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Oil & Gas Finance Market Gap Analysis

March 2016

Scottish Enterprise

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1. Introduction

Introduction

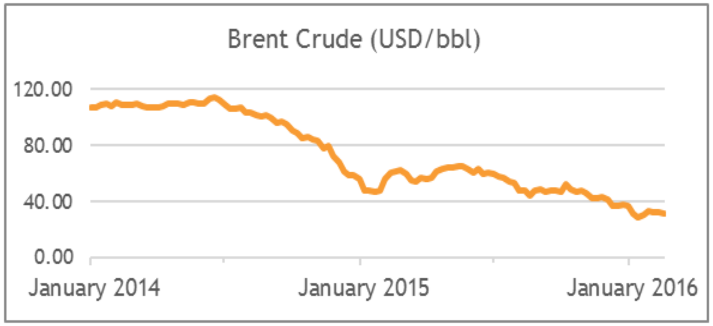
The following report details the key findings from the market analysis undertaken by Anderson Anderson & Brown LLP on behalf of Scottish Enterprise, reviewing potential finance gaps for SME Oil & Gas service businesses.

In response to the significant challenges currently facing the Oil & Gas industry, Scottish Enterprise commissioned this finance market analysis to understand if any gaps in supply of finance exist for businesses in this sector. This analysis will sit alongside other market research work currently being undertaken by Scottish Enterprise.

The market analysis is focused on SME businesses specifically involved in the Oil & Gas service sector across Scotland.

Timeframe

The market analysis was undertaken during January and February 2016 when the price of a barrel of oil was between c.$29 – $36. The time period under focus in the analysis of 12 – 18 months covers the period from mid 2014 to early 2016.



Source: ela.gov, Weekly spot prices (ending Friday)

Thank you to all consultees who contributed to this report, a list of whom is provided at Appendix A.

Key Objectives

The key objectives of the market analysis were to gain evidence of the following:

Demand for Funding by Oil & Gas Businesses

- Demand for debt funding and any changes in demand in the last 12-18 months.
- Demand for equity funding and any changes over the last 12-18 months.
- Why companies are seeking funding (i.e. working capital, growth capital, international expansion, investment in technology, supporting innovation).
- Demand and usage of alternative funding options with a focus on the role of asset-based lending in this industry.
- Awareness, demand and usage of existing public and private financial support including co-investment.
- Capture of other relevant issues including lack of awareness or knowledge of funding options or reluctance to approach funders due to preconceptions.

Supply of Funding for Oil & Gas Businesses

- Changes to the way lending decisions are being taken in light of the current industry challenges, including views from funders and borrowers.
- Changes in the requirements sought by funders.
- Changes in the availability and sources of debt and equity funding over the last 12-18 months.
- Gaps in the availability of funding types or for specific subsections of the industry.
- Capture of other relevant issues in connection with the supply of funding.

2. Key Findings

2.1 Key Funding Gaps

The key objectives of the market analysis were to identify any funding gaps which exist in the Oil & Gas service sector in Scotland. Evidence of two clear funding gaps was gathered during the process and these are summarised below:

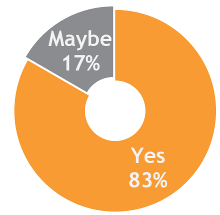
Gap 1 - Technology businesses not generating positive cash flow looking for up to £5m equity funding

Key points:

- No longer any significant Private Equity[(1)] funders in this space – which is not directly attributable to the fall in oil prices.
- Previous Private Equity participants (such as Energy Ventures) have refocused investment criteria outside this space with tens of millions of pounds of annual investment lost.
- Key Private Equity players have been turning down good opportunities because they do not meet their current fund criteria.
- Technology funding currently limited to either:
    - Corporate venture funds who are very selective in their technology related investments; or
    - Specialist energy investment consortiums (such as FrontRow) or high net worth individuals who typically back entrepreneurs known to them in the technology space through their own network of contacts.

[(1)] The term "Private Equity" refers to all formalised equity investment funds, including venture capital.

Gap 1 - Consultations Indicating an Equity Funding Gap (Banks And Private Equity Funders)

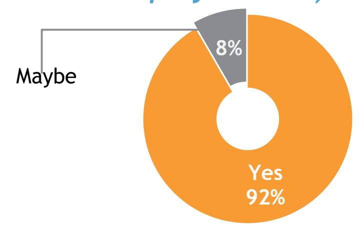


Gap 2 - All businesses looking to secure up to £2m equity funding

Key points:

- No visible Private Equity funders focused on this space, which is also not directly attributable to the fall in oil prices.
- Some of the widely recognised Private Equity firms in the £2m – 10m funding space are willing to consider smaller investments but find it difficult to complete deals in this space within their funding parameters.
- High net worth individuals are the main equity funding option for sub £2m investment.
- No business angel network in North East Scotland.

Gap 2 - Consultations Indicating An Equity Funding Gap (Bank And Private Equity Funders)



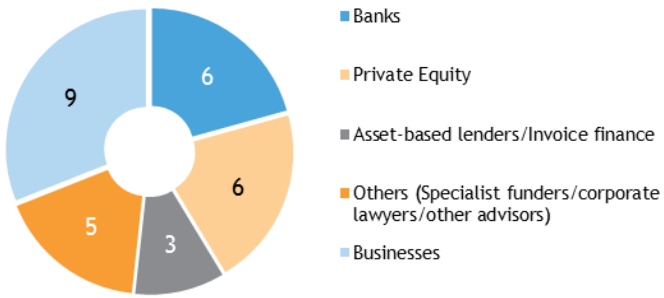
3. Methodology

Overview

The key requirement of the market analysis was to capture evidence by way of a small number of focused consultations rather than a large survey. The number of consultations was dictated by the timescale for delivery of the report.

