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BP suppliers toy with protection strategy as cost of vendor puts, CDS declines.

By, Reshmi Basu

As near-term risk for BP has decreased so has the cost of vendor protection and one-year CDS, said two underwriters and two brokers.

BP has capped the oil leak in the Gulf of Mexico, while the federal government recently reported that only about a quarter of the spilled crude oil remains and is degrading quickly. And from a balance sheet perspective, the company has bolstered its liquidity with asset sales.

The leaky well may be plugged but now comes the guessing game. Vendors are weighing whether or not to seek accounts receivables (AR) coverage to hedge against an event of default, the sources said.

AR puts, a type of vendor protection, are pitched as the capital market's expensive solution for suppliers seeking coverage for a risky entity. If a default occurs, the vendor has the option to put the accounts receivables to the underwriter at face value. Commercial banks typically use one-year CDS or short the bonds to offset their risk.

At the height of the crisis, suppliers to BP were willing to pay up to 1% per month of their total accounts receivables for one-year protection. On day 95 of the oil spill, a supplier agreed to pay USD 50,000 or 97bps per month on USD 5m of accounts receivables for a one-year AR put, said one of the brokers who places vendor protection. As a comparison, AR puts for the cash-burning Blockbuster is 400bps-500bps per month for outstanding accounts receivables.

For BP, a string of positive headlines brought down the cost of AR puts by 50bps as the short-end of the CDS curve comes in, said the first broker and both underwriters. But prior to that, prices for AR puts vacillated almost daily, compounded by uncertainty, said Fred Voccola of FGI Risk, a trade credit broker.

After the onset of the spill, one-year CDS spiked to 1,000ps on 16 June, before tightening to 614bps on 14 June, according to Markit. The one-year contract blew out to 742bps by mid-July, but has since tightened to 172bps -- with a burst of tightening coming last week.

But the recent spate of good news doesn't mean that BP is out of hot water. The company will face lawsuits, and possibly criminal charges, an overhang that doesn't sit well with suppliers, said a source familiar with the AR puts market and both brokers.

Spill-related litigation will likely come from all sides and take years to settle, said the sources. Adding to the pile, the company is subject to USD 10bn class action lawsuit filed against in a Galveston federal court that alleges BP's Texas refinery harmed residents earlier this spring when it released toxic benzene.

BP recently estimated that its gulf cleanup costs and penalties would total roughly USD 32.2bn. The estimate bakes in a bold assumption that there will be a zero gross negligence finding against BP, implying that Anadarko, the 25% stakeholder at the Macando well, would be on the hook for a fair share of around USD 12bn-USD 15bn of a USD 50bn-USD 60bn total bill, as reported.

Even as near-term risk diminishes, credit insurance providers continue to take a cautious view on the once all-mighty entity, said two credit insurance providers. Unlike AR puts, credit insurance provides coverage for a portfolio of companies, which could include Walmart and BP in the same bundle. Another important distinction, credit insurance is split between cancellable and non-cancellable policies.

Typically, a vendor will have to put pay 0.1%- 0.3% of annual sales for the multi buyer insurance. If BP is part of the total portfolio, cost for the premium has risen 0.15% to 0.35%, depending on the deductable, co-insurance rates, and other factors, Voccola said. Aside from price increases, credit insurance has also been harder to come by as underwriters have taken a vigilant view, said three brokers.

"From the US side, we are still on cover for BP, but, in general, we are not looking to add new coverage," said an underwriter for a credit insurance provider.

"We are taking a cautious view for any Gulf of Mexico-related company such as Transocean or Anadarko," he continued. "Our big concern is how potential policy changes will shake out in the Gulf."

A spokesperson for BP declined to comment.

Fundamental Shield

Although costs, penalties and liability apportionment among Macando well parties are still unsettled issues, trading in BP's once-sunken USD 31bn capital structure has snapped back this month. BP's USD 2bn 4.75% senior notes due 2019 traded at 98 today to yield 5%, up from 86 on 21 June yielding 7% on 21 June, according to MarketAxess. The shorter-dated USD 1.5bn 3.12% senior notes due 2012 traded at 100.25 today to yield 2.88% from 95 on 21 June yielding 6.3%.

"I've pretty much put the pens down for now on BP," said a hedge fund analyst. "To do it right from a distressed or capital structure arbitrage angle, you have kill a lot of brain cells. The balance sheet is strong and there would have to be something aggressive the government does to get me intrigued. For I-Grade buyers, it's easier, you look at the low leverage, the nice yield, you buy it."

Indeed, BPs credit stats and flexibility to raise financing is stellar. The company's bond indentures and credit agreements hold no limitations on debt incurrence or use of asset sale proceeds, said two sellside analysts.

The company has USD 10bn of bond maturities due over the next three years, but its balance sheet is unlevered and awash in liquidity. At 30 June liquidity totaled USD 23.3bn, including USD 7.3bn in cash, and USD 16bn of revolver availability, according to SEC filings. That doesn't include the USD 7bn of cash proceeds the company is in line to receive for its asset sale to Apache, and another USD 30bn of assets sales management is targeting over the next 18 months.

Moreover, the company is still expected to be a USD 30bn per year free cash flow generating machine based on a USD 50bn EBITDA run rate and annualized capex of USD 18bn with USD 1.2bn of interest, said the sellsiders and the hedge fund analyst.