Acquisition Financing in an Era of Energy Transition

HeirsHoldings Oil & Gas Limited ("**Heirs Holdings**") recently acquired a 45% interest in one of the most prolific onshore oil & gas licences in Nigerian from Shell, Total and Eni through an innovative, first-of-its-kind hybrid acquisition financing.

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Over the past decade international oil majors have been pivoting their investment strategy to offshore assets and divesting their stakes in onshore assets in West Africa. This process has been accelerated by the need of the majors to refocus on their gas rich assets as part of a portfolio optimisation process linked to energy transition.

In January 2021, Shell Petroleum Development Company of Nigeria Ltd., Total E&P Nigeria Ltd. and ENI sold a 45% stake in Nigerian Oil Mining Lease 17 (OML 17) and related infrastructure assets to Heirs Holdings, a related company of Heirs Holdings Limited and Transnational Corporation of Nigeria Plc. The deal is notable for the extensive cast of players involved on the financing side including international and local banks, multilateral financing institutions and asset

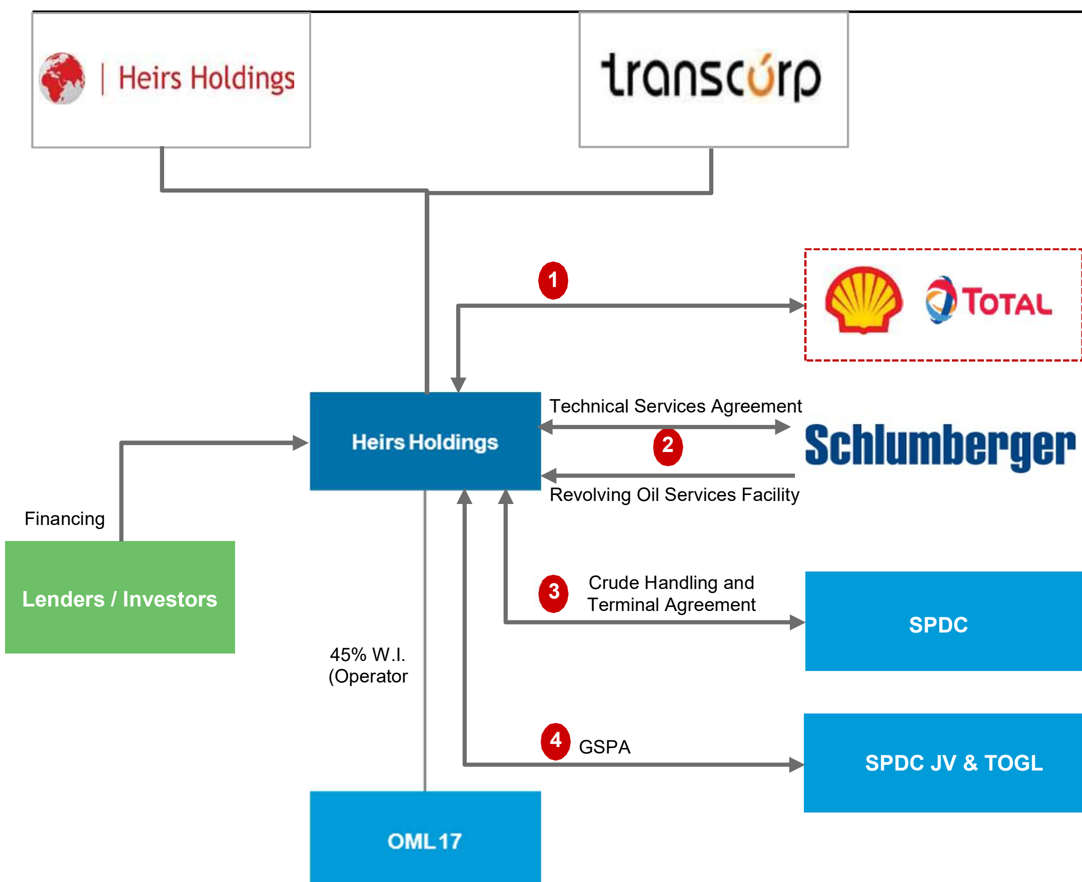
managers, as well as technical partners and crude offtakers.

