Guy Butler Limited
21 Great Winchester Street, London, EC2N 2JA Tel: 020 8828 2200 Email: enquiries@guybutler.co.uk

27 February 2020

Tullow Oil plc

Ticker: TLWLN

Isin	Issue Size	Rating M / S&P	Coupon	Min Piece	Maturity	Next Call	Offer	YTM
USG91235AB05	$650mn	Caa1 / B	6.25% s/a	$200k	Apr 2022	Until Apr 2020 @ 101.563	82.50	16.34
USG91237AA87	$800mn	Caa1 / B	7.00% s/a	$200k	Mar 2025	Mar 2021 @ 103.5	73.00	14.84

We last looked at Tullow in September 2015, when oil was around $50bbl and the then outstanding five- and seven-year bonds yielded 12+%. Market cap was £1.8bn. Fast forward to January 2020 and a series of production revisions during 2019 have resulted in the departure of both the CEO and Exploration Director, a dividend cancellation just a year after reinstatement, and a lot of scepticism. After falling 84% since November, market cap is just £460mn. Five years ago the trigger was the drastic fall in world oil prices. This time, Tullow's problems are mostly of its own making, and it will need to move swiftly and cross its fingers to head off the concerns evident in both the equity and bond prices.

Business

Tullow has been an oil and gas explorer for around 40 years. West Africa represents the largest part of its business, but it now also has interests in Latin America. Production cost has dropped from $15bbl to around $9 in recent years. This has been helped by cyclical lows in vessel dayrates that will likely start to move up again in the medium-term.

In **West Africa**, Tullow is present in five countries with 28 producing fields. The Jubilee field, off the coast of Ghana, has been the company's most important producing asset since commencing production in late 2010. Tullow's stake there is 35% and it generates 37% of working interest bopd for the group. The other flagship asset is the TEN offshore field (Tweneboa, Enyenra & Ntomme). It was due to come online in mid-2016 and did – and on budget as well. It produces 34% of group working interest production. UK North Sea assets are managed by the West Africa division, although production there ceased in mid-2018. Other producing assets are located off the coast of Côte d'Ivoire, Equatorial Guinea, and both on- and offshore in Gabon.

The **East Africa** business consists of onshore fields in Kenya and Uganda. It's a core growth area and Tullow is working with local governments to bring the projects to development. First initial drilling is due in Kenya in late 2H 2020. The early oil pilot scheme (EOPS) there commenced in August 2019, with 2,000bopd being transported by road.
In Uganda, first initial drilling was expected in the substantial Lake Albert Rift Basin by the end of 2019, but has been held up by the delay in the farm down.

New Ventures span both Africa and South America. Tullow seeks high-potential prospects of high value oil at low cost with commercially attractive licence terms. This translates to drilling three to five low-cost frontier wells a year. These opportunities are in Argentina, Côte d'Ivoire, Guyana (Carapa, Joe, Jethro and Kanuku fields), Jamaica, Mauritania, Mozambique (Comoros), Namibia, Peru and Suriname.

Setbacks in 2019

- Technical issues in Ghana that were resolved in Q1: gas compression constraints on Jubilee field in February, a delay in completing the Enrenya-10 production well in the TEN field, topside issues that constrained water injection and gas handling.
- Mechanical issue with Enrenya-14 well suspended its completion in July. Its paired water injector well, En16-WI was also postponed. The rig was moved to the next well while Tullow considered next steps.
- The Enrenya field is exhibiting faster than anticipated decline.
- Gas exports from Jubilee and TEN were limited by low demand from the Ghana National Petroleum Company. These exports are provided for free. Without offtake, excess gas has to be reinjected into the fields, which increases costs. Jubilee also experienced increased water cut on some wells and lower facility uptime (Dam Turwell).
- Despite main principles on tax treatment being agreed for the farm-down of Ugandan assets to JV partners Total and CNOOC, the sale agreement eventually lapsed as transfer of capital allowances couldn't be pinned down. Talks are ongoing between the JV partners, Tullow and the Government of Uganda for the transaction's tax treatment. Tullow will not be investing more in the first development there of 1.2bn bbl until farm-down can be

achieved and it has therefore commenced a new sales process to reduce its 1/3 stake in the project. Total has suspended work on the East Africa Crude Oil Pipeline project as a result.