Consultees

In total 29 consultees were interviewed over a period of 5 weeks with a specific focus on funders/advisors to the Oil & Gas industry and SME Oil & Gas service businesses. The consultees are analysed below:

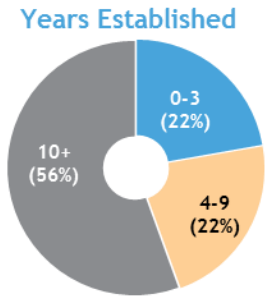


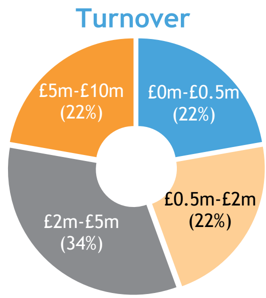
The funder/advisor consultees were chosen due to their significant experience in the Oil & Gas market, with all the consultees holding senior positions in their organisation. This included Regional Directors, Investment Directors and Oil & Gas Partners. The business consultees consisted of Managing Directors and Finance Directors.

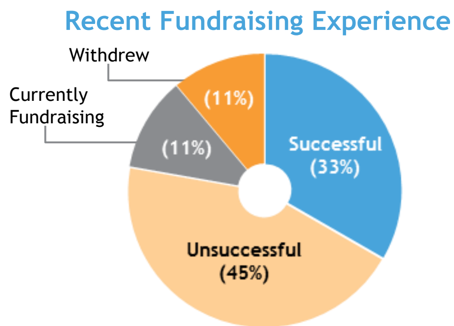
The key focus of the consultations was placed on the funders/advisors as these consultees were able to provide a "market wide" view, as a result of many interactions with businesses in this sector during the last 12-18 months. Whilst the consultations with businesses were extremely useful, a limitation of these was that their awareness of the market as a whole, beyond their own particular experiences, was more limited.

Nine consultations were held with businesses each having recent relevant experience of the funding market during the last 12-18 months. Further businesses were identified and invited to participate, however the rate of participation was lower than for the funders/advisors, which is attributable to many businesses in this sector facing significant challenges impacting on the availability of directors. Particular care was taken to ensure that all businesses who were approached had not participated in a Scottish Enterprise survey in the preceding 6 months.

The businesses consulted had the following characteristics:







A group consultation session with representatives from Scottish Enterprise was undertaken at the end of the consultation period to strengthen the evidence from both a demand and supply perspective and to confirm the validity of the key findings of the report.

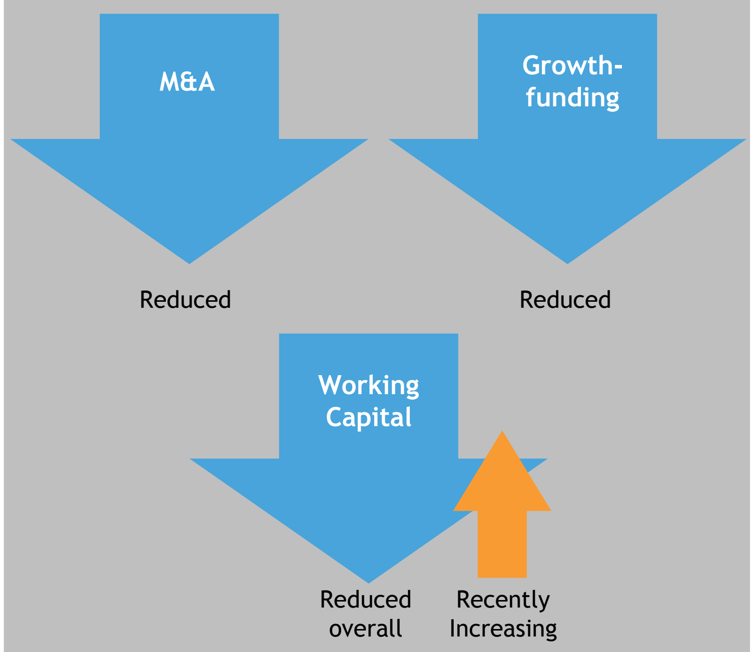
4. Supply and Demand of Traditional Debt Finance

4.1 Demand for Debt Funding

Key Points:

- Drop in demand for debt funding in support of M&A and growth finance.
- Existing working capital facilities have been under-utilised in the last 12 months due to reduced trading levels.
- However working capital facilities are now being severely stretched as payment terms are being extended across the supply chain.

Debt Funding Demand Trends Over Last 12 to 18 Months



For the purposes of this report, traditional debt finance refers to term loans and overdrafts. Asset-based lending and invoice finance are considered further at **Section 5.**

Overall Demand

Debt funders provided evidence of an overall decrease in demand for new debt funding.

The suppliers of debt funding were asked to describe the changes in demand they had observed in the market for debt funding products over the last 12 – 18 months. The general consensus was that there has been an overall decrease in the demand for new debt funding. However, some of the debt funders indicated that they had actually increased funding to the sector over this period, albeit those experiencing growth were typically less well established in the Aberdeen market and would normally be considered challenger banks to the traditional funders in the sector.

4. Supply and Demand of Traditional Debt Finance *(continued)*

4.1 Demand for Debt Funding *(continued)*

Mergers & Acquisitions

M&A activity has dropped off to a very low level in comparison with the period prior to the current low oil price environment.

When considering the consultations with debt funders as a whole, one of the drivers behind the overall fall in demand is the drop in demand in connection with mergers and acquisitions ("M&A") activity. Consultees suggested that the macroeconomic conditions have led to a deferral of projects and work in the sector which has created a lack of visibility of cash flow and reduced order books for Oil & Gas service businesses. The resulting uncertainty in the market and the falling valuations of businesses has contributed to a situation where it is very challenging to buy and sell businesses and hence the drop in the demand for funding requirements in support of these types of transactions. Business owners are deferring their exit and businesses looking to invest are deferring growth plans due to these market conditions.