OML 17 is located near Port Harcourt, Nigeria, and features 15 oil & gas fields, six of which are currently producing. OML 17 is in one of the most prolific oil & gas field clusters in Nigeria, and has the potential to double production in the short-medium term through STOGs and workovers. OML 17 was first discovered in the 1960s and at its peak in the 1970s production of 120,000 barrels of oil equivalent (boe) was being achieved – current production is equivalent to 27,000 boe per day. OML 17 is estimated to have proven and probable reserves (2P reserves) of c.1.2 billion boe (NNS), with potential exploration upside of one billion boe. OML 17 is supported by a comprehensive infrastructure network including an installed liquid processing capacity of 240 kbpd, 6 Flow stations and 2 Gas Processing plants with c.240 mbpd capacity (Obigbo North & Agbada Gas plants) supplying energy to the industries and power plants in Southern Nigeria.

As part of the acquisition, Heirs Holdings has been granted sole operatorship of OML 17. This is a resounding endorsement of the company's operational plans, as well as its management team, strategic partners and service providers, including Schlumberger, and is a critical element in Heirs Holdings stated intention to quickly ramp up production.

Set out below is an overview of the parties to the transaction and the key commercial contracts that have been put in place.

Transaction Structure



Contractual Overview

Heirs Holdings has negotiated agreements with the Sellers (Shell/Total/ENI), Schlumberger and other counterparties to create a structure that both maximizes performance and reduces risk for all parties

1 *Offtake Agreement*

- Long-term offtake agreement with Shell and Total to ensure regular revenue and minimize payment risk.
- In addition, Offtake agreements include flexibility to raise additional capex facilities against incremental production from 3rd parties under certain circumstances.

2 *Technical Services Agreement*

- Strategic co-operation with Schlumberger to implement an accelerated Field Development Plan, designed to support on-the- ground execution capacity, people and training for Heirs Holdings to optimize operations
- Revolving Oil Service Funding Facility designed to derisk and underpin expansion of O&G production

3 *Crude Handling and Terminal Agreement*

- Heirs Holdings to pay SPDC JV a fixed tariff charged on throughput and capacity for use of the Trans-Niger Pipeline
- Heirs Holdings to also pay tariff for use of the Bonny Crude Oil Terminal

4 *Gas Handling, Sale and Purchase Agreement (GSPA)*

- Gas sale and purchase agreement for an agreed portion of the gas production from the asset

