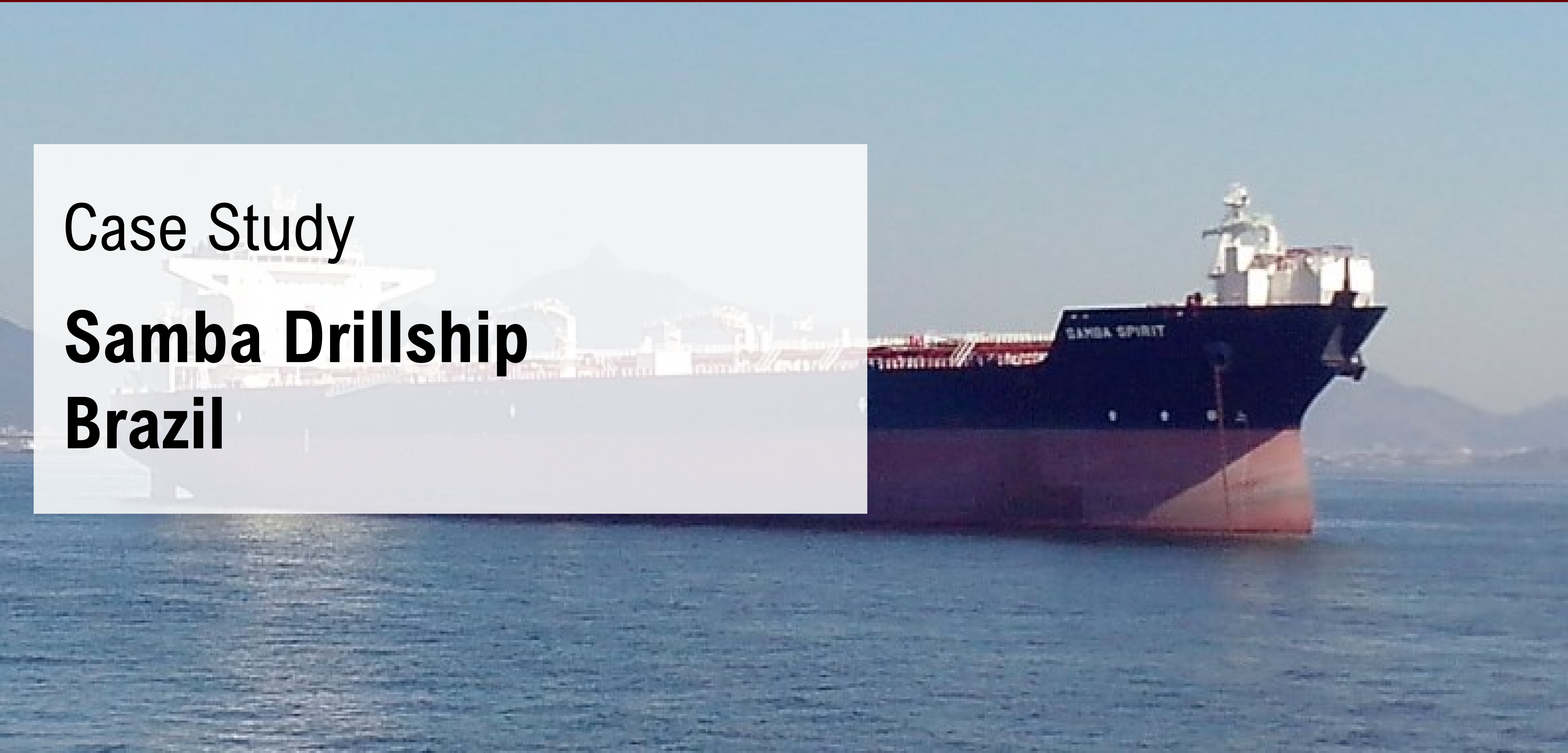
TheAfrican CATALYST

Case Study

Samba Drillship Brazil



Introduction

Samba is an $852 million deep-water drillship project in Brazil sponsored by Samba Drilling SA (“main sponsor”) and Mitsubishi Corporation (“Mitsubishi”). The project was funded with 80% project finance debt ($689 million) and reached financial close in December 2012.

The proceeds from the financing were used to construct a deep-water drillship on a lump-sum turnkey basis at Samsung Heavy Industries Co., Ltd.'s Goeje Shipyard in Korea. Upon completion, the drillship was to be chartered to Petroleo Brasileiro S.A. (“Petrobras”) under a charter contract and a related service contract for an initial term of 10 years with an option to renew for another 10 years. Samsung is a world-class special vessel contractor with a strong market reputation of on-time and on-budget delivery.