Consultees suggested that an increase in M&A activity may come as a result of distressed sales and mergers, should current market conditions prevail over the next 6-12 months.

Growth Funding

Demand for debt funding in support of growth funding opportunities has also decreased during the last 12-18 months.

Where there was demand from businesses seeking funding for growth in the market, this has been for internationalisation to other Oil & Gas producing regions, such as the Middle East, or diversification into complementary sectors, such as renewables. Evidence to confirm this demand was gained from both funders and businesses.

Working Capital

Debt funders indicated an overall reduction in demand for working capital facilities over the last 12 to 18 months for both new and existing facilities.

The debt funders cited lower utilisation of short term facilities as the main indication of this. As major oil projects have been deferred due to market conditions and therefore expenditure by the operators, there is reduced activity across the majority of the service sector. This has resulted in a decrease in the requirement for short-term funding which would normally be used to finance the upfront costs and working capital of contracts and projects.

The consultees suggested that there has been a return in some of the demand for working capital facilities in recent months as a result of customers in this sector delaying payments to their suppliers. This has been seen across the supply chain and is creating significant pressure on smaller businesses. In particular, many do not have a diverse customer base and therefore are less inclined to challenge customers on this and actively pursue the payment of invoices in a timely manner.

Comparison with 2008/09 Financial Crisis

In several consultations with banks, the current market conditions were compared to the global financial crisis in 2008/2009. Bank customers on the whole are being more realistic in their discussions around funding requirements in terms of their expectations of what the bank can/cannot do, both in terms of funding structures and pricing.

4. Supply and Demand of Traditional Debt Finance *(continued)*

4.2 Supply of Debt Funding

Key Points:

- Debt funders are unanimously prepared to lend where the ability to meet repayments can be demonstrated.
- However, debt funders are tending to focus on their existing customers through the downturn.
- Key challenge affecting the funders ability to lend is the lack of visibility in cash flow for businesses to demonstrate serviceability of debt.
- Invoice finance is favourable to funders and demand is increasing for this.
- Significant fall in demand for asset-based lending as capital expenditure is being deferred.

Process Changes by Debt Funders

The key message was that, on the whole, nothing has changed in terms of the processes around lending applications for this sector.

Suppliers of debt funding were asked how they have changed their processes for making lending decisions in light of the current industry challenges. Debt funders stated that their formal lending processes have not changed, however some have increased monitoring of their customers in this sector and are now placing more emphasis on current and future trading than in the past.

The increased monitoring of debt funders' existing customer base in this sector is in direct response to the challenges in the low oil price environment. An example of these new processes includes the introduction of more regular team meetings to discuss customer management information. Evidence suggests there has also been an increase in internal communication within debt funders across their various service lines. The reason for these changes are to identify those businesses that may require support and be able to address concerns with their customers at an early stage.

Requirements of Debt Funders

Focus of information requirements from debt providers is now more weighted towards forward-looking information.

To understand if the requirements of debt funders have changed in the past 12 – 18 months, the debt funder consultees were asked how the requirements had changed in response to the current market.

A consistent point made by the debt funders was recognising that there has been a shift in emphasis from historical numbers towards current and forecast performance in reaction to the macroeconomic conditions. The funders are therefore focusing more on short term cash flow forecasts, current order books and work pipelines.

As a result of several years of growth in the sector and the perceived market prospects, debt funders were more confident of a base-level of work prior to the fall in oil prices. Now the market conditions are more challenging, and projects are being deferred, debt funders must consider the outlook with more scrutiny.

4. Supply and Demand of Traditional Debt Finance *(continued)*

4.2 Supply of Debt Funding *(continued)*

Lack of Visibility of Positive Cash Flows

The debt funders stated that debt serviceability is the key challenge in being able to lend to businesses in this sector.

A key requirement of debt funders is for potential borrowers to demonstrate their ability to service the repayment of facilities. This is becoming very challenging for some businesses in the current market due to the lack of visibility of future cash flows. Where the borrower can meet this requirement the debt funders are clear that they are willing and able to provide facilities to business in the Oil & Gas sector. Consultees included the businesses who were both successful and unsuccessful in their applications for funding which provided evidence of these challenges. This confirmed the evidence gathered from debt funders.

In the current market, debt funders have many customers presenting funding requests for loss-making businesses which significantly increases the risk to the lender. A consistent theme from the consultees was that equity funding is far more suitable for funding loss-making businesses than debt, however not all business owners are prepared to dilute their shareholding. The role of equity in funding loss-making businesses is considered further in **Section 6.**

Management Information

Quality of information provided to debt funders in support of funding proposals varies significantly.

Almost all debt funders commented that, although many of their customers do have regular processes in place around the preparation of cash flow management information, some less sophisticated businesses still do not undertake this on a regular basis. This is discussed in further detail at **Section 7.**

4.3 Awareness and Usage of Debt Funding Options

Financial Sophistication

Awareness of funding options has improved since the financial crisis, however, there are still a number of less financially sophisticated businesses in this sector who require additional support.

Debt funders were asked on their thoughts regarding the general awareness and knowledge of businesses in this sector on the wider funding options available to them. There was a varied response to questions on this subject, indicating that there is a wide range in the financial sophistication of businesses in this sector.

Despite the differing opinions, on the whole, funders suggested that there has been an overall improvement in the awareness and knowledge of businesses of their funding options in recent years, since the financial crisis in 2008-2009 in particular. Businesses are now considering more of the wider range of funding options available to them, including asset-based lending and invoice finance.

Several debt funders acknowledged that they have a role to play in educating their customers to ensure that a full spectrum of options are considered and that the customer understands the various options available to them.

Awareness of Funding Options

Business consultees were also asked as to how well-informed they felt on the full range of debt funding options available to them. Most of the businesses responded indicating that they believe they had a good knowledge of the various options available to them. However, the businesses consulted had been involved in recent fund raising and therefore it would be difficult to apply the positive response to the whole market.