Financing Overview

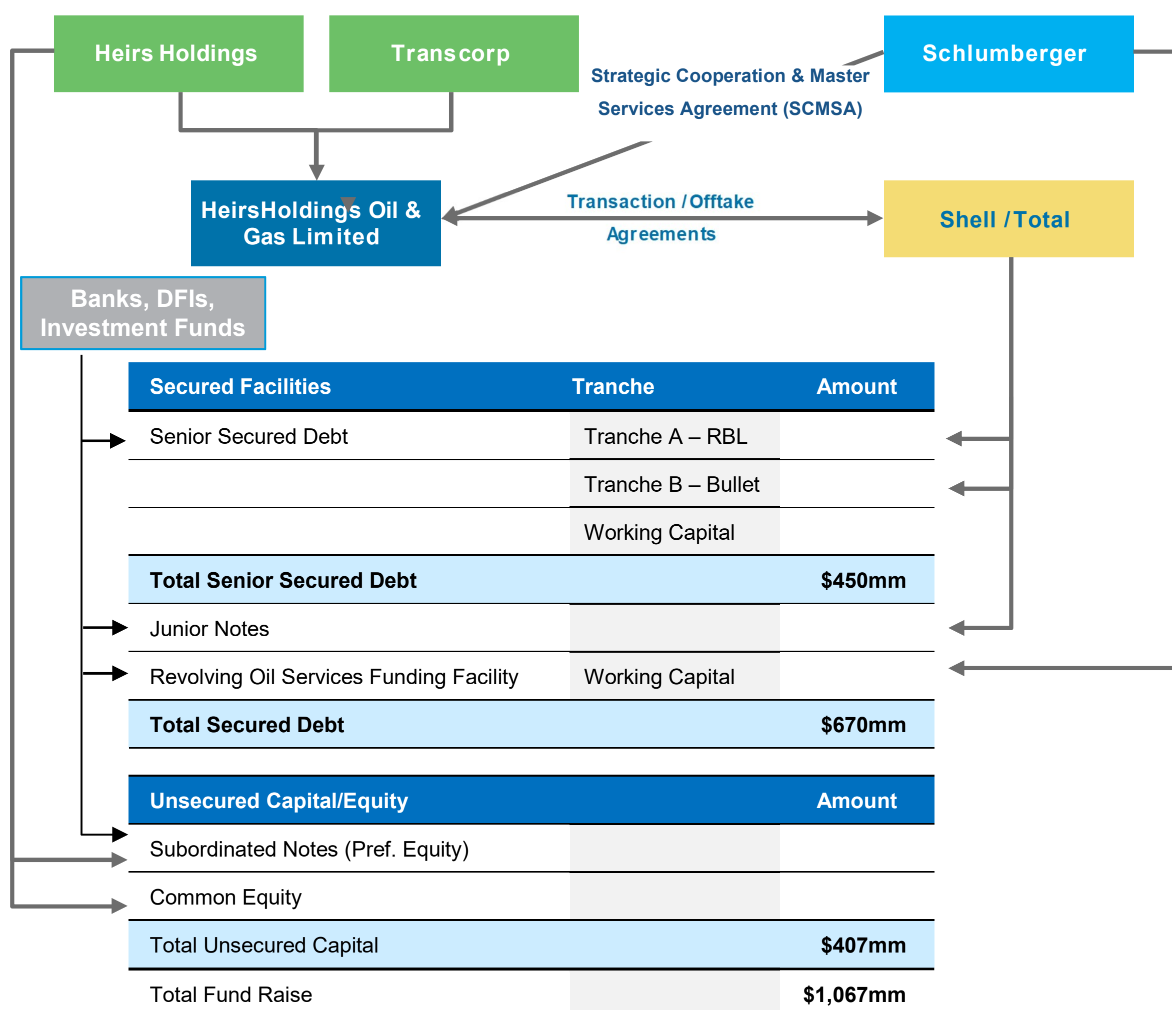
With more than US$1 billion in financing raised, this acquisition represents the largest M&A transaction in Nigeria since 2014. The financing for the acquisition of OML 17 utilises a highly innovative hybrid structure and comprised the following:

- A senior debt facility, including a Term Loan A (TLA) facility, a Term Loan B (TLB) facility and a senior revolving credit facility (RCF). The TLA is an amortising facility, and the TLB is repaid in a lump sum, a “bullet.” Proceeds of the TLA and the TLB are required to be applied solely towards funding the acquisition, while RCF proceeds may be used to fund the acquisition, or for general corporate purposes including funding for production ramp up.
- A junior debt facility, bifurcated into a Junior Loan A (JLA) and a Junior Loan B (JLB). The junior facilities are subordinated to the senior facilities, both in terms of the ordinary course cashflow waterfall and following an enforcement, and are repaid as a bullet. As is common with junior facilities, the JLA and JLB both have longer amortisation periods than the senior facilities.
- A third ranking working capital facility, provided as a form of ‘vendor’ financing by a syndicate of lenders primarily for funding production ramp up.
- The issuance of unsecured structured notes pursuant to individual note purchase agreements, including detachable petroleum economic participation units, which operate in a fashion similar to warrants. The proceeds of the structured notes are to be applied solely towards funding the acquisition of OML 17.

Among other key features, the structure enables Heirs Holdings to increase its lender’s commitments across the entire capital structure from time to time, subject to satisfying certain conditions. An illustrative overview of the financing structure is set out below.

