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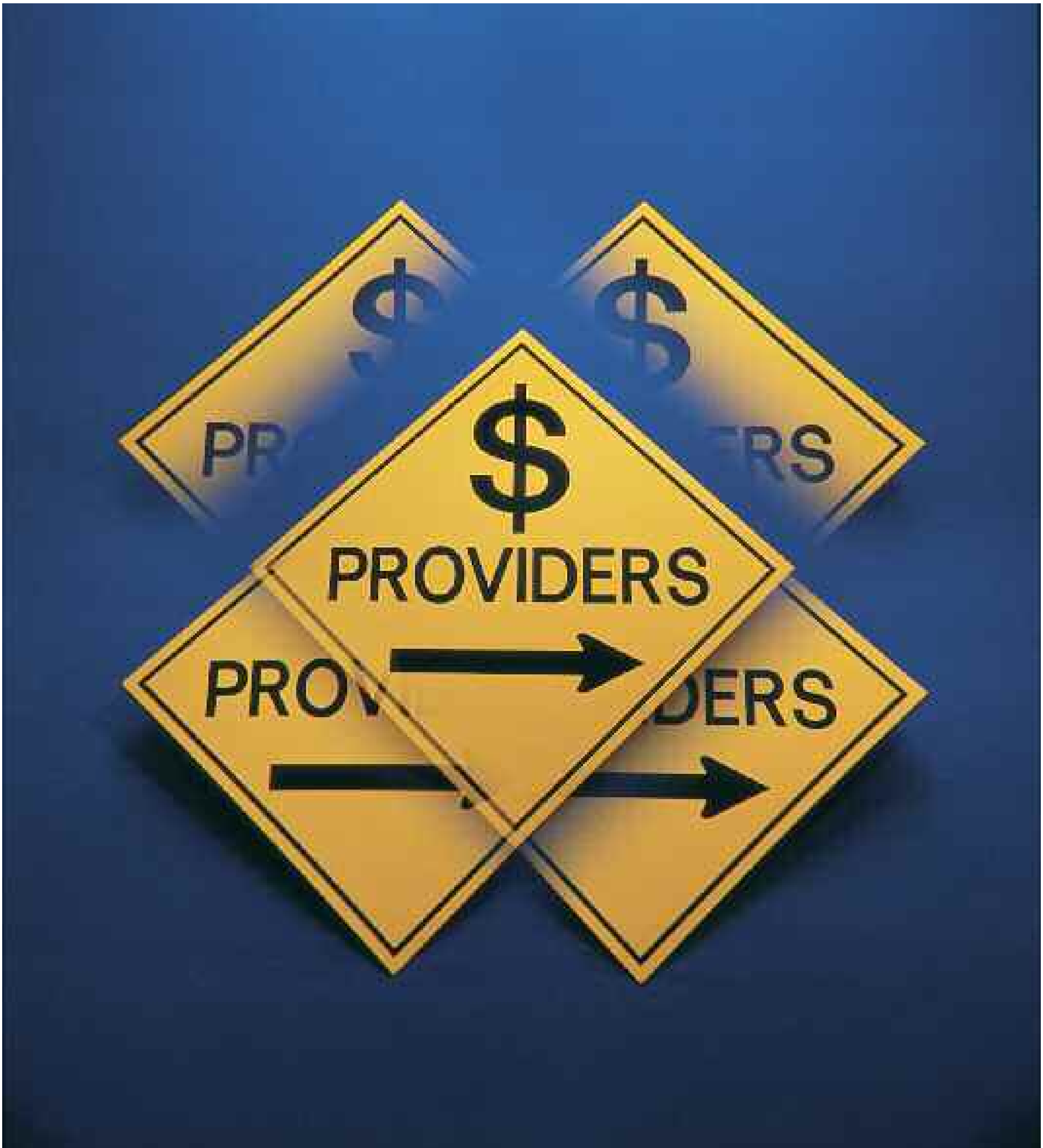
CAPITAL FORMATION 2014



A SUPPLEMENT TO

Oil and Gas Investor

JUNE 2014

HARTENERGY

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HERE'S THE MONEY
CAPITAL FORMATION 2014

PRUDENTIAL
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RELATIONSHIPS
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Energy Finance Group
Oil & Gas

Capital that Spans the Energy Value Chain

Energy Finance Group provides capital to companies and management teams across the energy value chain including oil and gas exploration and production, midstream, energy services, energy infrastructure projects and utilities.

Capital Characteristics

- Investment grade and below investment grade debt. Typically, fixed-rate, long-term senior notes and select floating-rate financings
- Junior capital: second lien, mezzanine and non-control equity investment capacity
- Energy infrastructure project finance, joint venture financing and equity participation capabilities
- Ability to accommodate long-term investment horizons

Typical Investment Size

• Senior Debt	\$10 - \$250	million
• Mezzanine Debt	\$10 - \$50	million
• Equity	\$10 - \$50	million

Issuer Benefits

- Single-source financing relationship, which allows for post-closing continuity
- Ability to provide both debt and equity capital in the same transaction
- Broad investment interest allows participation in project, joint venture and structured financings
- Ability to evaluate and structure transactions on either an asset or cash flow basis

Scale and Commitment

- A team of 13 experienced investment professionals
- Average tenure of investment staff is 15 years
- \$6.8 billion investment portfolio as of 3/31/14
- Committed capital through all market cycles
- Debt and equity appetite in excess of \$1 billion annually

Senior Debt | **Mezzanine Debt** | **Private Equity**

For more information contact:

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prudentialcapitalgroup.com

Prudential

FIELDING GREAT TEAMS

To match a company's long-term strategy (underpinned by its immediate cash needs) with the various forms of capital is a never-ending game in the E&P business. Luckily, it is very well-played, and capital is plentiful. Banks, institutions, private-equity firms and individuals are eager to put their money to work in the oil and gas business, one of the bright spots among industry sectors.