Samsung also provided a full refund guarantee from The Export-Import Bank of Korea (“KEXIM”) in relation to the construction contract. Petrobras (rated BBB/Baa1 at the time) is Brazil's national oil company and one of the largest publicly traded oil companies in the world with large offshore reserves and new deep-water oil discoveries, which required a large number of drillships and semi submersibles for exploration and development drilling

Project Overview

The funds secured were allocated to the construction of a deep-water drillship at Samsung Heavy Industries' Shipyard in Korea. Upon completion, the charter for the ship was awarded to Petrobras for a 10-year period, with an option for a further 10-year extension. **Samsung, renowned for its exceptional performance and adherence to budget and timeline, also provided a comprehensive refund guarantee through The Export-Import Bank of Korea (KEXIM).**

Petrobras, Brazil's national oil company and one of the largest publicly traded oil companies globally, emerged as the charterer for the drillship. Petrobras possesses vast offshore reserves and has made significant deep-water oil discoveries, necessitating an increased number of drill ships and semi-submersibles for exploration and development drilling. Samba Engenharia operated the drillship **under two 10-year contracts upon its completion and acceptance by Petrobras.**

The drillship's deployment aimed to **expand drilling capabilities in the deep waters of the offshore Campos Basin, where Petrobras lacked sufficient deep-water drilling resources within its chartered and owned fleet**. Petrobras committed to paying Samba a total day rate of $415,000 under the charter and service contracts. Additionally, Petrobras offered a bonus of up to 10% if the drillship's availability rate reached 93-98%.

Project Implementation

The drillship was constructed under a **lump-sum turnkey contract by Samsung in South Korea**. Upon completion and acceptance by Petrobras, the drillship was chartered to Petrobras and operated by Samba Engenharia under two 10-year contracts, respectively.

The deployment of the drillship is planned to expand the **drilling areas in the deep water of the offshore Campos Basin in water depths up to 3,000 meters where Petrobras** lacks this deep-water drilling capability among the units in its chartered and owned fleet.

Under the charter contract and service contract, **Petrobras will pay Samba a total day rate of $415,000. Petrobras will pay a bonus of up to 10% if drillship availability rate is 93–98%.Over the last 10 years, Petrobras has concentrated development investments in the deep-water fields located in the offshore Campos Basin where over 80%** of its total domestic proved reserves are located.

As detailed in its business plan for 2008–2012, Petrobras planned to spend over **58% of its total planned investments in the E&P activities ($112.4 billion in total), 84% of which will be in Brazil.** This level of investments is needed by Petrobras to support active development programs in existing fields as well as in the discovery and recovery of new reserve finds. Petrobras' business plan demonstrated a strong future demand for offshore exploration and production equipment.