4. Supply and Demand of Traditional Debt Finance *(continued)*

4.4 Other Issues in the Oil & Gas Debt Funding Market

Risk Expectations

Considering the responses from both the debt funders and the businesses during the consultations, there was evidence to suggest there is still a gap between the expectations of some businesses and debt providers regarding the levels of risk that are acceptable to debt funders. A result of this gap can be businesses focusing management efforts on unsuccessfully pursuing debt funding when equity funding is more appropriate from the outset.

Equity funding becomes a more suitable source of funding where the risk to the funder is too high for banks or other debt funders to structure a lending package which provides them with a suitable return for taking such a risk. Risk, and the perception of risk, is naturally heightened in the current market due to the lack of visibility of cash flow and the wider market uncertainty over oil prices.

An equity investment allows for the funder to gain a more significant upside without necessarily burdening the businesses with expensive debt repayments via capital growth. However, an equity funder will still have to be confident that their investment is going to grow and not devalue further to deliver the upside which rewards them for their level of risk.

Challenges for Specific Sub-Sectors

The consultations indicate that there is a stronger appetite from debt funders to lend to businesses providing products and services in connection with operational expenditure rather than capital expenditure.

This is because capital expenditure budgets have been reduced by more than those of an operational expenditure nature as existing producing wells still require to be maintained.

A challenge for capital expenditure led businesses to achieve their desired funding in the current market is due to the increased difficulty to demonstrate serviceability of debt facilities.

As a result of the reduced levels of activity in the North Sea, sub-sectors such as those servicing the drilling of new wells and those collecting/analysing seismic data and related businesses are being heavily impacted due to low levels of activity in exploration for Oil & Gas reserves.

The consultees indicated that businesses in these areas will find it extremely difficult to achieve their desired level of funding due to an even greater lack of visibility of future cash flows for these businesses.

4. Supply and Demand of Traditional Debt Finance *(continued)*

4.5 Suggested Potential Solutions by Consultees

During the consultations with debt funders, several consultees suggested possible solutions to the current market challenges. The possible solutions suggested were:

Debt Guarantee Scheme

A number of consultees suggested that there would be merit in reviewing the availability and use of guarantee schemes.

Larger Businesses Supporting the Supply Chain

Two debt funders indicated an alternative solution involving larger Oil & Gas players which would reduce the risk to the debt funders and potentially allow additional lending to the sector. This would involve lending applications being undertaken against the financial strength of the end customer (such as the Oil & Gas operators).

There are several ways an initiative such as this could be utilised, one suggestion was this could be a solution where a specific contract is being performed and several suppliers can utilise the funding package for that project.

5. Supply and Demand for Alternative Debt Finance

5.1 Asset-based Lending

Supply & Demand

On the whole, consultees indicated that there has been a significant fall in demand from Oil & Gas service businesses for asset-based lending due primarily to reduced levels of capital expenditure.

Asset-based lending was discussed with debt funders, including specialist asset-based lenders. Asset-based lending has played an important role in supporting growth of equipment rental businesses in this sector. A challenge for funders is that there is significant capacity in the equipment fleets of most rental companies and existing assets are being left in service longer to avoid replacement costs.

The debt funders and specialist lenders were clear that there is a willingness to provide funding in this sector, however the lack of visibility of future cash flows to demonstrate serviceability is again a key challenge as with traditional bank debt such as term loans.

Challenges for Asset-Based Lending in the Oil & Gas Sector

A specific challenge to asset-based lenders in this sector is that some assets are located on remote sites. The impact on the lending decision from the debt funders' perspective is that they may not be able to rely on the realisable value of the asset when looking at the security available. An example was provided contrasting the ease of recovering a car compared with the challenge of recovering large machinery located on an oil rig. The impact being if the lender is always unable to rely on the market value of the asset, further assurance may have to be sought around the future cash flow and serviceability of the facility.

5.2 Invoice Financing

Invoice financing is a favourable product for funders due to the increased security compared to traditional debt.

Invoice financing was discussed with debt funders and specialists in this area. One of the key themes from the consultation was that this range of products still suffers from a degree of stigma which means that some businesses have a negative perception and do not consider it as a funding option. Historically, invoice finance was seen as a sign of a bank taking control of a distressed business which has generated a pre-conception amongst some businesses which still remains today. However, despite the stigma, the overall view is that businesses are more amenable to the product now than in the past and this was confirmed by the individual business consultations.

Opportunities for Invoice Finance in the Oil & Gas Sector

Debt funders described that in the current climate, invoice financing can be the most suitable solution for customers due to the speed of set up. Additional security is provided to the funder over traditional debt by receiving security over the debtor book. In some cases, this will allow a funder to provide funding in circumstances where a basic overdraft product or loan cannot.

Invoice finance can also be put in place for only one or two invoices at any time and specialist lenders stated that there is an increased demand for this in the sector due to the flexibility it offers and often large contracts that companies have with a low number of customers.

5.2 Invoice Financing *(continued)*

Challenges for Invoice Finance in the Oil & Gas Sector

Despite improvements in awareness there remains a negative perception of invoice finance solutions amongst some businesses in this sector.

Debt funders and business consultees outlined a number of challenges for businesses in this sector utilising invoice finance as a source of funding. As the payment cycle is under severe pressure currently, some customers are paying their suppliers outwith 90 days on a more regular basis. The impact being that these older amounts would not normally be included as available funds for the facility meaning that businesses with particularly slow playing customers would be restricted on the level of funding available to them using an invoice finance facility.

There is also difficulty using invoice finance for some businesses in the sector due to the international nature of the Oil & Gas supply chain. Invoice finance facilities do not cover all countries, meaning that some invoices will not be eligible for the purposes of the facility depending on the geography of the customer base. The geographical coverage of the invoice finance facility can vary from provider to provider although certain locations such as Africa have less coverage than others regions meaning this product is not always a suitable solution.