After all, North American resource plays can generate some of the highest returns in the oil and gas world today, if they are managed smartly. The call on capital is great, however—and as you'll see from the sources quoted here, companies can access that capital in the public markets easily today, perhaps more easily than through strategic M&A transactions.

The interest rate environment is still very attractive, so fixed income is one popular path to capital; debt is the logical choice for companies of all sizes. Both investment-grade and noninvestment-grade issuers have done well. Even ExxonMobil placed a $5.5 billion issue, marking its return to the fixed income market after many years. However, this may be about to change. Barclays indicates it expects an upward drift in interest rates later this year as the Fed completes its tapering of the stimulus program. Bond issuers need to act fast, it would seem.

For micro-caps and small-cap E&Ps, issuing preferred stock could be the better way to play it. As engineering continues to remove the risks of oil and gas development, and new efficiencies are used by companies to reduce costs, it has become much easier than it was a decade ago to attract capital.

Private-equity players have taken the field by storm, funding—and coaching—E&P firms in all basins and plays. Some spectacular IPO exits have occurred recently that prove the viability of a private-equity approach.

Consider this special report as a playbook that guides you further into the capital provider leagues so you can evaluate the teams, the coaches and the terms that are right for you. We hope you see a way to win on a level playing field.

—Leslie Haines, Editor-in-chief

For more articles and news on financing topics, see **OilandGasInvestor.com**.
Note these in particular:

"The Big Shuffle," on investment bankers' views of capital markets. August 2013.

"The New Faces of Finance," on profiles of Twenty Under 40 in Finance. January 2104.

"Parsing the JOBS Act," on new ways for middle market companies to raise capital. January 2014.

"The Fashion Window Opens for IPOs," on the premium for public equity vs. private asset sales. One-on-One supplement published within the April 2014 issue.

CAPITAL PROVIDER NEWS

In Case You Missed It

In the energy finance world, there are many moving parts and they move fast, especially today, when interest in investing in oil and gas assets is at an all-time high. In case you missed it, here are some key financial news items compiled from June 2013, the publication date of the last edition of this Capital Formation Report, through May 2014.

PEOPLE MOVES

Wells Fargo Names Balombin Managing Director

Tim Balombin became managing director for the M&A practice within Wells Fargo Securities' capital markets and investment-banking group, focusing on the upstream sector. He joined the company from RBC Capital Markets, where he was part of the M&A team for energy, power and utilities.

Blackstone Bolsters Energy Practice

In late February, Keith Lord and Dayan Abeyaratne joined Blackstone Advisory Partners' power and renewables advisory practice. Lord's strategic and advisory experience from UBS includes structuring and financing the Cove Point LNG facility for Dominion Resources. Abeyaratne had been head of generation advisory for UBS' global power and utilities group, and led financings for companies including Dynegy. Blackstone is an investment and advisory firm based in New York.

Maguire Joins Carlyle International Energy Partners

Robert Maguire was appointed managing director for Carlyle International Energy Partners in late February. He has 30 years' experience in the energy industry, most recently joining Carlyle from Perella Weinberg Partners. The international energy team focuses on upstream E&P, midstream, oilfield services, refining and marketing, and is part of the company's $28 billion global energy platform.

Milne Joins Wells Fargo Energy Group

Kendal Milne joined Wells Fargo Energy Group in November. The group is part of Wells Fargo Bank. Milne will focus on the group's expansion into the U.K. He has about 40 years' experience in banking, 15 of which were in the energy sector in Aberdeen. Previously he worked for DNB Bank, and led the oil and natural gas group for banking at Barclays Plc.

J.P. Morgan Names Lister Energy Group Head

In September, J.P. Morgan appointed Mike Lister head of its corporate client energy banking group. Based in Dallas, Lister manages a group of bankers focused on E&P, midstream and service companies. He also oversees relationships between J.P. Morgan's commercial banking sector and energy companies. Lister has 23 years' experience in banking, beginning with J.P. Morgan's energy practice in Houston.

Montano Joins Roth Capital Partners

Alexander G. Montano has joined Roth Capital Partners, Newport Beach, Calif., as its new managing director for investment banking in energy. Previously, he was managing director for the energy and oil and natural gas practice at C.K. Cooper & Co. for more than 15 years. Energy banking is the fifth vertical being added to Roth's corporate investment-banking team, which also includes the health care and biotech sectors for sales, trading and research.

Connors/Goltermann Join Northland Capital

Adam B. Connors and Carl Goltermann have joined Northland Capital Markets as managing directors, energy investment banking, in the company's Newport Beach, Calif., office. Northland is based in Minneapolis. Previously they were managing directors with C.K. Cooper & Co., which was closed in June 2013.

PROVIDER NEWS

Pine Brook Opens Houston Office

New York investment and private-equity firm Pine Brook opened a Houston office in April to support its current and future investments in the region. Michael McMahon, Martin Houston and Claire Harvey are among the group leading the office. McMahon is a founding partner and the firm's managing director. Houston is a senior advisor, and Harvey is a vice president on the energy investment team. McMahon has about 40 years' experience in energy investing and advising and has represented Pine Brook as the director of Forge Energy LLC and other companies. Houston has more than 30 years' experience in the energy industry and joined Pine Brook from BG Group Plc. Harvey was most recently with TPH Partners, an affiliate of Tudor, Pickering, Holt & Co., where she worked in energy sector investments. Pine Brook's Houston office is located at 1301 McKinney St., Suite 3550.

Energy And Infrastructure Capital Is Formed

In April 2014, the new Energy and Infrastructure Capital LLC, which provides direct lending to energy and infrastructure companies worldwide, was formed. The subsidiary of Harbinger Group Inc., a holding company, is led by Jerry Polacek as CEO and COO and by Matthew Ordway, CFO and a co-COO.

Polacek was formerly the managing director at GE Capital Energy Financial Services. Ordway was formerly CFO at Ridgeline Energy. Polacek will oversee investments and strategy. The Stamford, Conn.-based company will provide debt lending for oil and gas, along with power, renewables and other energy sectors.

