

> East Cameron Gas Sukuk

One of the most complex Sukuk structures ever

The East Cameron Gas Sukuk is one of the most innovative, and consequently most interesting, Sukuk to have been issued in the recent past.

The issue was interesting for a variety of reasons that have already made the headlines as well as for a great number that did not.

Among the reasons that propelled the issue into the headlines were:

- that it was the first issue to come from a USA-based entity
- that it was the first such issue to be rated by Standard & Poor's
- it was the first securitisation embedding Shari'ah compliant hedges

There were many more unique features to the transaction that will be explored in this issue of Sukuk Insider.

Summary

East Cameron Partners is an independent oil and gas exploration and production company, based in Houston Texas with assets consisting of two gas properties located in the shallow waters off the State of Louisiana. These two properties consist mainly of natural gas and have net proven reserves of approximately 68 Bcfe net to the originator and have an estimated remaining production life of 14.5 years.

Terms

Amount: Up to \$165.67 million

Certificates: Sukuk al-Musharaka

Security: Right to oil and gas ORRI

WAL (Base Case): 3.5 years

Closing date: July 2006

Legal final maturity: 13 years from closing

Ratings: CCC+ (Standard & Poor's)

Repayment: Quarterly based on volume produced

Return: 11.25%

Governing law: USA

The main players

- **East Cameron Partners** - Houston, USA (the originator)
- **BSEC** - Bemo Securitisation, Beirut, Lebanon (arranger and administrator)
- **Merrill Lynch** - London, United Kingdom (co-arranger & bookrunner)
- **East Cameron Gas Company** - Grand Cayman, Cayman Islands (issuer SPV)
- **Baker Hostetler** - Houston, USA (legal advisers to the originator)
- **Vinson & Elkins** - Dubai, UAE (legal advisers to the arrangers)
- **Walkers** - Dubai, UAE (legal advisers to the issuer SPV)
- **Sheikh Yusuf Talal De Lorenzo** - USA (Shari'ah adviser)
- **Sheikh Nizam M S Yaqoobi** - Bahrain (Shari'ah adviser)

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Background

East Cameron Partners is a father and son, independent oil business based in Texas that has been operating, in one form or another, for 57 years. The business typifies what are called 'wildcatters' - or oil and gas speculators - and the business has significant oil and gas reserves in East Cameron which is an area of seabed off the coast of Louisiana.

East Cameron Partners bought a lease on the EC71 and EC72 oilfields from ConocoPhillips back in 1992 and sought financing to explore the fields with an aim to exploiting them. The financing they secured came from Macquarie Bank (from Australia) and it was considered to be very expensive. As part of the debt financing, the bank took significant (50%) equity in the asset.

East Cameron Partners' initial exploration was successful and reserves started to flow. The debt to Macquarie Bank was quickly repaid.

East Cameron Partners then wanted to buy back Macquarie Bank's equity in the lease. Most of the potential financiers they spoke to within the USA offered them deals that were very similar to the original deal they had struck with Macquarie Bank and were based on a mixture of equity and debt.

This was the point at which BSEC appeared on the scene and suggested an alternative mode of financing a buyout of the bank.

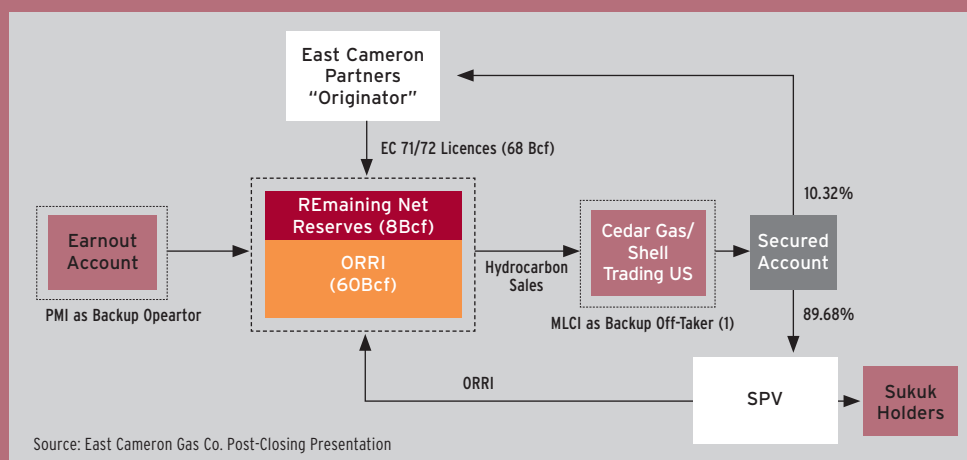
During this same period, BSEC had been looking around for new avenues to use both their securitisation knowledge and their knowledge of Sukuk.