Unlike an overdraft, an invoice finance facility will increase for a business growing its sales, however the opposite effect is true for businesses who are experiencing a fall in sales. In the current market, where this is the case for many businesses, less and less of the facility will be available as their sales fall, reducing their level of funding and headroom.

5.3 Mezzanine Debt Finance

Mezzanine debt providers have similar difficulties as other debt providers in the current market.

The Scottish Loan Fund and Santander Growth Capital were the only mezzanine debt providers regularly referenced during the consultations. Although mezzanine debt is a useful part of the overall funding mix, it was acknowledged that these products are normally used for high growth businesses generating positive cash flow.

Given the challenging market conditions, mezzanine debt providers would face similar challenges to traditional debt funders in providing funding due to the lack of visibility of future cash flows to evidence serviceability. The impact of this is that businesses which are currently breaking even or loss-making are therefore unlikely to be eligible to receive this type of funding.

5. Supply and Demand for Alternative Debt Finance *(continued)*

5.4 Crowdfunding

Crowdfunding has yet to play any significant role in the funding of SME Oil & Gas service businesses.

Peer-to-Peer Lending/Debt Crowdfunding

There may be some future opportunities to provide peer-to-peer funding for smaller SME businesses in the Oil & Gas sector however demand is currently perceived to be low. An important factor identified from our consultations is that the credit teams of peer-to-peer lending platforms are likely to take a similar negative view to funding losses as other debt funders such as banks.

Investors on some platforms can specify their interest rate, within certain parameters. This may allow peer-to-peer lenders to provide funding at a higher risk level than other debt funders, with the interest rate set accordingly.

Crowdfunding and peer-to-peer lending are becoming more common alternatives to traditional funding options in the UK, however evidence gathered suggested that they have not yet become established in the Oil & Gas service market. There is still an element of confusion between peer-to-peer lending and equity crowdfunding.

Equity Crowdfunding

Crowdfunded equity investments have tended to fund smaller start-up businesses but there is limited evidence of this form of funding in the Oil & Gas sector.

6. Supply and Demand of Equity Finance

6.1 Demand for Equity Funding

Key Points:

- Demand for equity funding in the last 12 - 18 months has reduced significantly due to the uncertain market conditions.
- Equity value of businesses has fallen to the extent that vendors are less willing to give up a larger share of equity, reducing demand.
- An increase in demand for funding from distressed businesses is anticipated should market conditions prevail.

Mergers & Acquisitions

There has been a marked reduction in M&A activity in this sector for the reasons discussed in **Section 4.1**, specifically the uncertainty in the market and the decline in valuation of businesses in the sector. It was suggested by consultees that there may be an increase in demand for equity funding to support restructuring and mergers later in 2016.

Growth Funding

On the whole, equity funders are still being approached regarding growth opportunities, however there are fewer of these than at the start of the period under review and the years leading up to the current low oil price environment. The current growth opportunities that equity funders are being presented with are typically businesses looking to diversify into new geographies and sectors and technology businesses. Most businesses in this sector who were not already looking at opportunities overseas are now considering how to access these markets.

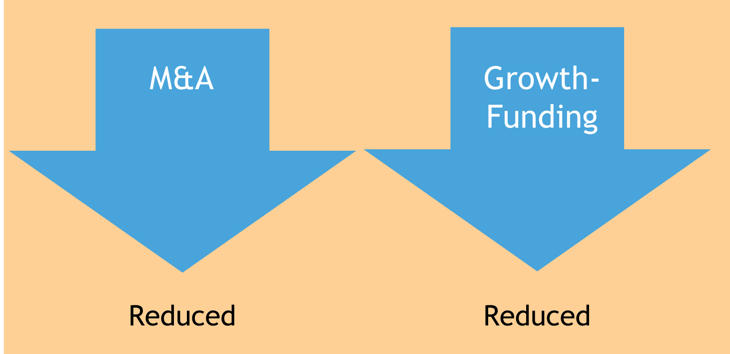
It was clear from the responses that businesses in the current climate are finding it increasingly difficult to develop a compelling investment proposition due to the overall market conditions and the lack of visibility of future cash flows.

Value of Equity

Some potential recipients of equity funding may not currently be seeking equity funding due to the impact of the current market conditions on the value of the equity in their business.

The considerable fall in value of businesses has reached a level where equity funding is unattractive to many shareholders. Importantly, the historical valuations are still influencing the decision-making of shareholders and a differential between the current market value and price expectations is causing them to hold on to their shares in the expectation that the market conditions will improve and that business valuations return towards historical levels. If market conditions do not improve, it is expected that there will be a fall in the expectations of shareholders and some may have no option but to consider equity investment at the reduced value.

Equity Funding Demand Trends Over Last 12 to 18 Months



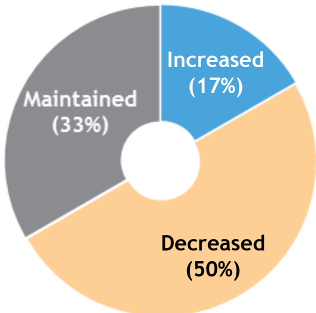
6. Supply and Demand of Equity Finance *(continued)*

6.2 Supply of Equity Funding

Key Points:

- Private Equity funders have funds available to invest in Oil & Gas service companies and are willing to invest for the right opportunity.
- Almost all Oil & Gas Private Equity funds now looking for positive cash flow generation where past funds could invest in businesses not generating positive cash.
- Lack of visibility of cash flows means significantly less investments happening.

Equity Funders: Funding to Oil & Gas Service Sector in Past 12 to 18 Months



Evidence of a decrease in supply of new equity funding with a reduction in M&A activity and reduced growth opportunities being the key drivers.