KKR Closes Energy Fund With $2 Billion

In March 2014, KKR closed its KKR Energy Income and Growth Fund I with $2 billion for investment in North American unconventional oil and natural gas resources. The fund will generate income, increase capital and support joint-venture drilling investments, mineral royalty acquisitions and producing assets. Marc Lipschultz is the global head of energy and infrastructure for New York-based KKR.

Intervale Capital Raises Oilfield Services Fund

Private-equity firm Intervale Capital raised $495 million in capital commitments through its Intervale Capital Fund III LP, which it closed in February. Charles Cherington and Eric Horsley led the fund, and Credit Suisse Securities (USA) LLC was placement agent. The fund will serve privately negotiated control investments at middle-market oilfield services companies and contribute to startup oilfield services companies. Choate Hall & Stewart LLP was Intervale's legal counsel.

Pine Brook Closes $2.43 Billion Fund

In February 2014, New York private-equity firm Pine Brook closed its second fund, Pine Brook Capital Partners II LP, with total capital commitments of $2.43 billion. The fund has made five investments totaling $300 million. New investors include domestic public pensions and endowments, as well as investors from China, Europe and Southeast Asia. The fund will target investments in new financial and energy companies. Sidely Austin LLP was Pine Brook's counsel, and Credit Suisse was the fundraising placement agent.

Ridgewood Energy Closes $1.1B Deepwater Fund

In January, Ridgewood Energy Corp., Montvale, N.J., closed private-equity fund Ridgewood Energy Oil and Gas Fund II LP with $1.1 billion in commitments. Formed to invest in oil projects in the U.S. deepwater Gulf of Mexico, the fund has already invested in two oil wells, one of which, the Dantzler Project, was drilled in partnership with Noble Energy Inc. Eaton Partners LLC, based in Rowayton, Conn., was placement agent for the fund. Vinson & Elkins LLP was fund counsel.

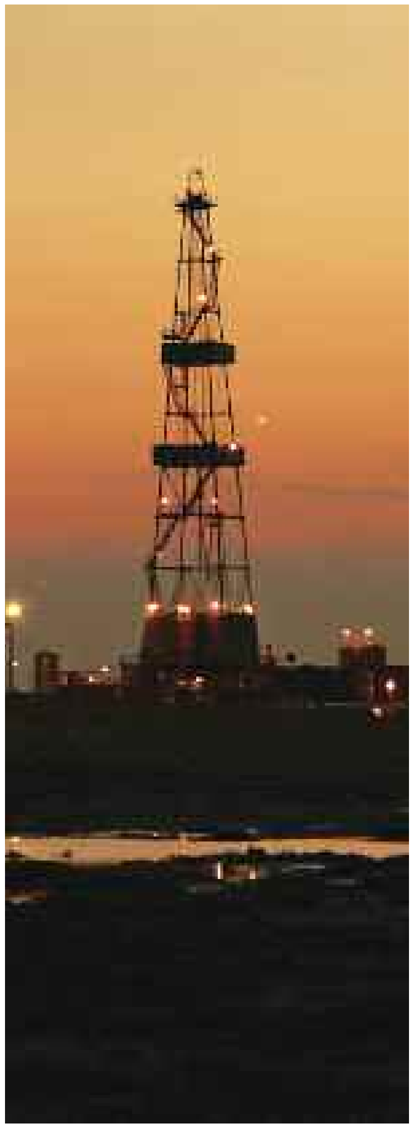
Angelo, Gordon & Co. Opens Houston Office

New-York based Angelo, Gordon & Co. LP hired Todd Dittmann and three others to head up its energy industry investment sector in a new Houston office, the company said in early December 2013. Dittmann has more than 20 years' experience in investment and finance in the energy industry, including closing about 85 investments as a principal investor or lender. He formed a team focused on energy sector credit opportunities in the spring of 2013.

Damon Putman and David Taylor joined Dittmann's team as managing directors, while Paul Gottheim joined as an associate. Putman was previously CFO of a private energy company, Taylor was a partner in an energy investment-banking boutique, and the two have closed more than 50 energy-related investments.

Tudor, Pickering Opens Calgary Unit

Tudor, Pickering, Holt & Co., an integrated investment and merchant bank with offices in Houston, New York, London and Denver, has picked Calgary as its entry point into Canada. As the energy hub of Canada, the city was selected as a means to serve Canadian clients as well as inter-



national clients focused on the Canadian market. The global firm has selected veteran Hilary Foulkes to lead the team as chair. She has operating and investment-banking experience, having served previously as COO for Penn West Exploration and as a managing director for Scotia Waterous.

Dallas Bank Forms New Energy Finance Group

In December 2013, Dallas' Community Trust Bank established an energy finance group focused on banking for domestic oil and gas companies. It is led by managing director Christina Kitchens. Patrick Leznicki and Jerry Horton are vice presidents of energy lending, while Carlton Cornelius is portfolio manager.

PRIVATE-EQUITY DEPLOYED

Post Oak Energy Capital Leads Equity Commitment

Midland, Texas-based Mike Black and Brandon Black of Crown Oil Partners V LP have formed and are leading a $100 million equity commitment provided by Post Oak Energy Capital LP, Houston, the company said in late April.

The equity commitment currently supports secondary-recovery operations and drilling and development operations in the Clearfork, Wolfcamp and Bone Spring formations in the Permian Basin. Post Oak and Crown Oil have collaborated since 2008, and this equity commitment is Post Oak's third investment with Crown Oil.

