SE Industries
HD A shift in focus for Santos
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LP After enduring its moment of crisis, Santos has unveiled measures that ought to ensure its stability in a low oil price environment.

The shape of Santos' response to the leverage in its balance sheet is somewhat different to what might have been anticipated when it began its strategic review nearly three months ago.

TD Nevertheless, the $3.5 billion of measures the group unveiled today ought to ensure its stability and, in the near term at least, continued independence. Moreover, the solution doesn't involve selling down any of its exposures to its best assets: its portfolio of LNG operations.

The package of measures Santos has opted for does involve a $2.5bn equity raising but, with some help from the takeover approach from a consortium of ultra-wealthy Asian and Middle Eastern investors, the deeply-discounted entitlement issue will be priced at a level ($3.85 a share) that would have been unthinkable when the shares were trading down towards $4 a share early last month.

The fully underwritten issue is the centrepiece of a debt-reduction package that includes the sale of Santos' 35 per cent interest in the Kipper gas field off Victoria to Mitsui for $520 million.

Potentially more controversial is a $500m placement, at $6.80 a share or a 15 per cent premium to Santos' closing price last week, to China's largest private equity firm, Hony Capital . The placement will give Hony (which already had a 1.4 per cent shareholding in Santos and which will participate in the entitlement issue) a 7.9 per cent stake in Santos .

As the placement shares will participate in the equity raising, the effective blended price Hony will pay is about $5.70 a share.

Hony, which counts among its investors Singapore's Temasek , the Bill & Melinda Gates Foundation and Goldman Sachs , has agreed to cap its Santos shareholding at 9.9 per cent for the next three months and not to sell any of the shares acquired through the placement and issue for 12 months.

The takeover approach from the Scepter consortium that Santos rejected out of hand was pitched at $6.88 a share, so the placement price helps put that approach, which Santos saw as opportunistic, into perspective.

Scepter, of course, would point to the average price Hony will pay rather than the headline $6.80 a share for the placement to argue that its offer wasn't completely out of the ballpark of reasonableness.

Hony's motivation in acquiring the Santos stake isn't clear (it first appeared on the register a couple of months ago) but it would make some sense as a counter-cyclical value play. In the near term, at its proposed level, it wouldn't be sufficient to deter further takeover approaches but its stake would help put a floor under the starting point for any discussions.

The various strands of the Santos package and the $3.5bn of cash they will generate will make a major dent in the group's destabilising net debt of $8.8bn, reducing it (after taking into account foreign exchange impacts) to $6.2bn.

The excessive leverage in Santos' balance sheet is largely due to the group's 30 per cent interest in the $US18.5bn GLNG export project in Queensland.

The project has just started shipping gas -- there have been two shipments -- and cash flows from the project will build over the next 18 months to two years, particularly once its second train starts operating early next year.

The project is cash flow-positive at an oil price of $US40 a barrel.

It was the timing of the collapse in the oil price -- just as Santos' funding of its share of the project was peaking but before GLNG was generating any cash flows -- that created the focus on its balance sheet, savaged its share price and ultimately forced it to act decisively.

Well-respected chief executive David Knox stepped aside as the crisis enveloped the group, with its chairman, Peter Coates, taking charge of the strategic review and the search for Knox's successor. Santos announced today that Clough Ltd chief executive and long-time senior Woodside executive Kevin Gallagher will take up the role early next year.

Much of the focus of speculation about the outcome of the review centred on what Santos would have to sell to have any meaningful impact on its debt levels. There was an expectation that it would be forced to sell down a slice of its best asset -- its 13.5 per cent interest in the PNG LNG project -- as the core of the debt-reduction package.

The outcome it has settled on, with only one non-core asset sale, leaves Santos' LNG portfolio (which would have been the major attraction to both the Scepter consortium and Hony) intact.

While there is a big call on Santos shareholders and a placement of a potentially strategic stake to Hony in the final outcome of the review, avoiding the sale of interests in its core assets during what is probably the low point in the oil price cycle (LNG is sold at oil-linked prices) is arguably a better outcome for shareholders.

Santos, before it announced the strategic review, had been under a lot of pressure to raise equity but had resisted as its share price kept falling.

The impact of the approach from the Scepter consortium on the Santos share price created an opportunity to issue equity on somewhat better terms, although it is arguable that a deeply-discounted issue that gives all shareholders an opportunity to participate or receive value for their entitlements would be fair regardless of the price.

Santos has now given itself a better opportunity to get through the next 12 to 24 months as the GLNG project ramps up and starts to generate meaningful free cash flows, hopefully in a stronger oil price environment.

It will help that its capital expenditures, having already been slashed from the original 2015 guidance of $2.7bn to $1.8bn, will fall further in 2016, to $1.2bn.

Santos has also carved into its operating costs -- it has reduced its cost base by about $370 million a year -- and said today it would change its dividend policy to one where dividends were set as a payout ratio of earnings, expected to be a minimum of 40 per cent of after-tax profits.

Having had its moment of crisis, all the group's policies and settings are now geared towards operating with an assumption that the current low oil price environment might be sustained for some time.

The appointment of Gallagher reinforces that shift and the focus on costs and financial discipline, given that Clough, an engineering and project services contractor, has been fully exposed to the impact of the collapse of commodity prices on the resource sector. He also has several decades of international experience in the oil and gas sector with Mobil and Woodside.

The strategic review put almost every asset Santos owns up for grabs and would have provided the group with a very detailed understanding of what its individual assets might be worth in an environment of depressed oil prices and while its status was that of a distressed vendor.

Gallagher, without the near-term balance sheet pressures, will have the benefit of the knowledge gained from the review. It will be interesting to see whether the Kipper interest is ultimately the only change to Santos' portfolio once its new chief executive has had time to settle into his role.

CO sants : Santos Ltd

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