Project Implementation

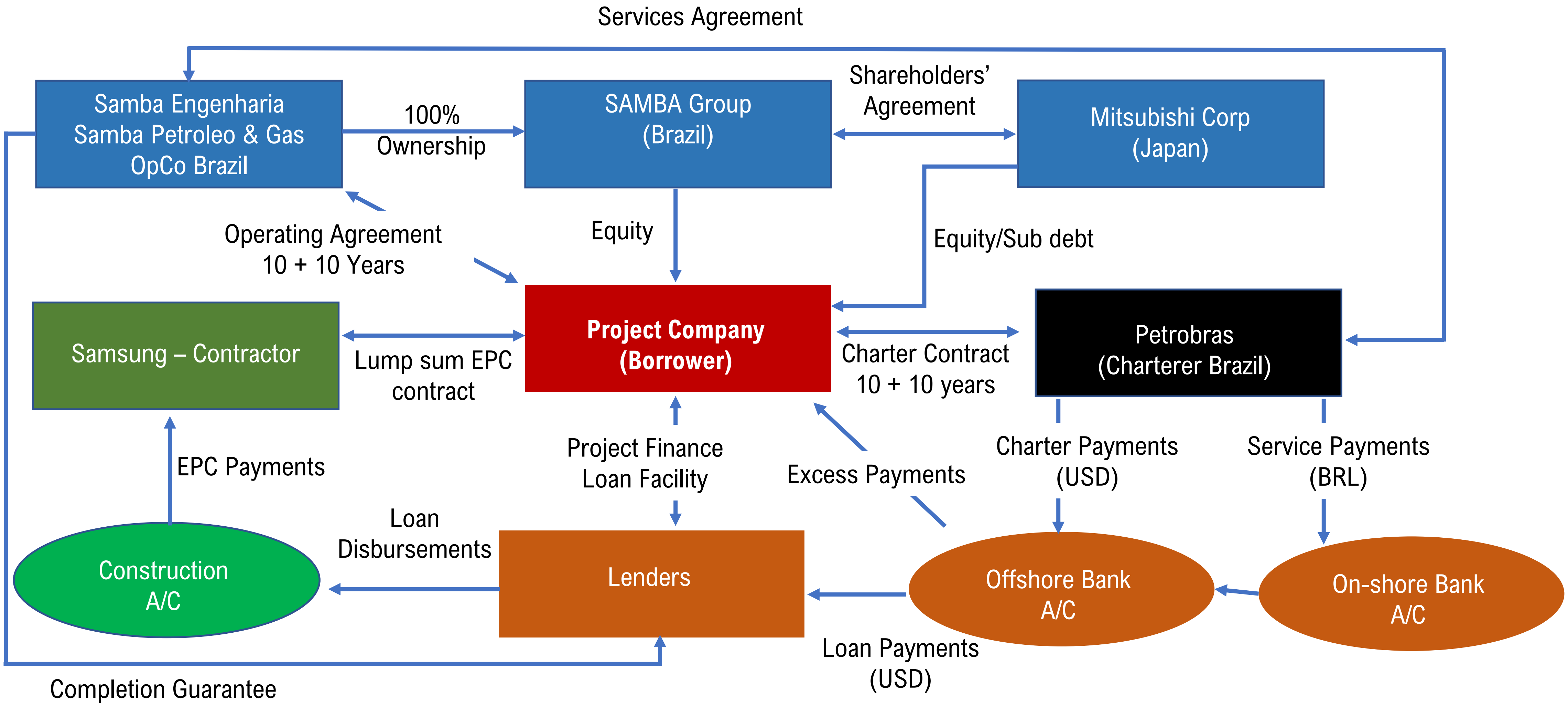
Samba was the Operator. Samba is an experienced and successful offshore operator. For about 15 years, they have operated a drillship with dynamic positioning system **that uses much of the same technology that will be applied to the platforms for about 15 years; and Samba has consistently** scored as one of the top independent offshore operators for Petrobras as measured by downtime and safety.

Projects of this size are often **fraught with significant political risk**; especially in young/emerging democracies countries like Brazil. The country and project sponsor's **however had investment grade credit rating and both entities' history of never defaulting on – or rescheduling/restructuring – charter payment obligations**

Also, the Central Bank of Brazil's **practice of extending preferential payment of charter payments as trade-related payments that have priority access to USD remittances**

Financial close was achieved in December 2012 with the drillship construction completed on schedule and on budget in 2013. **The $692 million financing was provided by a consortium of commercial banks along with non-bank financial institutions and KEXIM. KEXIM provided financing based on the role of Samsung as the EPC contractor.**

Samba Drillship – Transaction Grid



Project Outcomes

The drillship **commenced commercial operation in 2013**, drilling wells in deep-water blocks offshore Brazil for Petrobras. The drillship and the project financing contractual framework operated and functioned successfully until early 2014 when a **confluence of black swan events served to cause unprecedented stress testing** to the project's financial sustainability and the integrity of the project contracts and the lenders' security package. Specifically, the following developments occurred

International oil prices declined dramatically in **April 2014 from $110 per barrel to $50 per barrel**, precipitating a decline in day rates for deep-water drilling rigs from approximately $600,000 in Spring 2014 to about $400,000 in 2015 with drilling rig market utilization rates declining from close to 100% capacity utilization in 2014 to 80% by early 2015.

Samba's day rate of **$421,000 remained competitive relative to international market rates even after the market decline.** Simultaneously, in **April 2014 one of the largest corruption scandals in Latin America's history involving Petrobras, major Brazilian engineering and construction companies, and Brazilian politicians broke**. The corruption and bribery scandal was dubbed **"Lava Jato,"** which means car wash in Portuguese, as the corruption scheme was unearthed following a money laundering investigation where proceeds of the scheme were being laundered through Brazilian car wash facilities.