Available Funds and Incentive to Invest in Downturn

All equity funders stated that they have a desire and capacity to invest in the current market, however, the fall in demand has resulted in an overall decrease in investments in this sector during the last 12 – 18 months.

Equity funders are particularly keen to invest at the bottom of the market downturn due to the potential increased capital growth that can be achieved once market conditions improve.

The key challenge at the moment is that, for many businesses, it is not clear “where the bottom of the market is” and this uncertainty impacts upon transaction activity, despite appetite to invest.

Equity Funding Gap

Consultations confirmed that there is a clear lack of funding options for all businesses seeking up to £2m of equity funding.

Feedback from consultees also indicated that there is a specific gap for technology businesses seeking up to £5m equity funding as a result of reduced options in the Private Equity market which are considered further in **Section 8**.

Investment Processes and Information Requirements

Evidence gathered during consultations with equity funders suggested that, similar to debt funders, equity funders have not changed their processes when assessing investment opportunities.

As with debt funders, equity funders have a need to be comfortable that financial performance is robust going forward and this is challenging for business to demonstrate at present and equity funders are treating forecasts and projections with additional scrutiny.

6. Supply and Demand of Equity Finance *(continued)*

6.2 Supply of Equity Funding *(continued)*

Downside Protection

Several equity funders commented that they are seeking more down-side protection in reaction to the current market conditions to manage the risk to an acceptable level, such as ranking ahead of management should the business fail. However, some are also reducing the amount of equity they are taking and replacing this funding with loans to make their offers of funding more attractive to vendors in the current climate.

Distressed Opportunities

Equity funders have seen an increased number of distressed opportunities in the last 6 months, however a number of consultees commented that their funds are not able to consider distressed and specifically loss-making businesses as they are focused on growth opportunities and require positive cash flow to invest.

There will be good businesses with strong management teams who could survive the market downturn with restructuring of their funding. However, there are very few opportunities for equity investment and debt funders are unlikely to consider these loss-making businesses.

6.3 Awareness and Usage of Existing Equity Funders

General awareness of the main players in the equity funding market is considered good amongst funders and is reasonable amongst businesses.

These include; Business Growth Fund, Maven, Energy Ventures, Simmons Private Equity, Lime Rock and Lloyds Development Capital. However, when specifically asked which equity funders were providing investments up to £2m, there were few options suggested and this is discussed in further detail in **Section 8.2** in connection with funding gaps.

Co-investment

Co-investment was only recognised as an option for equity funding by Private Equity firms who have worked directly with Scottish Enterprise in the past.

6.4 Other Issues In the Oil & Gas Equity Funding Market

Technology Businesses

There is a specific challenge for technology businesses in this sector who are seeking equity funding.

Consultees were specifically questioned regarding the equity market and options for businesses developing new Oil & Gas technologies. The issues identified are not necessarily driven by the current market conditions, and more as a result of reduced funding options and the challenges in getting new technology fully commercialised in the sector. The specific gap for technology businesses is explored further at **Section 8.1**.

Resistance to Equity Dilution

Evidence from consultations with funders suggested that there are some businesses who, despite the current challenges, are still very reluctant to dilute their shareholding by bringing in outside equity investment.

Deteriorating Financial Performance

As the financial performance of many businesses in the Oil & Gas service sector deteriorate, more businesses will fall below fund criteria of the existing Private Equity firms, resulting in less businesses being eligible for these funds.

7. Wider Issues Across Oil & Gas Funding Market

7.1 Management Team Capabilities

Finance Management Skills

Management teams of Oil & Gas service businesses are under a high degree of pressure and not all have the skills required to navigate the downturn.

Some management teams in this sector have not experienced a severe downturn previously. Feedback from funders indicates that there are management teams who do not have the skills required to prepare detailed management information such as short term cash flows or financial projections which are now required to monitor businesses extensively and identify issues.

Time Pressures on Management

Part of the challenge for finance directors and financial controllers is that they can be performing a wider commercial role or dealing with the added financial scrutiny and do not have enough time to focus on the strategic part of their role. This is something which could impact on the ability of businesses to achieve their desired level of funding if they do not have the appropriate management information to provide to a potential or existing funder.

Dedicated Finance Function

Some smaller businesses have no dedicated finance function and may require critical support in this area.

Outsourcing additional skills would be an option however this may not be desirable in the current climate due to the cost of buying in the skills. During the group consultation with Scottish Enterprise, a “Finance Manager” grant was suggested as a potential solution. This had existed in the past and it provided support to small businesses to fill the resource gap in the management team. The re-introduction of this grant could provide additional support to businesses during the challenging market conditions.

7.2 Other Issues

Professional Advice Available

Evidence gathered suggested that some businesses in this sector do not understand the full value of advice from professionals, such as accountants and lawyers. Professional advisors can provide support by communicating with potential funders and adding value to this process by preparing information, however these businesses do not always see the big picture in terms of the value added.

Scottish Enterprise Role

The feedback received was that the general knowledge of support available from Scottish Enterprise is varied amongst the non Scottish Enterprise account managed businesses, however positive feedback was received from account managed businesses on the support they have received to date.

Based on the feedback from consultations, there appears to be an opportunity to increase the profile of Scottish Enterprise in the Aberdeen market, particularly with equity and debt providers.

Continued Deterioration of Financial Performance

It is clear that the financial performance of Oil & Gas service businesses has been severely impacted by market conditions.

The true extent of this deterioration will not yet be evidenced in public records due to the delay in this information being filed with Companies House. Feedback from consultations is that current management information demonstrates a sustained deterioration with a very difficult end to 2015 and start to 2016 for many businesses in the sector with a large number of businesses in survival mode.