- The Jethro and Joe discoveries in Guyana were shown to have heavy oil. The Carapa-1 well in Guyana showed low net pay, i.e. there was less oil than expected. It probably won't be commercialised despite the good oil quality.
- Early oil pilot scheme in Kenya was suspended in Q4 due to severe damage to roads from heavy rain. Trucking will resume when Kenyan authorities have repaired roads to safe standards.

These setbacks started slowly, but cascaded through the year until it all came to a head in December, at which point:

- The CEO and Exploration Director both resigned.
- Board Chair Dorothy Thompson was appointed executive chair on a temporary basis.
- EVP East Africa and Non-Operated, Mark MacFarlane, was appointed as COO.
- The freshly reinstated dividend was suspended.
- A thorough reassessment of the cost base and future investment plans was initiated.
- The search for a new CEO began.

Guidance Progression for YE 2019	16-Jan	25-Apr	24-Jul	13-Nov	09-Dec	15-Jan-20	2020 outlook
Production per day (boepd)	93k-100k	90k-98k	89k-93k	87k	87k	86.7k	70k-80k
Revenue					$1.7bn	$1.7bn	
Free cash flow		$450mn	$400mn	$350mn	$350	$350mn	$150mn minimum
Net debt		$3.0bn		$2.8bn	$2.8bn	$2.8bn	
Gearing		1.9x	1.8x	2.0x	2.0x	2.0x	
Capex		$570mn	$570mn	$540mn	$490mn	$490mn	$350mn + $100mn decommissioning

After the serial disappointments, this January's sales and revenue call at least came with a reiteration of the December guidance for 2019. It was a small consolation. The CFO flagged impairments related to a 30% reduction in Enyenra field reserves in Kenya. The pre-tax impairments and exploration write offs will together total $1.5bn for 2019, mostly due to a $10 reduction in the group's long term accounting oil price assumptions to $65bbl and the reduction in TEN's 2P reserves (probable reserves; i.e. 50% chance of commercialisation).

Financials

Back in September 2015, oil had fallen from over $100bbl in mid-2014 to around $45. It bottomed out just above $27 at the start of 2016. Since then it recovered to a high of almost $87 in October 2018, but spent most of 2019 ranging between $60 and $70. Results from 2014-2016 showed substantial operating and net losses driven by asset impairments coupled with high levels of exploration cost write offs. Action taken and more stable oil prices helped put it on the road to recovery during 2017, and 2018's $678mn operating profit was the highest in a decade. Excerpts from Tullow's income statements show the gradual recovery since 2014's oil price dive:

$ millions	2014	2015	2016	2017	2018	1H 2019
Revenue	2,212.9	1,606.6	1,269.9	1,722.5	1,859.2	872.3
Other income - lost prod ins proceeds			90.1	162.1	188.4	29.3
COGS	(1,116.7)	(1,015.3)	(813.1)	(1,069.3)	(966.0)	(375.1)
Gross Profit	**1,096.2**	**591.3**	**546.9**	**815.3**	**1,081.6**	**526.5**
Administration	(192.4)	(193.6)	(116.4)	(95.3)	(90.3)	(55.1)
Restructuring		(40.8)	(12.3)	(14.5)	(3.4)	(1.2)
Exploration costs written off	(1,657.3)	(748.9)	(723.0)	(143.4)	(295.2)	(81.2)
Impairment of PPE or Goodwill	(728.7)	(459.7)	(331.6)	(539.1)	(18.2)	(11.5)
Provision - onerous service contracts		(185.5)	(114.9)	1.0	(167.4)	1.3
EBITDAX	**314.5**	**235.3**	**435.2**	**758.0**	**1,407.7**	**772.1**
Operating profit	**(1,964.6)**	**(1,093.7)**	**(754.7)**	**22.4**	**528.4**	**387.6**
Finance costs	(143.2)	(149.0)	(198.2)	(351.7)	(328.7)	(158.8)
Net profit after tax	**(1,639.9)**	**(1,036.9)**	**(597.3)**	**(175.3)**	**85.4**	**103.2**

Of course, the good start to 2019 will be substantially undone given the $1.5bn charges announced for the full year, split between $700mn of impairments and $800mn of exploration write offs. Neither of these represent cash outflow in the current year, but clearly take a chunk out of the balance sheet and imply lower cash flow from existing assets in future. That's disappointing, as Tullow has shown consistent improvement in cash flow over the past five years. Once the large upfront investments in the TEN field tailed off and it started to produce oil, the cash flow dynamic flipped to positive, as apparent from our excerpts here:

$ millions	2014	2015	2016	2017	2018	1H 2019
Operating cash flow	**1,481.8**	**1,351.0**	**512.5**	**1,204.0**	**1,222.9**	**597.4**
Capex - intangible exploration & eval	(1,255.1)	(647.6)	(275.2)	(189.7)	(202.1)	(104.8)
Capex - PPE	(1,098.3)	(1,464.8)	(756.0)	(117.8)	(238.4)	(146.3)
Free cash flow	**(871.6)**	**(761.4)**	**(518.7)**	**896.5**	**782.4**	**346.3**
Finance costs	(172.9)	(203.6)	(284.0)	(265.4)	(234.5)	(95.0)
Net borrowing movement	1,196.6	973.7	715.1	(1,371.2)	(632.5)	(12.5)
Net cash flow	**(38.2)**	**44.1**	**(55.4)**	**(1.4)**	**(105.7)**	**182.5**

While there will be a substantial loss in the income statement for full year 2019, we expect cashflow to hold up fairly well given largely non-cash items will be the main culprit. Production problems did not put too much of a dent in cash flow. Finance costs were well covered at 5x-6x by operating cash flow over the past 18 months. Tullow's cost of production is currently below $10bbl, and although that has benefited from low vessel dayrates in recent years, a rise in rates to those of 2014 will probably raise cost per bbl c.$5-$10 at some point. Tullow will remain a fairly low cost producer.

Having signalled in December that there would be some restructuring, subsequent reports mention a 40% headcount reduction in Kenya, closure of its Dublin and Cape Town offices, and total group workforce reduction of around a third (upwards of 300 staff). Annual staff costs were just under £190mn in 2018. According to reports Tullow will be reducing costs by £20 to £80mn via the restructuring.

Assuming that the current average estimate of this year's oil prices –$60-$65bbl – turns out to be the case, then we think Tullow's $150mn minimum free cash flow outlook could have a fair bit of optimism built in. Below $65bbl Tullow needs to make sure it achieves somewhere within the mid- to high-end of its production range (75-80kbpd) to ensure it lands above $100mn of FCF. And either way, it needs to make some quick gains from restructuring, ideally achieving around $50mn in 2020. That's not an exit runrate either; as far as we can see it needs to be actual savings on costs that simply don't occur for the business this year.

The balance sheet is ok, but has some clear vulnerabilities: debt & leverage, diminished tangible net worth, the potential for lower oil prices to undermine its E&P asset values, and the ability to achieve full value for its JV farm down. How Tullow tackles these over 2020 will be crucial.

By our calculation, and not including any general impairments, net debt to EBITDAX fell from 9.61x in 2014 to 3.23x in 2018, so Tullow can be pretty pleased with its reduction in leverage. That said, and regardless of whether we include leases or not, total debt has not really budged. Bank debt has roughly halved to $1.5bn since 2015, but bonds and leasing have taken up the slack. Total debt is up around $500mn over that time and was $4.87bn in June, having hit a peak of $5.26bn in 2017.

$ millions	2014	2015	2016	2017	2018	1H 2019
Cash & equivalents	319.0	355.7	281.9	284.0	179.8	362.3
Inventory	139.5	107.2	155.3	168.0	134.8	243.9
Trade receivables	87.8	80.8	118.4	171.4	159.4	225.6
Other current assets	902.3	763.2	838.9	768.3	969.0	879.1
Intangible exploration & evaluation	3,660.8	3,400.0	2,025.8	1,933.4	1,898.6	1,860.3
PPE	4,887.0	5,204.4	5,362.9	5,254.7	4,916.4	4,902.8
Goodwill	217.7	164.0				
Other non-current assets	119.7	223.4	175.7	789.8	696.4	666.4
Deferred tax assets	255.0	295.3	758.9	724.5	649.4	614.2
Trade & other payables	1,074.9	1,109.1	914.2	797.5	983.1	1,014.7
Provisions		187.0	51.9	230.8	198.5	220.2
Current debt	131.5	75.3	593.4	228.1	221.2	290.8
Non-current trade & other payables	85.1	72.8	87.8	105.1	91.3	81.3
Non-current debt	3,209.1	4,288.9	4,413.0	5,029.0	4,501.4	4,583.4
Non-current provisions	1,260.4	1,065.1	1,106.7	801.6	677.0	638.6
Non-current deferred tax liabilities	1,507.6	1,164.5	1,292.4	1,101.2	1,075.3	1,152.0
Equity	4,020.3	3,174.7	2,242.5	2,716.4	2,893.2	2,811.5