The transaction

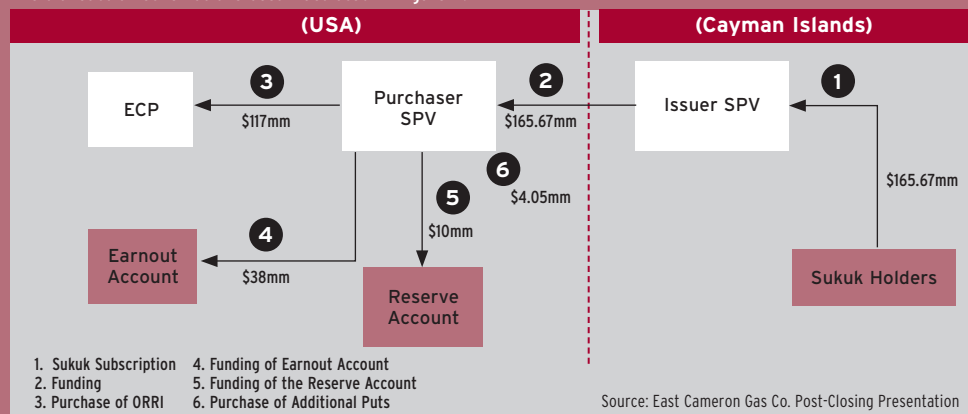
The transaction involves the securitisation of hydrocarbon sales from the EC71/72 fields and is best illustrated in Figure 1.

The Sukuk is a Musharaka with the two parties to the Musharaka being the East Cameron Partners and the Issuer SPV. The transaction is based on the acquisition of a physical asset: The Purchaser SPV is purchasing a physical asset on a true sale basis. The Funding Agreement that links the Issuer SPV to the Purchaser SPV is a Shari'ah compliant instrument aiming at (i) materialising the contribution of the Issuer SPV (as a Musharek) and (ii) conveying to the Issuer SPV a certain risk and reward profile which is passed on to the Sukuk holders.

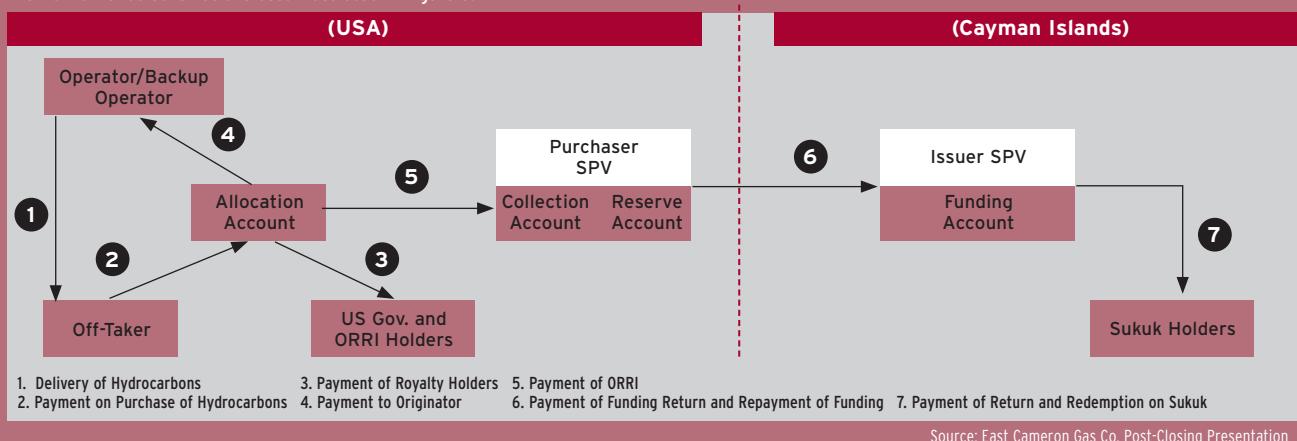
The initial idea was to structure the Sukuk as an Ijarah, using the rig equipment as the underlying asset to be securitised. In the event, this would have provided too small an asset base from which to raise the funds.