Financing Structure

Transaction structured to support production ramp up, whilst reducing risk for counterparties



Secured Facilities	Tranche	Amount
Senior Secured Debt	Tranche A – RBL	
	Tranche B – Bullet	
	Working Capital	
Total Senior Secured Debt		**$450mm**
Junior Notes		
Revolving Oil Services Funding Facility	Working Capital	
Total Secured Debt		**$670mm**

Unsecured Capital/Equity		Amount
Subordinated Notes (Pref. Equity)		
Common Equity		
Total Unsecured Capital		**$407mm**
Total Fund Raise		**$1,067mm**

Structuring the Senior Facility

The Senior Debt comprises 3 facilities (or tranches) secured on a pari-passu basis. Tranche A is a 5-year, US$300m amortizing term facility and Tranche B is a 5.5-year, US$50m facility with a bullet payment at maturity. In addition, there is a US$100m RCF with a 2-year tenor that can be renewed subject to mutual agreement between TNOG and the lenders. The senior debt capacity is calculated on a “stretched” NPV basis, using a 6-year tenor which extends 6-months beyond the maturity of Tranche B. Tranche B was designed to attract a specific investor class - non-bank financial Institutions such as asset managers and hedge funds - that are comfortable taking refinancing risk.

Tranche A, in comparison, is a traditional Reserves Based Loan (“RBL”) facility, whose lender base comprises banks that are typically active in the RBL market (such as Standard Chartered Bank, ABSA and African Import Export Bank) and Nigerian banks that are familiar with the domestic oil & gas sector. The repayment of Tranche A will be prioritized in relation to Tranche B; mandatory prepayments and senior

cash sweeps will be allocated to Tranche A on a 100% basis until this tranche is fully repaid, after which such prepayments will apply to Tranche B.

In addition to other accordions set out in the senior facility, there is also an uncommitted facility made available via an accordion of up to US$300m. The purpose of this, accordion is to prepay the Junior Debt on a cashless basis and to fund capital expenditures (in this order of priority). This accordion will be in place throughout the 5-year tenor of Tranche A. Please see further below a more detailed discussion on the cashless redemption mechanism.

The senior facility includes a principal repayment grace period which enables Heirs Holdings to spend the initial months after closing the acquisition deploying its resources solely towards ramping up production. The grace period mechanism is an important point of distinction from a traditional RBL and was a key element of this financing.

The RCF affords Heirs Holdings with the flexibility to use the proceeds of disbursements under this facility to fund the acquisition and for general working capital purposes.

The SFA has been structured to enable Heirs Holdings to incur additional indebtedness through a variety of means. In addition to the cashless redemption accordion, referenced above, the SFA provides for a petroleum asset accordion, which enables Heirs Holdings to request an increase in the commitments, with existing facility lenders having a right of first refusal.

The right to exercise the accordion is subject to a number of conditions, including:

- A specified minimum amount of the junior tranche must have been converted to senior prior to the exercise of the accordion (there is a more detailed explanation on the junior conversion concept below);
- No default is be continuing, or could reasonably be expected to result from the increase; and
- Specified projected debt service coverage ratio tests must have been satisfied.

In addition to the petroleum asset accordion, Heirs Holdings is permitted, after the first TLA principal repayment date to incur additional indebtedness from third-party senior secured lenders. The proceeds of such third-party indebtedness are required to be used for acquiring new oil & gas assets.

Incurring additional indebtedness in such circumstances is subject to satisfaction of a number of conditions, including:

- completion of satisfactory economic, technical and legal due diligence; and
- a requirement that the new lenders accede to the intercreditor agreement and that the existing lenders are granted security over any new assets acquired pursuant to such additional indebtedness; and
- a proviso that Heirs Holdings is only permitted to grant security to the new lenders over revenues generated from assets acquired utilising such additional debt indebtedness.

The benefit of the above arrangement from the Heirs Holdings perspective is that it can offer senior secured security to new prospective lenders, making this facility attractive to potential lenders and broadening the scope of potentially interested parties. From the existing senior lenders' perspective, the benefit of this arrangement is that the existing senior lenders will have the benefit of security over the new assets acquired and the new senior lenders coming into the financing will have recourse only to the newly acquired assets. As such there is no dilution in the value of the pre-existing security from the perspective of the existing lenders.