Denver's Rock Oil, Liberty II Capitalized By Riverstone

Rock Oil Holdings LLC, a newly formed Denver and Houston-based E&P, received an equity commitment of up to $250 million from funds managed by energy private-equity firm Riverstone Holdings LLC and additional amounts from the company's management team. The Riverstone commitment, announced in March, comprises up to $167 million from Riverstone Global Energy and Power Fund V and up to $83 million from Riverstone Energy Ltd. The Rock Oil management team previously built a substantial acreage position along with associated production in the Eagle Ford Shale that it successfully sold in separate transactions to Sabine Oil & Gas and Sanchez Energy Corp. in 2012 and 2013, respectively. The team is led by chairman and CEO Kyle R. Miller, who has led a number of E&Ps including Chicago Energy Associates. Rock Oil will likely concentrate its efforts in the Eagle Ford Shale, the Utica Shale and the Permian Basin.

Rivington Holdings LLC and its affiliate, Rivington Securities LLC, were exclusive financial advisors to Rock Oil. DLA Piper LLP and Latham & Watkins LLP provided legal counsel to Rock Oil and Riverstone, respectively.

In November, Liberty Resources II LLC, also a new Denver-based E&P, received $300 million in equity from funds managed by Riverstone Holdings, $50 million from Oakmont Corp., and additional amounts from its management team. Riverstone's commitment came from its Riverstone Global Energy and Power Fund V and from Riverstone Energy Ltd. CEO Chris Wright, president Mark Pearson, CFO Paul Vitek and others lead Liberty II.

Five Point Capital Funds Redwood Midstream

In February, private-equity firm Five Point Capital Partners LLC funded Redwood Midstream Partners LLC with $75 million. Houston-based Redwood focuses on development, expansion and optimization of midstream energy infrastructure for small to mid-sized producers in emerging shale-producing regions. Redwood is led by Marty Patterson, president, a midstream energy veteran with more than 30 years of industry experience. Prior to founding Redwood, he was a member of the founding management team at American Midstream Partners. Founded in 2011, Five Point Capital focuses on midstream energy infrastructure and energy sector investments across North America.

ArcLight's Logos Backing Upsized

Logos Resources LLC, Farmington, N.M., received an upsized equity capital commitment of $100 million in January 2014 from ArcLight Capital Partners LLC, Boston. Logos was formed in January 2012 in partnership with ArcLight and Consolidated Asset Management Services. Logos will develop its existing acreage in the core of the Gallup oil resource play in the San Juan Basin using both horizontal and vertical drilling technology. It will also expand its footprint and pursue acreage acquisitions.

Jay Paul McWilliams, David Gonzales and Austin Akers are Logos' senior management team members. Gonzales, who is vice president of operations, and Akers, who is vice president of land, joined the company from Linn Energy LLC.

Lime Rock, Wells Fargo, Rivington Fund Montana E&P

The former management team of Augustus Energy Partners LLC formed Augustus Energy Partners II LLC in December, led by Steven D. Durrett, the founder, president and CEO. It is based in Billings, Montana. Durrett is joined by certain other executives from the management teams at Augustus I and United States Exploration Inc., including Kenneth J. Meister, vice president-engineering; Bob Fisher, vice president-geology; Duane Zimmerman, vice president-operations; Lou Ann Carlson, vice president-administration; and Jeff Appelt, controller. The company's two-tier strategy involves leasing and drilling as well as acquisitions of producing properties in the Rocky Mountain region.

Simultaneous with its formation, Augustus II closed a new $96.7 million institutional private-equity commitment with Lime Rock Partners, Wells Fargo Energy Capital, and Rivington Capital Partners LLC (a subsidiary of Rivington Holdings, LLC).

EnCap Commitment Propels Silverback Exploration

In November EnCap Investments LP, Houston, provided Silverback Exploration LLC, San Antonio, with a $350 million equity commitment. Silverback is led by CEO George M. Young Jr. and a management team including COO Stephen Lipari and CFO Chris Williford. The Fort Worth office of Kelly Hart & Hallman LLP was Silverback's legal counsel. Thompson & Knight LLP was EnCap's legal counsel. ■

PATHWAYS TO MONEY

Proven management teams with assets and solid business plans attract capital.

By Gary Clouser

Capital providers—whether making bank loans or private-equity investments—are looking for proven management teams with demonstrated track records, technical and business management expertise, high-quality assets and a solid business plan.

Oil and Gas Investor asked representatives of capital providers representing three different forms of capital – banks, private equity, and a hybrid or single-source financing offering senior loans, mezzanine debt, and equity investments—to provide tips for E&Ps seeking capital. Participating were: W. Bryan Chapman, executive vice president and energy lending manager, IberiaBank; Carl Tricoli, co-founder, managing partner and co-president, Denham Capital; Denham Capital; and Brian Thomas, managing director within Prudential Capital Group's Energy Finance Group.

Regardless of the form of capital sought, a successful management team must demonstrate an ability to "create value," they agreed. There are pros and cons to bank loans and private equity, and E&Ps need to understand them and know what they want to accomplish in the short and long term, the capital providers said.

