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## EAST CAMERON PARTNERS: THE SUKUK BOND<sup>1</sup>

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*Stephen Sapp wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.*

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Version: (A) 2010-08-13

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### INTRODUCTION

It was July 2005, and Campbell Evans, chief executive officer (CEO) of East Cameron Partners LP, had just returned to his office to ponder the financing proposition he just received from halfway around the world. Over the past several months, Evans had been trying to figure out how to effectively reverse East Cameron's current relationship with Macquarie Bank ("Macquarie") — Macquarie was a 50 per cent equity partner that was not interested in further investing in the business. Since Evans wanted to both regain majority control of East Cameron and take advantage of soaring oil and gas prices with new exploration and development (see Exhibit 1), Evans was looking for alternatives to raise the funds in order to buy out Macquarie and finance new exploration and development. Though the proposal he just received to use a Sukuk bond was something new to Evans, it did appear to have several advantages over the other financing options he was facing.

### HISTORY

East Cameron Partners was a father and son independent oil business based in Houston, Texas, that had been operating — in one form or another — for 57 years. The business typified what were called "wildcatters" (oil and gas speculators). Evans and his father together held an approximately 66 per cent interest in East Cameron. Campbell acted as the general partner of East Cameron through Open Choke Energy, LLC (see Exhibit 2). East Cameron, like most other companies in the industry, was subject to the cyclical nature of the oil and gas business and, in its short history, had been through several booms and busts. In 2005, they were enjoying the benefits of both a successful exploration and development program and increasing oil and gas prices.

Oil prices were rising as the demand for oil and gas from rapidly-growing economies — such as China and India — continued to grow while world supplies were not keeping pace. During the 1990s, the interest of oil companies in building more capacity to pump oil was low due to the excess capacity and low price of

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<sup>1</sup> This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of East Cameron Partners LP or any of its employees.

oil at that time: this was allowing companies who could rapidly bring new capacity online an opportunity to benefit greatly from the increase in prices while the demand remained high.

East Cameron Partners' main assets were two gas properties located in the shallow waters off of Louisiana. These two properties were obtained in early 2000, when East Cameron had acquired a government lease from Conoco Phillips, one of the world's largest integrated energy and refining companies. The lease gave East Cameron the right to explore and exploit two gas properties (EC71 and EC72) located in the East Cameron region of the Gulf of Mexico, just off the coast of Louisiana.

At the time East Cameron obtained the exploration rights, they required outside funds to develop and exploit the sites. Macquarie, a well-established Australian bank specializing in infrastructure investment, was willing to provide the required financing for this venture, but at a significant cost. Macquarie provided East Cameron with the US\$45 million it required for development and exploitation of the sites, but demanded interest on the loan of 15 per cent per annum and a 50 per cent equity stake.

Exploration on the East Cameron site began shortly after Macquarie's financing closed. The reserves proved to be extensive, and oil and gas prices were increasing at that time: East Cameron was quickly able to repay the Macquarie debt.

These two properties consisted mainly of natural gas and were found to have net proven reserves of approximately 68 Bcfe,<sup>2</sup> with an estimated remaining production life of 14.5 years. With the price of natural gas skyrocketing (see Exhibit 1), Evans was eager to develop this site further. He believed that they could expand their reserves by at least 50 to 75 per cent with further exploration on these two large properties; however, Macquarie was unwilling to fund further development. This left Evans considering funding options that would leave him and his father in control of the company they built and entitled to as much of the cash flows from their successful gas explorations as possible.

Most of the financing proposals they received from hedge funds and major investment banks included an equity component. It was in response to their inquiries for financing that East Cameron received a significant offer from BSEC.

## THE BSEC OFFER

Evans had just finished a telephone call with Ibrahim Mardam-Bey, a financier at Lebanon-based Bemo Securitization (BSEC), who had approached him with an interesting financing solution — the use of a Sukuk bond. While Evans had never heard of Islamic finance or Sukuk bonds, the proposed financial solution sounded interesting. The Sukuk bond would allow East Cameron to buy Macquarie's equity stake and replace it with high-yielding bond-like instruments.