The SFA also provides for a junior redemption accordion. The junior redemption accordion is an accordion that can be utilised to convert amounts outstanding under the junior facility to senior debt. Upon exercise of this accordion, amounts outstanding under the JFA are deemed to have been incurred as new senior loans; in effect, the relevant junior lenders become senior lenders with respect to the converted amounts.

The SFA also includes a requirement that Heirs Holdings take out hedging in accordance with a pre-agreed hedging policy and with a pre-agreed criteria of hedging counterparties. Heirs Holdings is required to hedge a minimum amount of its quarterly production against oil price fluctuations for the first few years of operations. This insulates senior lenders against adverse oil price changes and offers Heirs Holdings stability in its forecast revenues, which is a critical requirement in a borrowing based RBL facility.

Structuring the Junior Facility

The junior debt comprises two tranches – A and B – of US$100m and US$70m, respectively. The tenor of Junior Facility A is 6 years and Junior Facility B has a 7-year tenor. Both facilities have a bullet repayment at maturity and are subordinated to the senior debt both in terms of cash waterfall payments and security. The junior debt is expected to be refinanced within 24-36 months of closing by way of exercise of the senior debt accordion which prioritises prepayment and cancellation of the junior debt by way of transfer of those commitments to the Senior Facility.

The Junior Facility Agreement (JFA) was targeted at strategic industry investors. The JFA is repaid as a bullet, and has a longer maturity than the facilities provided under the SFA. When the junior tranche was first explained to potential lenders during the market sounding process, it was described specifically as not a ‘true’ junior, but as a facility more akin to a ‘stretched senior’ instrument. The junior facility incorporates an accordion, (this accordion dovetails with the junior redemption accordion set out in the SFA) and provides that upon the exercise of the accordion, the amount requested by Heirs Holdings to be converted shall be deemed to have been repaid on a cashless basis and converted to senior debt. This accordion can be exercised if specified economic and technical conditions are met. To ensure that Heirs Holdings does not incur additional indebtedness under the SFA without first converting any outstanding amounts under the junior, the SFA includes a requirement that prior to incurring additional indebtedness at the senior level a specified minimum amount of the amounts outstanding under the junior facility shall have first been converted to senior.

Given that junior lenders are subordinated to senior lenders, the JFA carries a margin uplift relative to the SFA. Consistent with its ranking, the JFA offers greater flexibility to the obligors relative to the SFA in terms of applicable covenants and representations. Similarly, as the JFA is not a borrowing base facility it does not incorporate the same periodic economic and technical assumption update and projection approval provisions found in the SFA.

Both the Junior Facility A and Junior Facility B are repaid as bullets, but the Junior Facility A is required to be converted to senior prior to the JLB, and the Junior Facility A is converted to senior solely as TLA debt, while the Junior Facility B is converted to senior solely as Senior Facility B debt. This provision helped to ensure as broad a market as possible for the Junior Facility A and Junior Facility B, and to create an essential point of difference.

Adding the Revolving Oil Services Facility

Schlumberger/Hybrid Capital have arranged a consortium of investors and banks to provide a US$50m Revolving Oil Services Funding Facility (“ROSFF”) that is “evergreen” and subordinated

to Senior and Junior Debt. The facility is priced in line with the Junior debt and includes both a cash and PIK interest component for the first 2 years and full cash interest thereafter. Utilisations under the ROSF can be applied towards the payment of project costs for capex and opex to support the accelerated ramp-up or expanded production.