Project Outcomes

The Lava Jato scheme involved collusion between **Petrobras officials and Brazilian construction companies to rig contract awards to those companies who in turn inflated the contract price by 3–5%, which served as the kick-back payment to the Petrobras officials involved with the scheme.** The scheme ensnared most—if not all—major Brazilian construction companies including one of the largest (Odebrecht) and involved embezzlement of Petrobras funds to the tune of over $2.5 billion and spanned 11 countries in Latin America. ***The high-profile casualties of this corruption scandal included Marcel Odebrecht, CEO of the largest Brazilian construction company, Odebrecht, who was sentenced to 19 years in prison for paying $30 million in bribes to Petrobras officials along with former Brazilian president Lula.***

The impact of these two simultaneous commodity market and political crisis events had a significantly detrimental impact on Petrobras's financial condition. **Petrobras delayed releasing its 2014 annual results and in April 2015 released audited financial statements showing $2.1 billion in bribes and a write down of $17 billion due to overvalued assets.**

Due to the high debt burden that *Petrobras had taken on to develop offshore oil reserves, the company was forced into an emergency capital expenditure reduction and asset sale program of almost $14 billion to conserve cash and reduce debt.* Samba had two main lines of business, **being offshore oil and gas drilling along with a separate engineering and construction business.**

Project Outcomes

The engineering business of Samba was caught up in the **Lava Jato scandal** and **in an effort to save the business and stave off bankruptcy, the owners tried to cross-subsidize the business with cash flows from the drilling business unbeknownst to the project lenders.**

The **siphoning of project cash flows from Samba and the company's other rigs, along with the escalating financial difficulties of the engineering business and over $2 billion in corporate debt, led Samba to cut back operation and maintenance expenditure for its rigs, including Samba.** In April 2015 Samba, without either notice to—or approval from—the lenders, halted operations on all its operating rigs, including Samba, amid a liquidity and cash flow crisis. Ten days later Samba filed for bankruptcy.

Petrobras, focused on capex reduction opportunities, used the unilateral cessation of rig operations as an opportunity to terminate the charter contracts for all rigs, including Samba. **The project lenders sought to exercise their remedy rights afforded under the direct agreement with Petrobras by replacing Samba as the project operator and in doing so cure the termination event and preserve the critical charter contracts. Usually the security agreements would function normally, and lenders would be given the opportunity to cure the default.**

However, these were unprecedented times for Brazil and Petrobras, and there was no willingness or capacity on the part of Petrobras to honor the lenders' security rights and engage with the lenders or seek a solution that would reverse the termination notice and preserve the charter contract.

Project Outcomes

Having exhausted all options and faced with the termination of the charter contract with little prospect of re-contracting the drillship in Brazil, **the lenders sought to take possession of the drillship by enforcing their assigned security interests in the shares and mortgage over the project company and the project assets**. This was a complicated legal and operational challenge as the project sponsors sought to block lenders in the Brazilian courts as the drillship was physically sitting in Brazilian waters about 300 km offshore.

The sanctity of the security documents was upheld by the Brazilian courts, and lenders successfully took legal possession of the drillship asset. The next step was to secure operational control and take the drillship out of **Brazilian waters so that it could be redeployed in another key deep-water drilling location—the "golden triangle" of Gulf of Mexico or Offshore Africa.**

The lenders and their representatives secured the service of a third-party rig asset manager/operator who helicoptered in a new crew onto the rig, paid and flew to shore the Brazilian crew, and then spirited the drillship out of Brazilian waters to a port in the Caribbean where it could be laid up and inspected while the lenders determined their next course of action. **It was very much drama on the high seas more akin to a Jason Bourne plot than mundane project financing!**

Project Outcomes

The offshore drilling market continued its decline through the remainder of 2015 and into 2016 with day rates plummeting to below $300,000 and the industry utilization rates below 60% as integrated oil and gas majors cut back capital spending due to low oil prices and speculative rigs constructed without contracts in the peak 2012–2014 period were delivered to owners—further exacerbating the oversupply situation. Project lenders were unsuccessful in re-contracting Samba in the midst of this market collapse.

Due to the significant costs associated with maintaining and laying up the drillship, **the lenders elected to seek a buyer for the unit via a public auction.** In April 2016, the Samba drillship was sold **for $65 million** to another offshore driller. **The fire sale price for a relatively new, state-of-the-art deep-water rig represented barely 10% of the original construction cost just 3 years earlier.** By this point most lenders had either written off their loan exposures or sold their loans for cents on the dollar.

The Samba case study provides a good example of how project lender security rights work in practice when tested by a project loan default. It also reveals the challenges and issues faced by lenders in exercising and enforcing security rights over project company shares and assets

Questions for consideration/discussion

- What were the key risk mitigation measures implemented in the Samba project? And how effective were these measures addressing the risks that emerged during the project's lifetime?
- What lessons can be learned from the Samba drillship case study regarding the importance of conducting due diligence on project sponsors and understanding their unrelated business activities?
- How does the Samba case study highlight the importance of understanding and managing political risk in project financing, particularly in emerging markets like Brazil?
- What are the key takeaways for lenders and project developers involved in similar projects? How can these lessons be applied to future projects to enhance their chances of success?