The transaction schematic is best illustrated in Figure 2.



The flow of funds schematic is best illustrated in Figure 3.



Source: East Cameron Gas Co. Post-Closing Presentation



The arranger and administrator

Ibrahim Mardem-Bey, director and senior adviser to BSEC

Why would a USA-based energy company ever consider a Sukuk in the first place?

Through BSEC's network of contacts in the USA, we identified an independent oil and gas operator... in the Gulf of Mexico in an area called East Cameron. Several years ago they had bought a government lease for the underlying asset. They had also tried to get some financing to begin exploration. At the time the only financing they could get was from Macquarie Bank.

Macquarie Bank is renowned for being very aggressive and for being at the cutting edge of these types of deals. They took a long look at the asset and they decided that it was worth financing but the terms were very, very expensive. They did the debt financing but it included a significant equity piece.

The client took it and started exploring and the reserves panned out. The asset started cash-flowing and the debt was fairly quickly repaid. But of course they had given up essentially a 50 percent working interest in the asset for getting the financing from Macquarie. So they were now stuck, having paid back the debt but they now had a partner in Macquarie. They wanted to buy Macquarie Bank out and be masters of their own destiny.

They then sought financing from a range of different sources in the USA but most of the terms of the financing that they received from hedge funds and major investment banks were a combination of equity plus debt again.

When I met them I told them that they had a very interesting asset that would suit a Shari'ah compliant Sukuk. First of all the underlying asset is now proven so you have a reasonably certain view on collateral, it was cash-flowing very nicely and it is not in a haram area of industry. Furthermore, being in oil and gas, it is an asset class that people in the MENA region would understand.

So we asked if they would be interested in BSEC trying to structure a Sukuk that has no equity component to it and was simply an asset-backed bond equivalent. On their books it would look like debt but on the Sukuk-holders' book it is an asset-backed unit certificate with ownership in the underlying asset. It is a fixed-income type product.

Hurdles?

With the price of oil at a high level, the client's pain threshold was quite high. His view was: So long as I don't need to give up equity and so long as you get me as much as possible from a debt to collateral issue, the yield that I have to pay to an investor becomes secondary. And we saw that this gave us the flexibility that we needed.

We signed the mandate and we then talked to some banks in the region. The first reaction was disbelief. They said, who are you at BSEC to advise an oil and gas independent with an asset that has been independently valued at \$500 million? Is BSEC up to more crazy stuff?



How are you going to pull this off?

We plugged on and then we started facing some hurdles. They wanted to know who had valued the reserve at \$500 million. Were they credible enough? So we had to upgrade the quality of the valuation. Another hurdle was whether or not it would work from a Shari'ah compliant point of view. We appointed Vinson & Elkin as the transaction attorneys and we appointed Sheikh Yusuf De Lorenzo as the Shari'ah adviser.

So we ended up with a working model that said that a Sukuk investor could invest an amount of money and it would amortise over a number of years and could give yields between X and Y.

We then had to face the issue of how to price it so that we got the originator as much cash as we could and at the same time get the investor the proper yield for the risk that they were taking as the Sukuk holder. An obvious solution to this was to get it rated.

We did the ratings round and finally settled on Standard and Poor's. We knew that the rating posed its own hurdles and some of them were: What sorts of credit enhancements do you build into the structure so that you ensure that when you give the operator the money that he is going to deploy it the way it should be deployed to get the best and most efficient way of getting the resources out of the ground and sold into the market.

How long did all of this take?

It took quite a bit of time. From date of origination to closing was two years. Some of the reasons for this long lead time are related to the structure and some are not.

The fact that this was an independent oil and gas company meant that they were not prepared for the types of data and audited financials that would be required to do a transaction of this sort. So they needed time to catch up.

The second reason was that the asset itself and the underlying assets and its valuation report needed some updating so that it fitted into the standards that we needed.