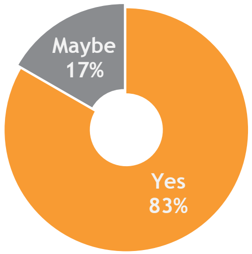
8. Funding Gaps

8.1 Gap 1: Technology Businesses not Generating Positive Cash Flow Looking For Up To £5m Equity Funding

Key evidence gathered:

- No longer any significant Private Equity funders in this space - which is not directly attributable to the fall in oil prices.
- Previous Private Equity participants (such as Energy Ventures) have refocused investment criteria outside this space with tens of millions of pounds of annual investment lost.
- Key Private Equity players have been turning down good opportunities because they do not meet their current fund criteria.
- Technology funding currently limited to either:
    - Corporate venture funds who are very selective in their technology related investments; or
    - Specialist energy investment consortiums (such as FrontRow) or high net worth individuals who typically back entrepreneurs known to them in the technology space through their own network of contacts.

Gap 1 - Consultations Indicating an Equity Funding Gap (Banks and Private Equity Funders)



To gain supporting evidence of a gap, all consultees were asked who they were aware of currently investing in Oil & Gas technology businesses. Strong evidence suggests that there is a gap for technology businesses not generating positive cash flow who are seeking up to £5m of equity funding, as consultees identified very few funders making such investments.

Loss of Private Equity Funding

Private Equity funders who would have previously invested in technology businesses have refocused their investment criteria.

Equity funders suggested that the changes in Private Equity fund criteria for technology businesses were primarily driven by the success of previous funds which had invested in those types of companies.

Funders such as Energy Ventures have raised larger funds on the back of previous success and have subsequently altered their investment criteria. Accordingly these Private Equity funds now focus on making larger transactions and require businesses to be generating positive cash flow to fit within their funding criteria.

A number of technology businesses which are ready to be fully commercialised are not generating positive cash flow as a result of low revenue and research and development costs. As a result, there are very few options for equity funding for these businesses, other than high net-worth individuals, investment consortiums such as FrontRow and corporate venture funds.

8. Funding Gaps *(continued)*

8.1 Gap 1: Technology Businesses not Generating Positive Cash Flow Looking For Up To £5m Equity Funding *(continued)*

Private Equity is a critical part of the technology funding mix and it was estimated that tens of millions of annual investment has been lost in this space in recent years, increasing the difficulty for technology businesses to achieve full commercialisation. No significant new Private Equity funders have emerged to replace those who would have invested up to £5m in technology businesses previously, such as Energy Ventures and Lime Rock.

Consultees also highlighted that technology businesses in the Oil & Gas sector can take a longer time to generate returns for investors due to the challenges of getting new technologies adopted when rig down time is very costly. Private Equity funds in return would require investors who are prepared to take a longer term view to support such investments.

Good Investment Opportunities Passed Up

As evidence of the gap, a number of Private Equity funders identified that they had been recently presented with investment opportunities relating to technology businesses in the last 6 months looking for funding which were attractive to the funder but could not be pursued due to fund parameters.

Three different Private Equity consultees specifically stated that they would likely have invested in 2-3 technology companies in the last 6 months if these opportunities had met their funding criteria.

Previous Success Stories

A company that was often referenced during the consultations in connection with technology companies seeking funding was Red Spider Technology Limited.

Red Spider received an initial investment of £400k in 2005 from the Nova Technology Fund and Scottish Enterprise. A second follow-on investment of £2m was secured from Bank of Scotland Corporate Banking alongside an additional £500k invested by Scottish Enterprise in 2007. In 2010, Simmons Parallel Energy Fund and Energy Ventures invested a total of £7.5m before successfully exiting with a sale of the company to Halliburton in December 2012.

It was suggested that it would be challenging for similar businesses to secure such funding at present, limiting growth opportunities for these type of businesses.

Corporate Venture Funds

There are a number of corporate venture funds, backed by the Oil & Gas operators, in the market funding technology businesses. These funds can provide funding and also provide access to support for development stage technology companies via programs such as Statoil's "LOOP" initiative.

The corporate ventures have an important role to play in the funding market for technology businesses, however the key challenge with these funds is that their investments are driven by the technology agenda of the operators and require buy-in from internal technical groups before proceeding to investment. This can lead to good innovative businesses not being successful in their approaches to these funds if they do not fit with the requirements of the operator.

8. Funding Gaps *(continued)*

8.1 Gap 1: Technology Businesses not Generating Positive Cash Flow Looking For Up To £5m Equity Funding *(continued)*

Successful Models Supporting Technology Businesses Achieve Equity Funding

It was suggested that Houston, Texas (a comparable Oil & Gas focused region) has a more structured support network available for funding Oil & Gas technology businesses. Organisations that support technology investments in Houston include:

- SURGE Ventures;
- Houston Technology Centre; and
- Rice Alliance

Appetite for Technology in the North Sea

It was suggested during several consultations that there was an increased appetite for technology in the North Sea as a result of the low oil price. In particular, technologies that can enhance production or save on downtime are becoming more attractive.

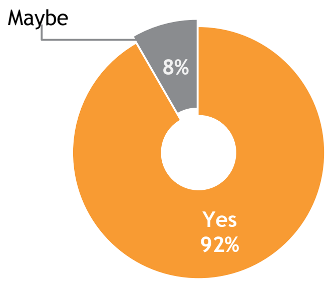
The new Oil & Gas Technology Centre which was announced as part of the City Deal for Aberdeen in January 2016 will require an active equity market for these businesses to successfully raise funding to go on and fully commercialise their technologies. The availability of funding for businesses being supported by the Centre should be a key consideration with specific support provided for technology businesses to achieve their required level of funding.

8.2 Gap 2: All Businesses Looking To Secure Up To £2m Equity Funding

Key points:

- No visible Private Equity funders focused on this space - which is also not directly attributable to the fall in oil prices.
- Some of the widely recognised Private Equity firms in the £2m - 10m funding space are willing to consider smaller investments but find it difficult to complete deals in this space within their funding parameters.
- High net worth individuals are the main equity funding option for sub £2m investment.
- No business angel network in North East Scotland.