Evan's mind was filled with questions: How did this Sukuk structure really work? Was there anything about it that would put East Cameron's assets at risk? How did it influence their control over East Cameron and its operations? What was the downside to this structure? Who would buy such a debt instrument? How would the effective cost of this debt compare to his other alternatives? Was there sufficient demand in the U.S. market for such a product? Based on Evans' understanding of the proposal, if

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<sup>2</sup> Bcfe stands for billion cubic feet of gas equivalent. A term typically used to measure the amount of natural gas that is either untapped in reserves, or being pumped and delivered over extended periods of time (such as months or years). The "equivalent" is used to describe the equivalent amount of energy liberated by the burning of this type of fuel versus crude oil, with every 6,000 cubic feet of natural gas being equal to one barrel of oil.

East Cameron and BSEC could pull this off, then Evans and his father could benefit from the high returns from gas prices and take back a greater degree of control over the company.

On the other side of the ocean, Mardam-Bey put down the telephone and was hopeful that he had convinced Evans of the value of his proposal. He recognized that it was a foray into a new market for his firm, but he was confident that it was the right product at the right time. Mardam-Bey had spent months designing a Sukuk structure that he believed would be of interest to players in the North American oil and gas sector. Given that these companies would generally have to accept a combination of debt and equity from U.S. hedge funds and investment banks to receive funding, he was convinced that despite the unfamiliar nature of the bond-like Sukuks to U.S. investors, small-cap oil and gas companies in the United States would be keen to test the demand for such instruments.

Although “Sukuk” is the Arabic name for a financial certificate, it is frequently viewed as the Islamic equivalent of a bond. Since interest bearing bonds are not permissible in Islam, Sukuks are securities that comply with Islamic law and its investment principles by not paying interest but still provide investors with regular payments. The Sukuk essentially sells to the investors the ownership of a cash-generating asset, and it is the ownership of this asset which provides investors with predictable returns. The key is that the investor’s returns are derived as payments from the set of assets that the investors purchased when they bought the Sukuk bond, and therefore these payments are not classified as interest payments. The issuer of the Sukuk therefore sells assets to the buyers of the Sukuk and provides to the Sukuk holders regular payments based on the cash flows generated by the assets that were sold. The issuer of the Sukuk also gradually repurchases the assets from the Sukuk holders and thereby is able to decrease the cash flows that it owes to the Sukuk holders.

### **FINANCING ALTERNATIVES: CONVENTIONAL BONDS, BANK LOANS AND EQUITY**

Before making any decisions, Evans knew he needed to compare the proposed Sukuk bond with the more standard alternatives in front of him. Most of the potential financiers he spoke to within the United States offered him deals that were very similar to the original deal they had struck with Macquarie. The deals were mixtures of equity and debt.

Small oil and gas companies like East Cameron were considered high-risk by credit providers. To manage this risk, traditional financing for firms like East Cameron typically resembled private equity transactions and consisted of a combination of equity, mezzanine finance and commercial debt. These structures were employed because the suppliers of finance felt that these risky companies also provided opportunities to achieve a significant return on their investment. Simply lending to these firms put a cap on the potential returns they could get from the investment (the interest paid and principal repayment) with a large potential for loss; to overcome this, a combination of debt and equity was required with overall returns targeted at rates such as 20 per cent.

The structure of most financing required that all of the assets were used as collateral and the cash flows from the assets were used to service the debt — the better the cash flow-generating ability of the assets, the greater the ability to repay the debt. The equity portion therefore allowed the investor to participate in the upside if the project succeeded. In either case, the value of debt or equity would be the residual value of the assets if the project failed. Unfortunately, such financing alternatives would put East Cameron back into the same situation as with Macquarie but with a different partner.