Another reason was that Hurricane Katrina came in the middle of this transaction and was very disruptive and shut down production for months. Remember that this asset is a huge plot of land on the sea bed. There are two platforms standing in the middle of these fields and

Katrina went right through the middle of this area.

The final reason this all took so long was that when we had a structure and we went to market, we targeted GCC financial institutions. The reception we got was mixed. There was a lot of interest in such a unique transaction and its being the first US issue. The other reaction was that BSEC was too small and too regional. BSEC had indeed never done a transaction of that size before and had never done a transaction in that asset class.

The argument we kept coming back with was that BSEC was a best-in-class structured finance house, specialised in asset-back finance, both conventional and Islamic. It has proven itself in many difficult transactions and we felt comfortable that we could do this one. But still there were some reservations. We realised at this point that we would have to bring in another party to the transaction that would bring in the global distribution and credibility to act as bookrunner. We talked with several banks and eventually settled on Merrill Lynch and found a team in London that was keen on doing a Sukuk and that had tremendous expertise in the oil and gas business. They had just recently purchased a very large oil and gas commodities trading business in the US.

In the meantime the client was still under pressure and wanted to buy out Macquarie and to start developing the field since the price of oil and gas was up. So they agreed to bring Merrill Lynch into the deal as co-arranger and bookrunner.

Then we went to S&P and asked them to rate it. That in itself took another two and a half months because they had never really rated a Sukuk of this nature. In the end it got a rating of CCC+. We could have achieved investment grade rating but it would have taken longer and the client just wanted to get on with it.

We priced it very attractively based on its rating and together we took it to market and we successfully closed the transaction.

Where did the investors in the Sukuk come from geographically?

This was the surprise of the deal. There were some GCC institutions but the majority was from non-Shari'ah conventional brand name hedge fund investors. The interesting thing is that they felt that the deal was structured to global standards and that gave them a taste of what a Sukuk was like and might give them a window into the regional capital market.

The structure managed to combine what in US terms would be commercial debt, mezzanine finance and equity into one instrument that was Shari'ah compliant, easy to understand and had a very transparent risk-reward opportunity for the Sukuk holders. I think this also shows that Shari'ah finance is growing up. It is maturing.

BSEC background in Sukuk

BSEC had structured and arranged the first automotive-backed Sukuk in 2004, CARAVAN 1

The three-year maturity transaction gave Islamic investors 6% return paid on a monthly basis.

The transaction had a total size of \$27 million (SR102 million) and was backed by a pool of vehicles and lease agreements sold by HANCO Rent-A-Car, one of the Kingdom of Saudi Arabia's leading car leasing and rental companies.

BSEC worked with Baker & McKenzie who acted as legal counsel for Saudi law, Voisin & Co as Jersey counsel and Volaw Trust as Trustee. Shari'ah compliance was provided by Yasaar, the Shari'ah consultancy.

The Sukuk had the following structuring and credit enhancement features:

- A two-tier two-jurisdiction structure with 15.39% overcollateralisation
- 4.25% equity tranche
- 8.77% cash reserves

The structure also benefits from embedded early-warning triggers mitigating its performance risk.



The legal adviser to the arrangers

Ayman Khaleq from Vinson & Elkins

The transaction was a very protracted one. How long did you spend working on it?

We became involved very early on. My first trip to Houston for a pre-kick off meeting was in November 2004. We met with the originator, Campbell Evans at East Cameron Partners and we were toying with some structures at that point in time including an Islamic sale leaseback. At the time we focused on a structure that would buy the oil rigs and lease them back to his company.

It developed further from that into an interest in the oil and gas properties themselves. In the USA you have well-defined interests like volumetric production payments and so on. The problem with the sale leaseback was that the value of the rigs and the platforms in the water was not equal to the amount that we were looking to raise because the value is not in the rigs but in the natural resources under the sea.

It went into a slow phase until the summer of 2005 when it picked up again and we started looking into mimicking existing US royalty interests involving oil and building an Islamic structure over those because at least the law is tried and tested on those matters.

How did Campbell Evans respond to a Lawyer from Dubai and an investment bank from Beirut turning up on his doorstep and saying, 'have I got a structure for you'?