The main liabilities are the $4.9bn debt, deferred tax of $1.15bn, accruals of $697mn and provisions of $859mn split $220mn current and $639mn non-current. Decommissioning obligations account for 92% of provisions.

Although goodwill was cleared out of the balance sheet several years ago, net worth includes a merger reserve of up to $560mn. Tangible net worth sits at $951mn. There won't be much wiggle room once $700mn of reserves impairments go through the year end 2019 accounts.

Cash and equivalents tends to remain well above $200mn, with $362mn on hand at the end of June. Inventory is a bit higher than usual at $244mn, but being oil & gas it is of course pretty liquid. Assets held for sale total $912mn, but given the bulk of that is the lapsed farm down, it's proving tricky to realise. Oil & gas assets total $4.84bn out of the $4.92bn PPE, $685mn of which related to finance leases and $44mn of which is capitalised interest. Exploration and evaluation assets sit in the intangibles figure of $1.86bn, which we already discount in our TNW calculation.

Other current assets include $659mn due from JV partners, the remainder being mostly underlifts, prepayments and "other". Other non-current assets similarly break down into $561mn due from JVs, VAT recoverable from Uganda ($32mn) and "other". The trade & other payables figures are dominated by the $697mn in current accruals, and includes $128mn trade payables and $138mn current and $81mn non-current designated as "other".

Funding & Facilities

Tullow's funding is simple. The good news is that debt is mostly long term, so Tullow has some breathing space to tackle the current challenges. It might wish it hadn't cancelled the $500mn revolver it wasn't using in 2018, but as it stands liquidity looks adequate for 2020 with the combination of cash on hand, likely cash generation and facility headroom as backup.

The $300mn convertible maturing in 2021 is issued out of Tullow Oil Jersey, while the two larger bonds are senior unsecured group parent issues from Tullow Oil Plc.

Debt $ millions	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**Total**
Reserves Based Lending facility	215	415	415	400	400	600	2,445
6.625% July 2021 convertible bond		300					300
6.25% April 2022 bond			650				650
7.00% March 2025						800	800
Total	**215**	**715**	**1,065**	**400**	**400**	**1,400**	**4,195**

In addition to the bank and bond debt in the table, according to the half year results there was $291mn of leasing due within 12 months and $1.2bn due thereafter (probably around $800-900mn in 2-5 years and the remainder longer judging by the YE 2018 accounts).

The RBL is backed by Tullow's oil reserves and commences amortisation at the rate of $200mn per half year from November 2020, with small annual repayments for the $100mn international part of the RBL. Headroom on the RBL stood at $1bn as of the January 15 update.

New ownership?

Samuel Dossou-Aworet, long time oil investor who sold Energy Africa to Tullow back in 2004, has gradually increased his stake in the company over the past 2-3 months, reaching 14% so far. Total's CEO has reportedly dismissed the idea of taking over Tullow. Certainly as a smaller O&G company with decent producing assets it could become a target – particularly at a P/E of just 4.38. The difference now is the raised awareness of a potential secular shift towards decarbonisation, meaning there is some speculation that raising capital will be difficult for Tullow, and its fields may be among the first to be stranded as energy investors start to switch their long term bets towards renewables.

Bonds

Bonds are nominally senior unsecured and subordinate to the Reserve Base Lending facility. Guarantees come from the overwhelming bulk of the group's operating subsidiaries in terms of revenue, earnings and assets. After the April 2020 call date the 2022 bond can be redeemed at par. There is a change of control put at 101%. Equity clawbacks up to 35% are at 106.25 for the 2022s and 107 for the 2025s.

Restrictions are in place on asset sales to ensure at least 75% comes in cash/equivalents. Limits on the non-cash portion are pretty high (greater of $500mn or 5% of consolidated total assets – around $465mn after 2019's writedowns). Proceeds should go to the repurchase of notes, senior debt reduction, further capex or additional assets. Excess proceeds of $50mn or more will also be applied to the notes and may be applied to other debt pari passu with the notes.