		Overview	Target Investor Universe	Maturity Profile	
Secured Financing	Senior Debt (Facility A)	▪ Hybrid RBL Structure ▪ Amortising Loan	▪ Banks, Oil Traders	5 Yrs	Senior Lenders- (1P Debt Capacity)
	Senior Debt (Facility B)	▪ Bullet Repayment reducing repayment during ramp up	▪ Banks, Debt Funds, Hedge Funds and Traders	5.5 Yrs	
	Revolving Credit Facility	▪ Working Capital Facility – to support ramp-up	▪ Banks	5.5 Yrs	
	Junior Debt (Facility A)	▪ Bullet repayment ▪ 2-Yr PIK	▪ Debt Funds, Hedge Funds and Traders	6 Yrs	Junior Lenders (2P Debt Capacity)
	Junior Debt (Facility B)	▪ Bullet repayment ▪ 2-Yr PIK	▪ Debt Funds, Hedge Funds and Traders	7 Yrs	
	Revolving Oil Services Funding Facility	▪ Funding for Asset Development Plan ▪ Bullet repayment	▪ Strategic Investors, Service Partners	7 Yrs	
Unsecured Funding	Subordinated Notes	▪ High Yield Instrument ▪ Bullet repayment ▪ 3-Yr Non-Call / PIK	▪ Fund Managers, Private Equity, Hedge Funds, Private Investors	7 Yrs	
	Deferred Consideration	▪ Balance of purchase consideration ▪ Pay-as-you-can	▪ Sellers	7 Yrs	
	Equity	▪ Ordinary Equity	▪ Sponsor		

Drafting the Structured Notes and Petroleum Economic Participation Certificates

The issuance of structured notes and petroleum economic participation units (“**PEPs**”) was a key element of the financing, as a synthetic equity instrument. The Structured Notes are a hybrid debt instrument with debt and equity features designed to give higher risk-taking investors such as equity investors, and asset managers risk-reward exposure to the Transaction whilst being senior to common equity. A number of the private equity and debt funds who committed to the financing at the senior TLB level also expressed an interest in both a fixed-rate instrument as well as an instrument that could offer equity-level return, on a highly subordinated basis. The structured notes and PEPs evolved as a means of satisfying this request from investors.

Structured Notes

The structured notes are unsecured subordinated debt securities with a fixed coupon and cleared through the clearing systems. Holders are entitled to receive interest payments only after the expiry of a cash interest grace period. The structured notes require the issuer to meet a specified debt-to-equity ratio prior to the incurrence of additional secured indebtedness. The Structured Notes are designed to have a fixed dividend component as well as a detachable oil royalty component – both deeply subordinated and payable only upon sufficient cash – that effectively solves for a target IRR to the investor, under McDaniel 2P / Management Base Cases. The Structured Notes accrue cumulative dividends of 10% (delayed payment starting from 36 months), with a common equity dividend stopper feature – this enables Heirs Holdings to defer dividends until all cumulative

deferred Notes dividends have been paid. The Structured Notes are mandatorily redeemable 7 years after the closing date.

PEPs

The PEPs are an equity like instrument and give holders exposure to the amount of oil being produced and sold by the issuer. The PEPs have a fixed term of 8-years (debt service on the PEPs begins 3 years after closing of the acquisition). The royalty stream under the PEPs will survive any redemption of the Structured Notes and produces an additional yield to the detachable royalty instrument. The amount payable will move up or down period depending on the liquids production rate and realized oil export prices.

Approach to Drafting the Agreements

In the initial stages, there were extensive discussions about how best to approach the drafting of the documents, and what format the documentation should take. Whilst lenders under the Senior and Junior facilities were represented by separate counsel, it was important that the various debt facility agreements worked together, and were entered into on terms consistent with the lenders' relative seniority. For example, if a matter is prohibited at the senior and junior level but a waiver or exemption to such prohibition has been approved by the senior lenders, then junior or ROSF lender consent should not also be required (subject to a limited subset of amendments which would require the approval of all secured creditors).

It was commercially agreed that White & Case, as sponsor counsel, should have primary responsibility for drafting the various facility agreements and note instruments, given that the firm had visibility across the entire structure. The approach to drafting adopted was to secure substantive agreement on the SFA, and then to begin negotiations with the junior lenders using the SFA as a base document, excepting provisions which are not appropriate for the junior lenders. The same process was then undertaken for the ROSF. Given the approach to drafting, it was important that a degree of confidentiality was maintained between the lenders under the various tranches of capital.

Closing the Acquisition

In keeping with the nature of the acquisition, the closing was carefully and extensively structured by the Standard Chartered and Heirs Holdings teams.