He was intrigued by the whole thing and he is the type that is curious enough that he had done his own research on Islamic finance and had reached his own conclusions. He had done some serious work in terms of theology. That is one of his interests as a person. This helped the deal immensely. That is one pillar of how we ended up where we did.



The other pillar is that he had had some bad experiences with some international conventional lenders when prices were low and he needed some money. The interest rates were unbelievably high and who also took an interest in his company as security. He thought that Islamic finance would give him a better way out. Despite what the industry says about Islamic finance being more expensive than conventional finance, here at least he ended up saving himself at least a couple of percentage points a year because the only option open to him was hedge funds and there is no hedge fund that will lend you at less than 13-15%. Here we had a good Islamic product that charged a lower rate.

Once you had decided on what the structure would be, what was the process then?

The process was that between us and our client, being BSEC, we had to come up with a structure that worked. We had experience of US type royalty structures. They

had excellent experience in securitisation. What we had to do was merge the two. They needed to come up with a structure that gave them the level of security that they had become accustomed to and we came up with a kind of interest that can be used within that structure and arrive at a term sheet that ended up taking quite a while to develop. It took a couple of months to get it to the point where we were both comfortable with it.

Then we took it to the counterparty. Then there was some give and take but the counterparty had some conceptual questions about Shari'ah and how it affects things but at least 80% of the discussions related more to the terms that any deal would have to address than relating to Shari'ah. That was the easy part. The more complex part was the type of royalty interest we were going to use, the tax consequences and the bankruptcy consequences.

In each structure you want to treat this as a true sale and when you have a true sale it might enhance your bankruptcy protection but jeopardise your tax protection because it is no longer a finance but a sale and there might be some US tax implications in that. So we had to reach a balance between three things; Shari'ah, tax, bankruptcy. And that is assuming that we arrived at the right royalty interest. It was one of the most complex deals I have ever worked on.

Is that why it took so long?

That is one reason. Keep in mind that this is the first real Islamic US energy securitisation or Sukuk. We had to start from scratch. We had the concepts on every level. On the oil and gas level. On the Shari'ah level. On the securitisation level. We had all of this. But how do you put them together into one structure that works?

In addition this was sold to Islamic and non-Islamic investors and that is a sign of its success. Many US

investors bought it. They understood the concept and I think that is partly because we utilised an existing and well tested US royalty interest structure.

Do you imagine that this knowledge will come in handy in the near future?

Absolutely. We have the know-how now and we can really duplicate that structure or do variations on that structure. Not just in terms of the structuring and documentation but also in term of how to ago about certain things and what we need to focus on. There was also a huge amount of work went in between BSEC and Merrill Lynch.

Who owns the intellectual property behind such a deal?

This is never addressed. The documents for the deal are owned by the parties to the deal. You develop the know-how and you can use that going forward. There is nothing to prohibit you from doing that. But many of the core documents are tried and tested. We didn't reinvent the wheel on the interest-type documents. Given that most of the work within this firm is within the energy field, some of the forms were created by lawyers in the firm 20 or 30 years ago. So we went back and checked them and found what was most common these days because the industry went through ups and downs and some structures were added and some were abandoned and some were changed.

We went back to the gurus in these areas and we asked them what the most up-to-date structure was. What are the standard documents that have been utilised time and again and have been tested before the courts? This was our start point.

Was this the first time that Merrill Lynch had done a Sukuk?

The first Sukuk but they have been involved in other Islamic structures and they are very bullish about doing more Sukuk. I was very happy when they came on board. It gave the structure a big boost. But the BSEC guys did a wonderful job. They know their securitisation.

Did the S&P rating affect the pricing?

Yes. If you get a good rating you are targeting a different breed of investor than would go for a junk bond. You will still sell it, but it will have a different interest rate or profits margin in this case.

Could you describe the structure of the Sukuk?

It is more of an Islamic funding arrangement between a Cayman Islands entity and a US entity. Within that US entity it is a quasi-Musharaka type structure. We had to abandon the idea of an Ijarah Sukuk because if we are trying to raise \$160 million and the value of the rigs and the platforms is \$40 million then the Sukuk would only be tradable to the extent of the \$40 million. So we went for a Musharaka type agreement in terms of the management of the assets and then a funding agreement between the Cayman Islands entity and the US entity.

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