BOVINE SPONGIFORM ARGENTITIS

Argentina's inability to access the international capital market leaves it with few options for feeding its sacred cow, the giant shale gas field Vaca Muerta. Unless the financial pariah can find more than US$30bn, the reserve's potential, like the gas itself, will remain nothing but hot air.

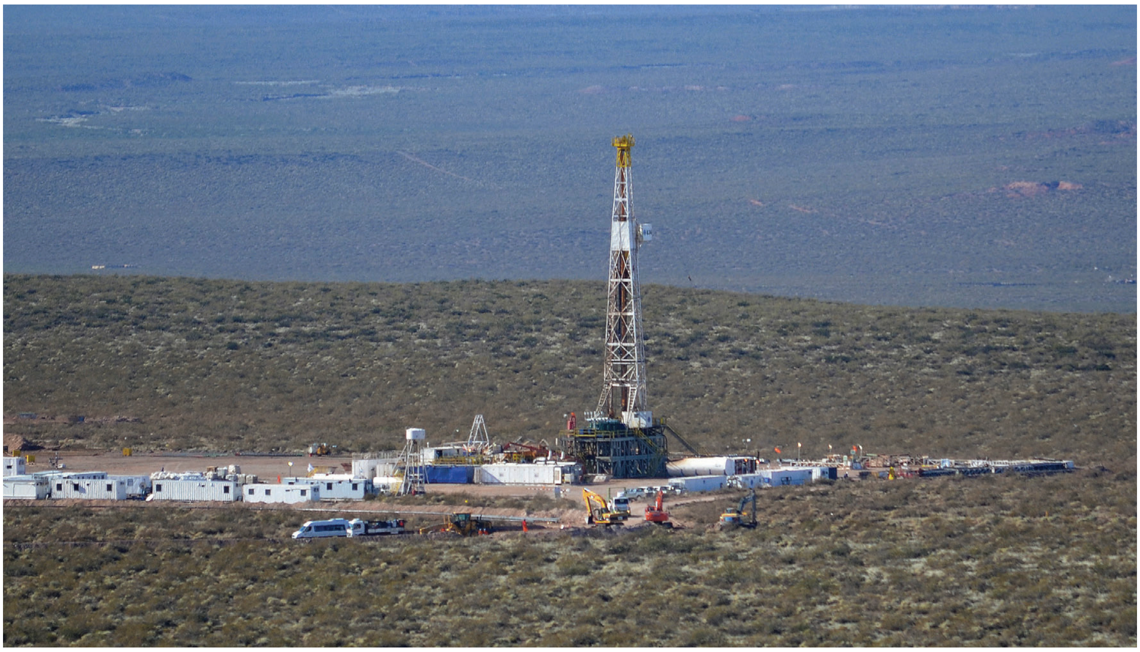
BY SOLOMON TEAGUE

Argentina's seizure of national champion and oil giant YPF from its Spanish owner Repsol in 2012 was a defining moment in the country's economic history. The raid saw the country take custody of its prized asset, gas field Vaca Muerta (which translates as dead cow). It was hoped the revenues from this bountiful gas field would provide a much-needed shot in the arm for Argentina's flailing economy

Yet the gas beneath the field cannot be extracted without capital investment, and capital is hard to come by. Without access to the capital markets, Argentina is low on options.

Investors that might have been tempted to take a punt on the huge potential of Vaca Muerta saw the nationalisation of Repsol's asset as evidence of the government's disdain for property rights. Despite YPF sitting on what is thought to be one of the biggest shale reserves in the western hemisphere, which it estimates to contain 661bn barrels of oil and 1,181trn

A cow feeds at Managua's municipal garbage dump
REUTERS/Oswaldo Rivas



An aerial view of a shale oil drilling rig in the Patagonian province of Neuquen REUTERS/Prensa YPF

cubic feet of natural gas, investors judge the risk to be too great.

According to YPF's own calculations, it needs capex financing of US$32.6bn for 2013–17, of which about three-quarters will be used to exploit Vaca Muerta and other existing assets. According to an August 2012 filing with the SEC, it will generate 80% of this sum from internal cashflow generation.

The remainder will come from financing, assuming it finds a partner to share the cost of exploiting its energy assets. This, it said, will enable it to increase oil and gas production by 32%, and diesel and gas production by 37%.

Expanding on this plan, Miguel Galuccio, president and CEO of YPF told investors and analysts: "From the US$32.6bn that are on the YPF balance sheet, 80% of it is going to be taken by our free cashflow, and 20% of that is going to be debt. We believe that with the solid operational performance and with the portfolio of project that we have, we can generate 50% Ebitda year on year for the next five years, and we believe that we will move from 0.8 of debt- to-Ebitda ratio to no more than 1.5 in the next five years."

Subdued oil action

Commodities exporters are certainly better placed than their peers in other sectors to raise money for capex and other purposes, because they are essentially pre-financing their exports.