Following financial close, proceeds of disbursements under the SFA and JFA, and proceeds of note issuances earmarked for such purposes, are required to be funded into an escrow account. Amounts standing to the credit of the escrow account can be released from escrow only after specified conditions set out in the SFA have been satisfied. If the conditions to release are not satisfied by a specified longstop date, an automatic unwind mechanism kicks in to return monies to the lenders.

Given the diversity of the lenders, funding at financial close took place in a multi-phase manner. Some lenders were required to provide evidence of funding by delivering acquisition letters of credit at financial close, other lenders were cash funding at financial close, and others were required to cash fund into the escrow accounts only at the latest point permitted under the share purchase agreement.

Takeaways

The successful financing of the OML 17 acquisition demonstrates the confidence Nigerian investors and international financiers have in the market, and illustrates the broad appeal of the innovative financing structure. We have set out below some suggested key takeaways from the financing.

- **Credit Diversity:** The approach taken to this financing with regards to tailoring each tranche of debt to the requirements of specific types of lenders can be adapted and employed on a sector and asset class agnostic basis. With the ongoing process of energy transition and portfolio rationalisation by IOCs, there is increasing need to access liquidity pools beyond traditional commercial banks and accordingly there is the need for financing structures that will attract a new class of lenders/investors into energy and infrastructure projects. As the search for yield continues and given current monetary policies worldwide, stronger inflation on the horizon and a weak US dollar we expect to continue to see a broad range of lenders and investors in emerging markets and the energy sector in particular bringing with them new requirements and approaches. The challenge for borrowers and lenders alike will be putting together financing structures that work for all sides.

- **Energy Transition and Gas Processing:** Nigeria's huge gas reserves will be a key element in buffering the nation from the effects of the energy transition process. Given the increased interest in gas development, we have started seeing increased appetite for gas commercialization projects from industry players and commercial banks. More particularly, independent companies are seeking to expand their focus to gas commercialisation activities in order to maximize their earnings from the gas value chain. A good example of the increasing participation of independent companies is the US$700 million greenfield 300mmscf/d gas processing plant being developed by ANOH Gas Processing Company Limited (AGPC) (a 50:50 joint venture company of Seplat and the Nigerian Gas Company) in south-eastern Nigeria. The plant will be dedicated to the processing of non-associated gas from the unitized area of oil mining leases 21 and 53. Another illustrative example is a developer which has just received approval to establish Nigeria's first floating LNG facility.

Further, NNPC/NGC is currently being advised by SCB in connection with the development of the Ajaokuta-Kaduna-Kano Project (AKK) - a pipeline project that aims to reduce gas flaring and establish a guaranteed gas supply network between the south and the north of the country. The AKK project is proposed to be completed within twenty-four months of the launching of the construction, in July 2020. Gas fired power plant projects with c.3.6GW capacity and gas-dependent industries (in many cases spurred by existing industry players) are under development across the AKK pipeline route, due to the increased access to gas.

On a broader macro level, we think that gas processing plants and other related projects are a sector ripe for additional investment and one where there is a real opportunity and need for private sector investment in Africa both from commercial banks and development finance institutions. Extensive studies have been undertaken with regards to the negative externalities caused by gas flaring and biomass energy sources and the next stage in the evolution of the energy picture for Africa will be a move towards cleaner, more diversified and more sustainable energy sources and gas is a key element of this.

- **M&A and Divestments Acquisitions:** For over a decade, there has been a steady reduction by oil majors in their onshore and shallow water footprint in Nigeria. This has increased the opportunities for independent companies to participate in the upstream business. We expect that there will be more divestments by the majors and given the provisions of the Local Content Act and recent divestment history, we expect independent companies to acquire the relevant assets.

- **Increased FDI:** With increased participation by independent companies in the Nigerian oil & gas market (especially taking into account Heirs Oil & Gas' acquisition of interest in OML 17 and the 2020 Bid Round, we expect to see increased investment (debt and equity) in independent companies. Successful participants in the 2020 Bid Round will require working capital for field development. Further, as we have seen from the larger independent companies (such as Seplat and Oando), it is not unlikely that newer players will, at some point, take steps to raise funding from the capital market through IPOs and Eurobond issuances.

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