Gap 2 - Consultations Indicating an Equity Funding Gap (Banks And Private Equity Funders)



Strong evidence was gathered that a clear funding gap exists for all businesses looking to secure up to £2m of equity funding, whether the business is generating positive cash flows or otherwise.

8. Funding Gaps *(continued)*

8.2 Gap 2: All Businesses Looking To Secure Up To £2m Equity Funding (continued)

All consultees were asked who they were aware of investing up to £2m in Oil & Gas service businesses (whether generating positive cash flow or not) and relevant follow up questions to understand the extent of the gap in the market. The key drivers of the gaps are considered below.

Current Fund Parameters Restricting Investment

The strongest evidence of the gap came from the Private Equity firms themselves. Although they do look at opportunities below the £2m threshold, it is very difficult for them to do deals in this space due to the requirements of their existing funds. One Private Equity firm, for example, stated that they would look at deals below £2m, however there must be clear plans for a larger follow on investment.

In the current funding market there is not an equity funder who has successfully modelled a fund structure which completes and manages a larger number of deals at a lower value relative to the existing funds in this sector. It was suggested that this is challenging due to the cost of due diligence processes. However, one equity funder identified that they are now actively looking at sub £2m investments and another was also interested in considering this space.

The evidence gathered was not enough to suggest that equity funders on the whole are reviewing their minimum investment criteria, however this may be required going forward to allow the funds to access more investment opportunities.

High Net Worth Individuals

It was recognised that high net worth individuals are the main equity funding option for sub £2m investments. There are a number of high net worth individuals with significant experience in the industry who will invest in businesses, however, these investors can be hard to access for businesses who require investment. These individuals would normally be accessed via professional advisers or personal networks.

Lack of Angel Networks

It was also noted by a large number of consultees that there is not a significant angel investor network in the North East of Scotland. This is in stark contrast to the Central Belt of Scotland where there are a number of well established angel networks which play a key part of the funding mix.

An angel network in Aberdeen could address some of the issues associated with high net worth individual funders such as more visibility and easier access for businesses who require funding.

Previous attempts at forming angel networks in Aberdeen have largely been unsuccessful. This is believed to be as a result of the culture and ingrained behaviours of high net worth individuals in Aberdeen who would be reluctant to form part of a visible network.

8. Funding Gaps *(continued)*

8.3 Suggested Solutions to Equity Funding Gaps by Consultees

Specific Equity Fund

A number of consultees commented that a possible solution would be the set up of a specific equity fund to invest in good businesses in this sector who are finding it difficult to achieve funding in the current market.

The funders indicated that this solution should target the injection of additional funding into SME Oil & Gas service businesses with strong management teams and that are able to demonstrate compelling growth opportunities or are developing innovative technologies.

A number of the Private Equity funders stated that they would be interested in investing in the sub £5m technology and/or sub £2m gaps but, as discussed previously, their current fund criteria make this extremely challenging and impossible in the vast majority of cases. However, these existing funders could form part of the solution if new funds were set up specifically to meet the identified equity funding gaps.

9. Conclusions

Debt Funding

- Demand for short term funding has decreased however some demand has now returned due to businesses delaying payments to suppliers across the supply chain which is extremely challenging for many SMEs.
- Demand for new debt funding has decreased for M&A and growth opportunities.
- Debt funders are willing to lend to sector however there is a significant challenge to demonstrate the ability to service debt repayments.
- There is increasing demand for specialist invoice finance facilities however a stigma still exists with some businesses regarding invoice finance products.

Equity Funding

- Demand for equity funding has fallen due to reduced M&A activity and it is currently challenging to demonstrate a compelling growth story.
- Equity funders are willing to invest, however they are currently cautious as businesses may not have "reached the bottom" of the downturn.
- Almost all Private Equity funds now require positive cash flow to invest which is not driven by current conditions.
- An increase in demand is expected for supporting distressed businesses and mergers should market conditions prevail over the next 6-12 months.

Other Issues

- Management teams in this sector are under pressure and some do not have experience of a severe downturn.
- Some businesses at the smaller end of the SME market do not have a dedicated finance function and may require support to survive the downturn.
- Strong evidence to suggest that the financial performance of businesses in this sector have been impacted severely which may not yet be evident via publically available information such as Companies House.

Funding Gaps

- Gap identified for technology businesses not generating positive cash flow seeking up to £5m as previous participants have re-focused fund criteria away from these opportunities.
- Gap identified for all businesses seeking up to £2m equity funding with high net worth individuals the only main option.
- Consultees identified the opportunity for a specific fund to invest in businesses with good management teams, compelling growth opportunities or developing new innovative technologies.
- Gaps identified not directly attributable to the fall in oil prices.

Appendix A - List of Consultees

Ref	Organisation
1	International Cable Management Limited
2	Maven Capital Partners UK LLP
3	Pressure Test Solutions Limited
4	Energy Ventures Limited
5	Edinburgh Alternative Finance Limited (trading as Lending Crowd)
6	Equalizer International Limited
7	Oil and Gas Innovation Centre
8	Santander UK PLC
9	Simmons Private Equity
10	Working Capital Partners Limited
11	Maritime Developments Limited
12	Burness Paull LLP
13	Lloyds Development Capital (Holdings) Limited
14	Averon Engineering Limited
15	Lime Rock Management LLP
16	The Royal Bank of Scotland PLC
17	Mark Robertson Drilling Services Limited
18	Bibby Financial Services Limited
19	SAEV Europe Limited
20	Clydesdale Bank PLC
21	Business Growth Fund PLC
22	Compass Print Holdings Limited
23	Brodies LLP
24	The VISA Team Limited
25	Lombard North Central PLC
26	HSBC Bank PLC
27	Tech 27 Systems Limited
28	Barclays PLC
29	Bank of Scotland PLC