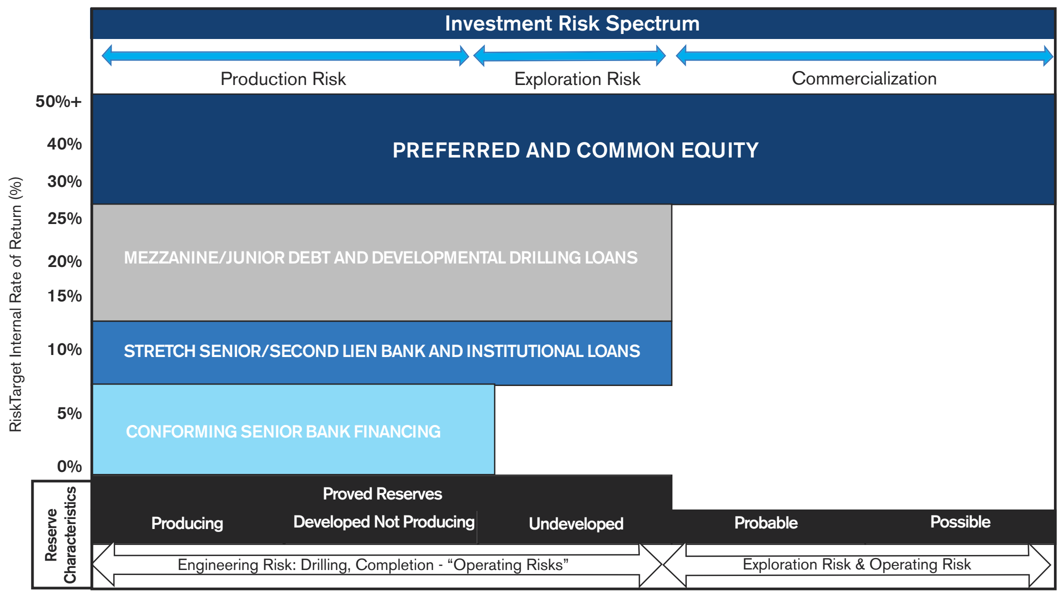
Using bank debt and/or other conventional financing, if available, may take longer to grow an E&P company, but the company can maintain control of the business. With private equity, the deal is usually much larger and management is part of an overall team, but the company gives up a majority share of the profits to the private-equity investor.

Private-equity deals typically have the opportunity to generate significant profits within a few years, whereas debt-financed deals are typically smaller and take longer to generate significant profits.

E&P teams need to decide if they want to own 100% of a smaller pie, or if they would prefer a smaller percentage of a much larger pie. For some,

OIL AND GAS INVESTMENT RISK SPECTRUM

The reserve characteristics, taken together with the size and maturity of the issuer, drive the form of capital required for growth



Source: Prudential Energy Finance Group

"If your business plan includes a lot of acquiring leases with no production in a new play or involves significant exploration risk, then you need that to be funded with equity until you establish enough production and cash flow to support bank debt."

W. Bryan Chapman, executive vice president and energy lending manager, IberiaBank

building a legacy company takes an entire career, and even beyond. If they want to build a legacy company, they need funding sources other than private equity, because typically, private-equity-sponsored companies are intended to grow more quickly and be sold or monetized through mergers or public markets, according to the capital providers.

Banker's tips

The market for reserve-based loans to E&P companies has been increasing over the past several years because horizontal drilling and hydraulic fracturing have enabled companies to find and produce increasing volumes of oil and natural gas—but the need for capital has increased tremendously. However, the energy lending policies for banks have been consistent for many years, said IberiaBank's Chapman.

The majority of the value supporting secured first-lien borrowing base credit facilities is proved developed producing properties (PDPs). Lines of credit can also be supported by some proved developed nonproducing reserves (PDNPs) and proved undeveloped reserves (PUDs) if they are still economic at bank price decks after applying a discount or risk factor. However, PUD values typically do not exceed 10% to 15% of the total value.

"While management teams may acquire valuable acreage in a de-risked area indicating significant untapped potential, the bank regulators state that banks should not rely on unproved reserves as the source of repayment for a loan," Chapman said.

Sometimes banks are accused of being too conservative, but Chapman makes no apologies for the caution. "We need to be good stewards of our clients' deposits and only take appropriate risks, with the full expectation that the loan will be paid, and there is the minimal chance of a loss. Banks that were not prudent lenders in the 2008-2009 financial crisis were shut down, taken over by the FDIC and sold to other banks.

"If your business plan includes a lot of acquiring leases with no production in a new play or involves significant exploration risk, then you need that to be funded with equity until you establish enough production and cash flow to support bank debt."

The most frequent and biggest mistake E&Ps make is to get over-leveraged or take too much exploration risk, followed by a drop in commodity prices that results in impaired liquidity to replace or grow reserves. Before accessing the bank loan market, a company needs to have a good management team with all the disciplines—technical, operational, land management and financial—an independent third-party reserve report, financial projections and enough equity to support the risk associated with its business plan, he said.

Success in one play, location or type of production does not necessarily equate to another,

INVESTMENT CRITERIA

Source: Prudential Energy Finance Group

Reserves	Instrument	Terms	
Proved Reserves	Sr. Secured/ Unsecured Fixed Rate Debt	Cash Flow, Covenant Based Lending Yield Range: 3.5% - 7.0% $10- $200 million Investment	
	Second Lien Fixed/ Floating Rate Debt	Coupon: 8% - 12% No royalty or equity linked component $10- $100 million Investment	
	Mezzanine	Targeted returns typically in the mid-to-high teens Contractual coupon with varying types of yield enhancing features (e.g., warrants, ORRI, NPI)	Secured / Unsecured $10- $50 million Investment
Probable & Possible Reserves	Equity	Non-Control Position Long Hold Period $10- $50 million Investment	

Source: Prudential Energy Finance Group

Chapman cautions. For example, a team that had great success in developing conventional plays is not necessarily going to be successful in developing a shale play, just as a team with success onshore is not necessarily qualified for offshore exploration. The management team's track record should match as closely as possible the purpose for which the borrowed money is sought, Chapman said.

IberiaBank's energy lending group was started in October 2009. Loan commitments increased to more than $1 billion earlier this year with about 80% made to private, private-equity-backed and small- to mid-cap upstream companies. The remainder has gone to private and private-equity-backed midstream companies.

Private-equity tips

Aligning interests and building partnerships is what makes investments successful, said Denham Capital's Tricoli.

"Collaboration and teamwork are integral to success, so we look for like-minded management teams who value the power of partnership and trust. Our portfolio companies are experienced and patient, and they share our vision of growth and value creation. Harnessing their ambition with our financial and technical background, we work as peers, creating a win-win for everyone," he said.

Denham Capital Management is an energy and resources private-equity firm with more than $7.9 billion in invested and committed funds in the oil and gas, power and metals and minerals industries.

It seeks E&P teams that share its approach centered on partnership, risk mitigation and operational competence over a variety of market environments.

