that complied with Islam's Sharia law, but the structure of and legal documentation for these investment solutions had yet to be standardized or tested by courts.

There remained some confusion about how the December 2016 law would be interpreted by the courts, and, as of late 2017 a debt-restructuring dispute between energy producer Dana Gas and holders of its Sharia-compliant bonds, such as BlackRock, highlighted the risks of the market.[10]

ABC had been able to engage in debt financing, but resolving it debts proved challenging. Salim lacked a legal framework like the US court system's Chapter 11, which halts creditor collection efforts and litigation while a debtor and its lenders work out a plan to restructure liabilities. His efforts to clean up the company's balance sheet hinged on informal, personal talks with ABC's banks and investors.

Similarly, Salim found capital-raising efforts in the UAE informal and subject to significant uncertainty. As ABC's distress mounted, he nearly negotiated a potential sale of 30% of the company, seeking proceeds meant to keep ABC afloat another 18 months. Rather than hire investment bankers to market the stake, ABC's owners asked him to approach a family friend to discuss the sale. The parties agreed on terms, but as the EPC market continued to deteriorate, the bidder asked for a discount before signing. The talks fell apart. In contrast to the type of auction process typically run by an investment bank, ABC lacked the option to simply turn to the next bidder for financing.

Moreover, conflict between management and some of ABC's shareholders worsened as the company's travails increased. As is the case with many small and medium-sized businesses in emerging markets, the investment offices of handful of local families controlled most of ABC's equity capital. In the UAE, the law required, with some exception, that nationals own at least 51% of companies incorporated in the country.[11]

Many of the ABC shareholders had business interests throughout the region and feared damaging their reputations or relationships with local banks. While one shareholder was integrally involved in helping to guide ABC's financing decisions, most shareholders generally engaged in decision-making only when they feared that a problem at one of their companies could lead lenders to cut off funding for the rest of their portfolios. As a result, these investors were reluctant to approach the banks to renegotiate debt terms or restructure ABC's balance sheet. In addition, when ABC executives did speak to the banks, they weren't authorized by shareholders to disclose the totality of the company's financial stress. Thus shareholders, who had typically played a passive role, had become key decision-makers when ABC became distressed.

How to Restructure?

Global macroeconomic factors, missteps by ABC's executive team, and an uncertain local business environment had left the company in a bind. ABC's lack of liquidity and capital markets access had limited its ability to complete projects in process and earn milestone payments. The company lacked the cash to sit out the downturn. Prospects for a recovery in oil prices remained speculative at best, as the market grappled with producers' reluctance to cede market share and the growing role of the US in energy markets. The US stood to become the world's largest oil producer in a matter of years, according to the International Energy Agency.[12] Salim saw few options for moving forward, but knew action was necessary because the company was simply running out of time.

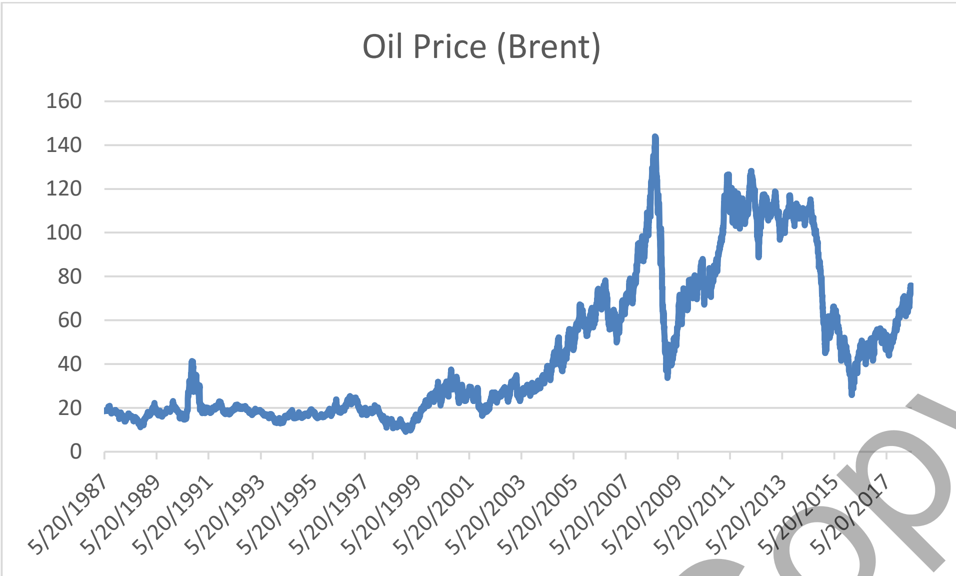
Salim wondered: How could he communicate the severity of ABC's cash flow problems to the firm's shareholders? How could he best approach banks and other capital providers seeking the kind of funding the company would need to collect on contracts in process?

Questions for Discussion:

1. The 2014 oil-and-gas downturn posed a challenge for the entire energy industry. Should ABC have done anything differently before prices fell, given its business model and other circumstances?
2. What ought ABC to do to right itself? What should Salim do to effectuate that outcome?
3. How does ABC's experience demonstrate the advantages and disadvantages of doing business in emerging markets and in the UAE in particular?

Exhibits

Exhibit 1



Source: U.S. Energy Information Administration, Crude Oil Prices: Brent - Europe [DCOILBRENTEU], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DCOILBRENTEU, May 12, 2018.

Exhibit 2

ADNOC Crude Oil Production and Exports

Thousands of barrels

Year	Production	*% Change*	Exports	*% Change*
2011	913,191		833,070	
2012	948,200	*3.8%*	873,515	*4.9%*
2013	996,928	*5.1%*	920,687	*5.4%*
2014	1,002,179	*0.5%*	808,131	*-12.2%*
2015	1,068,575	*6.6%*	892,230	*10.4%*
2016	1,104,827	*3.4%*	885,474	*-0.8%*

Source: Statistics Centre, Abu Dhabi Emirate, https://www.scad.ae/Release%20Documents/Energy%20and%20Water%20in%20Figures%202016%20-%20English.pdf

Endnotes

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