Restricted payments come with plenty of exceptions, sizeable quantums, and utilise a calculation of consolidated net income and/or a fixed charge cover ratio (FCCR). The FCCR needs to be at least 2.25x for any new debt or preference stock. There is plenty of room for additional leasing ($225mn or 2.25% of consolidated total assets) and yet leasing hit over £1bn in 2017 and hasn't looked back. Curious.

Events of default are fairly standard, including cross default, but cross acceleration does not trigger until $100mn in aggregate is reached (the same goes for non-compliance judgments).

New York law applies to the notes, note guarantees, and indenture. Guarantee Subordination Agreement is under England & Wales.

View

Assuming Tullow hits the middle of its daily production outlook for 2020 (75k bpd), and oil prices remain at or below $60bbl, the company's free cash flow outlook of $150mn minimum looks a bit vulnerable. However, it does have the cash and facility headroom to cushion it during this year. As long as oil prices cooperate, it should be able to navigate the year. The sale of the Uganda asset is an important swing factor. If that can be achieved at a favourable price, debt reduction is covered to the end of 2021, making it a lot easier to accumulate the cash it needs in the interim to continue exploring and meet payments falling due in 2021 and beyond. Clearly there is at least one investor looking to take advantage of Tullow's slump, or perhaps just get a look under the bonnet.

Full year accounts are due out on the 12th of March. Please contact the desk if you have any questions.

Penelope Fitzherbert

27th February 2020

Appendix – Definition of Change of Control

"*Change of Control*" means the occurrence of any of the following:

(1) the direct or indirect sale, lease, transfer, conveyance or other disposition (other than by way of merger or consolidation), in one or a series of related transactions, of all or substantially all of the properties or assets of the Company and its Restricted Subsidiaries taken as a whole to any "person" (as that term is used in Section 13(d) of the U.S. Exchange Act);

(2) the adoption of a plan relating to the liquidation or dissolution of the Company; or

(3) the consummation of any transaction (including, without limitation, any merger or consolidation), the result of which is that any "person" (as defined above) becomes the Beneficial Owner, directly or indirectly, of more than 50% of the Voting Stock of the Company, measured by voting power rather than number of shares.

"*Clearstream*" means Clearstream Banking, *société anonyme* and its successors.

342

The Change of Control clause notes that "certain events that would constitute a Change of Control could constitute a default under the RBL Facilities and the Corporate Facility". The Corporate Facility was the revolving credit facility that Tullow cancelled.

Disclaimer

This material has been produced or compiled by Guy Butler Ltd. This document is not, and should not be construed as, an offer or solicitation to sell or buy any investment or product. The information and opinions contained in this document have been derived from sources believed to be reliable and in good faith or constitute Guy Butler Ltd's judgement as at the date of this document but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness. Any information contained in this material is not to be relied upon as authoritative or taken in substitution for the exercise of judgement. Redistribution in whole or in part is prohibited. To the full extent legally possible, Guy Butler Ltd accepts no liability whatsoever for any loss arising from any use of the material.

This material is for use by Eligible Counterparties and Professional Customers only and it is not intended for Retail Clients as defined by the rules of the Financial Conduct Authority. This material may be distributed in the United States solely to "major institutional investors" as defined in Rule 15a-16 of the US Securities Exchange Act 1934.

This material should be treated as a marketing communication for the purpose of the European Markets in Financial Instruments Directive (MiFID) as it has not been prepared in accordance with the legal requirements designed to promote the independence of research and is not subject to any restrictions on dealing ahead of the dissemination of the material.

Guy Butler Ltd and its officers, directors and employees may own or have position in any investment mentioned herein or any investment related thereto and may from time to time add or dispose of any such investments. Guy Butler Ltd may have an underlying position in the securities of the companies discussed (or investments related thereto) and may sell or buy them from their customers on a principal basis and may also perform or seek to perform underwriting services for or relating to these companies. Guy Butler Ltd's Conflicts of Interest Management Policy can be obtained from your normal contact at Guy Butler Ltd.

Guy Butler Ltd is authorised and regulated by the Financial Conduct Authority for the conduct of investment business.