"We are looking for the best investments, or anticipated best risk-and-reward profile," Tricoli said. "Usually our funded companies have what we call 'dislocated value,' meaning that the value we perceive is not yet fully recognized in the market, and often the company possesses assets and potential that are underpriced."

Denham believes it is a value-added partner and seeks to apply its operational and commercial expertise and risk management strategies to create value in investment opportunities.

The most important criteria for securing funding sounds trite, but it is by far the most important, Tricoli said: "We look for the best people." Denham seeks to team with a CEO that has technical and management capabilities. "The CEO

"There is a big difference between knowing how to produce hydrocarbons and knowing how to make money."

Carl Tricoli, co-founder, managing partner and co-president, Denham Capital

"The reserve characteristics, taken together with the size and maturity of the issuer, drive the form of capital required for growth."

Brian Thomas, managing director, Prudential Capital Group's Energy Finance Group

needs to know how to allocate capital. There is a big difference between knowing how to produce hydrocarbons and knowing how to make money," Tricoli said.

Once comfortable with the people, the second consideration is that the applicant company demonstrate it has the necessary technical resources and knowledgeable personnel, Tricoli said. Of course, there is the number crunching, due diligence and relative merit of the projects. Usually, if the first two are present—good people with technical resources—applicants come to the table with projects with merit, or a feasible plan.

As with all private-equity firms, an exit strategy and timetable are part of the plan. That plan involves Denham providing capital to a company to enable it to reach an identified goal or benchmark. In exchange for the capital, Denham receives a partial or full ownership stake in the company. Typically, Denham expects to exit, or sell, its stake in a portfolio company in two to six years.

"Denham Capital is flexible in creatively structuring the best transaction to fit all parties' interests. Our investments are structured to create alignment with the interests of management teams, ensuring a shared definition of success and a shared vision of how to achieve goals," Tricoli said.

"We strive to partner with managers who truly seek to build businesses, not just to own assets, and who understand the power of collaboration. Because Denham Capital has a flexible investment horizon and a patient long-term orientation, we are not looking for market timers or quick results. We work with management teams to develop an exit strategy that makes sense for all

FACTORS IMPACTING BORROWING BASE LOAN AMOUNT

Borrowing Base Decrease	Borrowing Base Increase
Lower prices / price deck	Higher prices / price deck
Unwinding existing hedges with strike prices above price deck	Additional hedges at prices above price deck
Reserve divesture (with material PDP component)	Reserve acquisition (with material PDP component)
Producing existing PDP reserves and not replacing them through drilling or acquisitions	Converting PUD or unproven reserves into PDP category through drilling of development or exploratory wells
Increased operating costs, G&A expenses, production taxes, drilling / completion CAPEX	Reducing operating ccompletion osts, G&A expenses, production taxes, drilling / CAPEX
Converting PDP reserves to PDNP category because of weather and/or (hurricane, freezing temperatures) mechanical/operational problems (requiring well maintenance or repair of pipeline/processing facilities)	Converting PDNP reserves to PDP category, recompletion of additional "behind pipe" zones
Negative reserve revisions (performance was less than expected resulting in fewer reserves being recovered	Positive reserve revisions (performance was better than expected resulting in more reserves being recovered)

- Risk associated with the volatility of commodity prices/market values for oil and gas properties is mitigated by the flexibility in a reserved-based loan with standard borrowing base provisions.
- Borrowers can manage risk through commodity hedging, maintaining adequate liquidity, taking prudent exploration risks, not over-leveraging the balance sheet and partnering with a strong bank with experienced energy bankers.

Source: IberiaBank

parties in view of expectations set at the onset of the partnership," he said.

Single-source financing

"The reserve characteristics, taken together with the size and maturity of the issuer, drive the form of capital required for growth," said Prudential's Thomas.

Prudential's Energy Finance Group is representative of a hybrid capital provider, offering senior debt, mezzanine and equity capital. "We can provide both debt and equity capital in the same transaction," said Thomas.

The group had a $13 billion portfolio at the close of 2013. It provides capital to companies and management teams across the energy value chain, including oil and gas exploration and production, midstream, energy services and energy infrastructure projects.

Prudential has the ability to evaluate and structure transactions on either an asset or cash-flow basis. That flexibility enables an E&P team to plan the most realistic scenario to ensure sufficient capital is available to prosecute a development plan. Prudential, unlike many private-equity firms, does not seek controlling interest in the invested companies.

"Because of the breadth of Prudential's investment interests, we have the ability to offer an E&P management team a clean sheet of paper. We listen to their needs and plans and then match the best form of capital to support their objectives," Thomas said.