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In seizing YPF, Argentina appears to have gambled on Western thirst for oil to trump anxiety about doing business in Argentina. It believed its new-found oil wealth to save it, as Russia has in the past. However, the macro outlook for oil does not look supportive, said Abbas Owainati, an economist on the multi manager desk at Old Mutual Global Investors.

Demand looks reasonably stable, with slowdowns in the US and China and little prospect of upside surprises from Europe, while supply is plentiful, with OPEC having spare capacity, Venezuela boasting considerable reserves, Iraq looking set to start exporting oil again and conditions looking increasingly stable in the Middle East.

While trouble is brewing between Russia and Ukraine, raising the spectre of supply side shocks, the medium-term outlook remains stable, said Owainati. "The subdued action in oil contracts is comforting," he added.

Even the US has spare capacity and has plenty of shale gas of its own to exploit without looking to YPF's Patagonian shale and gas field. The prospect of any shock that will send oil prices soaring and replenish the coffers of oil-exporting countries looks decidedly bleak.

Argentine President Cristina Fernandez de Kirchner was not wrong in her judgement that Vaca Muerta would arouse interest from partners around the world. Despite Argentina's protracted legal battle with Repsol, which was only settled in February with Repsol winning US$5bn in compensation for the loss of its stake, YPF has held negotiations with a string of suitors from around the world.

Courting Petronas

In January YPF chief Miguel Galuccio told Reuters by e-mail that the firm was negotiating a deal with Malaysia's Petronas to unlock investment to develop the its assets. Dow Chemical and Chevron Corp have signed deals for which few specifics have been disclosed. The Chevron deal, the larger of the two which was signed in the summer of 2013, will see the US group invest US$1.24bn for the first phase of development in the Loma La Lata Norte and Loma Campana areas, drilling 100 wells in a 5,000-acre tract.

Mexico's Pemex and French firm Total are also thought to be considering their options. Yet so far there seem to be few firm offers. Some potential partners appear to be backing away: Apache Corp is in the midst of selling its stakes in Vaca Muerta, and other deposits in Argentina, to YPF.

It won't be easy

If a handful of oil giants have the stomach for the risk of working with the Argentine government, few investors do. Although the energy giant has had some success in its forays into the local markets, the size of the Argentine local market has been prohibitive. The capital raised has suffered from rampant inflation that is running at no less than 30%.

"The local markets are very difficult in the current environment," said Javier Canosa, partner at Canosa Abogados, a law firm in Buenos Aires, citing also devaluation and the inability to purchase foreign currency to pay debts.

The international markets look no more promising. With Argentina remaining in a state of default, the cost of capital for its corporates is sky-high. YPF was in fact the last Argentine institution to find any joy in the international markets, in December capitalising on a tightening of sovereign spreads, and a preliminary agreement in the Repsol dispute, to raise US$500m.

President of Argentina's oil company YPF Miguel Galuccio
REUTERS/Marcos Brindicci

The way had been paved for its first market-driven transaction for more than a decade when it priced US$150m five-year New York law bonds at par in September, a deal that was itself the company's first foreign foray in close to 15 years. But few believe such feats can be repeated, and if even if they could the sums available would be negligible.

Old Mutual Global Investors is typical of the institutional investor community in assessing the risk of asset seizures and the lack of credibility of the government – its unpredictable policies and the misreporting of all official figures from growth to inflation – to be too great.

Seeking stability

"As a general policy we do not like to invest in corporates in countries which have a high probability of experiencing macro distress," said Shamaila Khan, portfolio manager for emerging markets corporate bonds at AllianceBernstein, confirming Canosa's fears. Investing in any Argentine corporate debt would therefore require a stabilisation of the macro situation, she said. It is very difficult to guess when that might happen. Because there are no accepted international procedures for resolving the insolvency of countries, it is very difficult to predict how the matter will be settled by the US Supreme Court, said Canosa. Until this and other legal issues are resolved, attracting investment to Argentina is going to be difficult.

Among the biggest disincentives to investment are differential exchange rates, the inability to transfer dividends and profits and aggressive policies towards investors, said Canosa. The Argentine peso has seen a dramatic revaluation as the government attempts to bring economic turmoil under control, going from Ps4.40 in April 2012 to Ps8 in January 2014.

"It is not difficult to see that the funds have been negligible as compared with YPF's needs of capital expenditures in the short and medium term," said Canosa.

"I think investors are waiting for a change in the government's policies," he said – assuming a change of government in 2015 doesn't come first to restore investor protections. Until that happens, he predicts investors will remain wary of Argentina.

"Argentina has not paid its creditors, that is a fact," said Canosa. "However, it is also true that some of its creditors have purchased the debt with a big haircut and now are seeking payment of the full face value." This partially accounts for the government's intransigence.

It all adds up to an opportunity that should have investors queuing up, but instead they are conspicuous by their absence. And the main worries are volatility and macro shocks, and, even more, the risk of asset seizures.

"If, and it is a very big if, there was some kind of legal reform in Argentina that changed the custody issue, you could start to see a very different picture emerge in Argentina," said Owainati. It is likely to be a long wait before that happens. Until then, Argentina will struggle to nourish its dead cow. ●