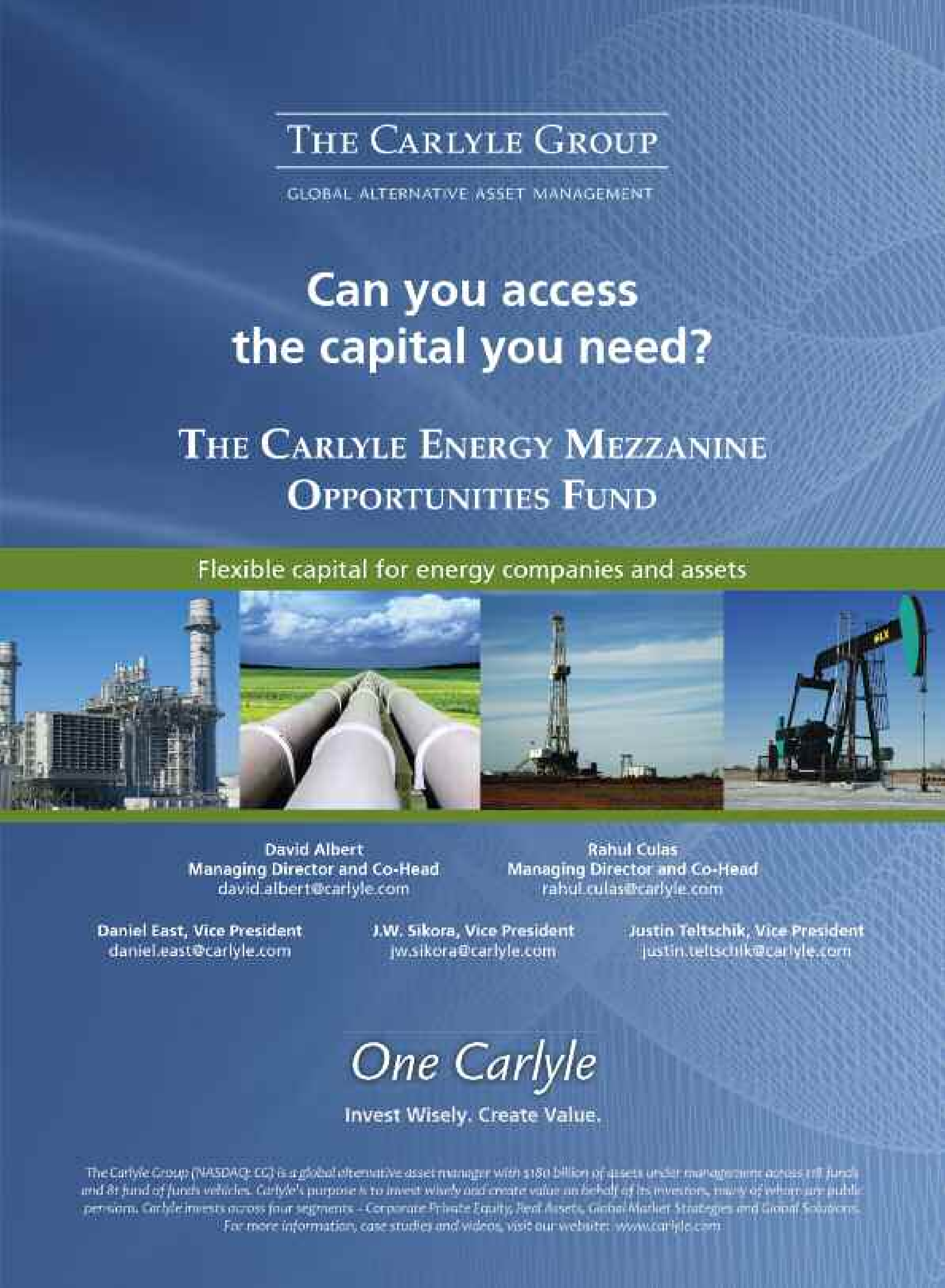
The due diligence for senior debt, which offers the E&P the lowest cost of capital, is often more focused on the quality of existing production and cash flow; whereas mezzanine and private-equity investments depend on management's ability to convert "potential value" into "real value" through cost-efficient developmental drilling and the conversion of undeveloped resources and acreage.

"We offer a variety of financing options along with the ability to fund entire transactions and serve as a single-source lender, delivering a quicker closing, post-closing continuity and a certainty of execution," Thomas said. "Because we are investing on behalf of Prudential's general account, we also have the ability to consider opportunities that involve longer investment horizons than would otherwise be a fit for other banks or fund-based capital providers".

Typical size of transactions for senior debt are $10 million to $200 million; for mezzanine debt, $10 million to $50 million; and for equity, $10 million to $50 million.

Structural characteristics are investment grade and below investment grade debt: typically, fixed-rate, long-term senior notes and select floating-rate financing. Junior capital involves second lien, mezzanine and noncontrol equity investment capacity. ■

Photo by Tom Fox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One Carlyle
Invest Wisely. Create Value.
The Carlyle Group (NASDAQ: CG) is a global alternative asset manager with $180 billion of assets under management across 118 funds and 81 fund of funds vehicles. Carlyle's purpose is to invest wisely and create value on behalf of its investors, many of whom are public pensions. Carlyle invests across four segments – Corporate Private Equity, Real Assets, Global Market Strategies and Global Solutions. For more information, case studies and videos, visit our website: www.carlyle.com

GOING IT ALONE

For these entrepreneurs, recognizing gaps in the marketplace helped them to break away from larger companies to enter the independent world on their own.

By Taryn Peine

Even in an industry as old as oil and gas, there are gaps. For those who decide to leave the shelter of a large independent or major and venture out on their own, recognizing a gap and finding a way to fill it is often the key to success.

"Our initial team saw a void in the asset A&D market," said Christina Hilton, vice president of reservoir engineering for Covey Park Energy LLC based in Dallas. "A big buyer pool is focused on assets that are all PDP [proved developed producing], while another large group of buyers is focused on acquiring acreage positions with very few wells already drilled. We wanted to play the middle ground between high PDP and majority-acreage plays. We wanted to form a company to specifically target assets with a significant PDP component and a delineated acreage position."

Kate Richard, chief executive and founder of Warwick Energy Group, spent the first two years of building her business losing every deal the Oklahoma City company bid on.

"Finally we said, 'Alright market, you're on.'

"The market was laying down a challenge. We had a 'light bulb' moment and saw exactly what we were going to do with the challenge and with the opportunity. It forced us to be very critical, targeted and analytical about our acquisition and asset-management strategy."

The challenge that Richard identified led her to focus on nonoperated interests.

When seeking financing, **Christina Hilton**, vice president of reservoir engineering for **Covey Park Energy LLC**, found private-equity players were highly focused on the management team and even more focused on what each member had done in the past.

"We buy interests that, for myriad reasons, prior owners don't want to continue owning and that MLPs, private equity and other dominant buyers in the current market generally aren't seeking," she said.

With a unique niche and a story to tell the market, for most entrepreneurs the next steps are assembling a team and accessing capital. Often, the two tasks go hand-in-hand, particularly if the capital is coming from private-equity providers, many of which need to be comfortable with the background and track record of each member of the management team. Hilton and the rest of the Covey Park team knew from the start that partnering with an established private-equity fund was the most suitable option.

Debt or equity?

Since Covey Park didn't have any assets, debt financing wasn't possible for the new company. "Raising other forms of equity would have taken too long or wouldn't provide sufficient certainty of funding. The speed that private equity would allow us to get into the market and start doing deals was also very attractive," Hilton said.

"We felt like we were missing opportunities in the market. Doing a deal subject to financing is the kiss of death. You have to have all your ducks in a row."

With private equity as the best bet for funding, the entire eight-person Covey Park management team met with multiple private-equity firms.

"Our team is larger than most historical teams, but each member brings something unique to the table," Hilton said. "Because of our diverse backgrounds, our team can evaluate and operate any type of asset. And because our strategy is to acquire and exploit, our team is heavily weighted in transactional experience, so it requires a few more people to get the job done."

The team behind Covey Park brings deep experience within the oil and gas space and with private-equity-backed companies. Their combined track records were the biggest focus of the private-equity firms they met with.

"We spent a lot of time vetting and being vetted by private equity," she said. "We found they were highly focused on our management team—and even more focused on what each member had done in the past. The majority of us came from experienced acquisition shops, so it helped that most of us already had a good track record of working on deals, and we brought others over with us to supplement."

After all the vetting was said and done, Covey Park determined the best fit was Denham Capital. It liked Covey Park's business plan and advanced a $300-million commitment. The new company officially launched in June 2013.

"We really clicked with them and felt they shared our vision for the company," Hilton said.

Marketplace adaptation

"The marketplace has changed in the past couple of years. Where companies were focused on acquiring acreage, drilling a few wells and flipping, now buyers want to see more wells drilled and more acreage delineated, and Denham recognized that change as well. It's a large commitment in terms of total amount, but because our strategy is a little different, we need that additional capital because higher PDP properties are more expensive to acquire."

Hilton said the initial plan for Covey Park involves a three- to five-year investment window, depending on its assets.

"Since we're already buying an asset that is 50% developed, our ultimate goal is to further de-risk it, and then exit," she explained. "But the exit strategy might vary depending on the asset. We think the exit will take care of itself if we acquire high-quality properties. Right now we're more focused on the asset and the resource potential behind it instead of the exit, so we're not opposed to holding onto the asset longer if it doesn't make sense to sell during that three- to five-year time frame. Every asset has a maturity point, and we'd like to time our sale with that maturity peak."

As Warwick Energy has grown, Richard's technical team has grown commensurate with its asset portfolio. The company owns more than 4,000 wells across 13 states and 34 hydrocarbon basins, and it specializes in exploration and production in the Anadarko, Permian, East Texas, Gulf Coast, Appalachian and Rockies basins.

"Our technical team is led by industry greats; it's really an 'Ocean's Eleven' team," Richard said. "Warwick has a strong cultural chemistry and the level of professional excellence and camaraderie is inspiring. We demand a lot of our team and we push people hard."

The type of assets Warwick acquires require a certain type of investor, she added, and Warwick's investor base is comprised of public companies, insurance companies, private equity, hedge funds and family offices.

"Being exclusively or majority funded by private equity wasn't the right road for us; I didn't want our growth to be limited by the proclivities of a particular firm's viewpoint on E&P, or internal risk management's arbitrary limits of fund exposure to our team, because I knew we had a lot of horsepower and could grow rapidly into an industry force," she said.

"I wanted us to be able to grow in a way that was limited only by good, transactable deal flow. I just couldn't hitch our destiny to one star. It was a risk but it worked out."

Richard and her team eventually settled on funding Warwick completely through their own fundraising efforts, which are focused on investors that have a financial or strategic reason to like long-dated hydrocarbons.

"Meeting with equity partners is one of the things I love most," she said. "Our equity partners all have different but fundamental internal, strategic reasons to be invested in energy. We help them achieve that in a way that both safeguards and grows capital. It has been particularly enriching to work with investors from different sectors who approach E&P as a sector and asset class very differently."

SOME TIPS

Thinking of shucking the org chart and going out on your own? Take the advice of those who have successfully navigated the muddy waters of obtaining capital, putting together a business plan and competing in the crowded marketplace of today's oil and gas industry.

- **Focus on your track record.** Even though competition is tight across the country, Christina Hilton of Covey Park Energy still thinks it's a great time to enter the marketplace, and having a great track record is the key to securing the best financial backing to make you and your team as competitive as possible. "There's a sizable amount of private-equity money looking for homes, and they're all looking for good management teams to back," she said. "You're seeing commitments in bigger chunks. I would advise for a team to be organized and have a clear, drawn-out plan, but most importantly, to be focused on its track record. Our track record was the key to getting the best opportunities for our team."
- **Make sure.** No one who has started their own business has said it was easier than working for a bigger company. Everything is up to you, from ordering the office supplies to meeting with investors to drilling wells, and all of that makes going out on your own a daunting task for all but the most fully committed. As Kate Richard of Warwick Energy said, running an oil and gas business is an athletic endeavor.
- **Take the long view.** "It's about endurance, stamina, teamwork and pursuit of excellence," she said. "A few years ago, I had dinner with Gio Valliante, an academic professor of excellence focused on golf psychology, and he went around the table asking what we thought the data showed to be the fundamental defining difference between those who were great and those who were truly excellent in their various fields. The answer: recovery time. In this business, everyone faces setbacks, known unknowns and unknown unknowns. You have to have water-tight assumptions, cast-iron wills and make that recovery time as tight as possible when things don't go your way.

  "It helps to take the long view. It also helps to be surrounded by people who don't mind if you are constantly on the phone."

"I wanted us to be able to grow in a way that was limited only by good, transactable deal flow. I just couldn't hitch our destiny to one star."

Kate Richard, chief executive and founder of Warwick Energy Group

As Richard and her team travel the globe, meeting with investors and potential investors, the success and growth of Warwick has snowballed.

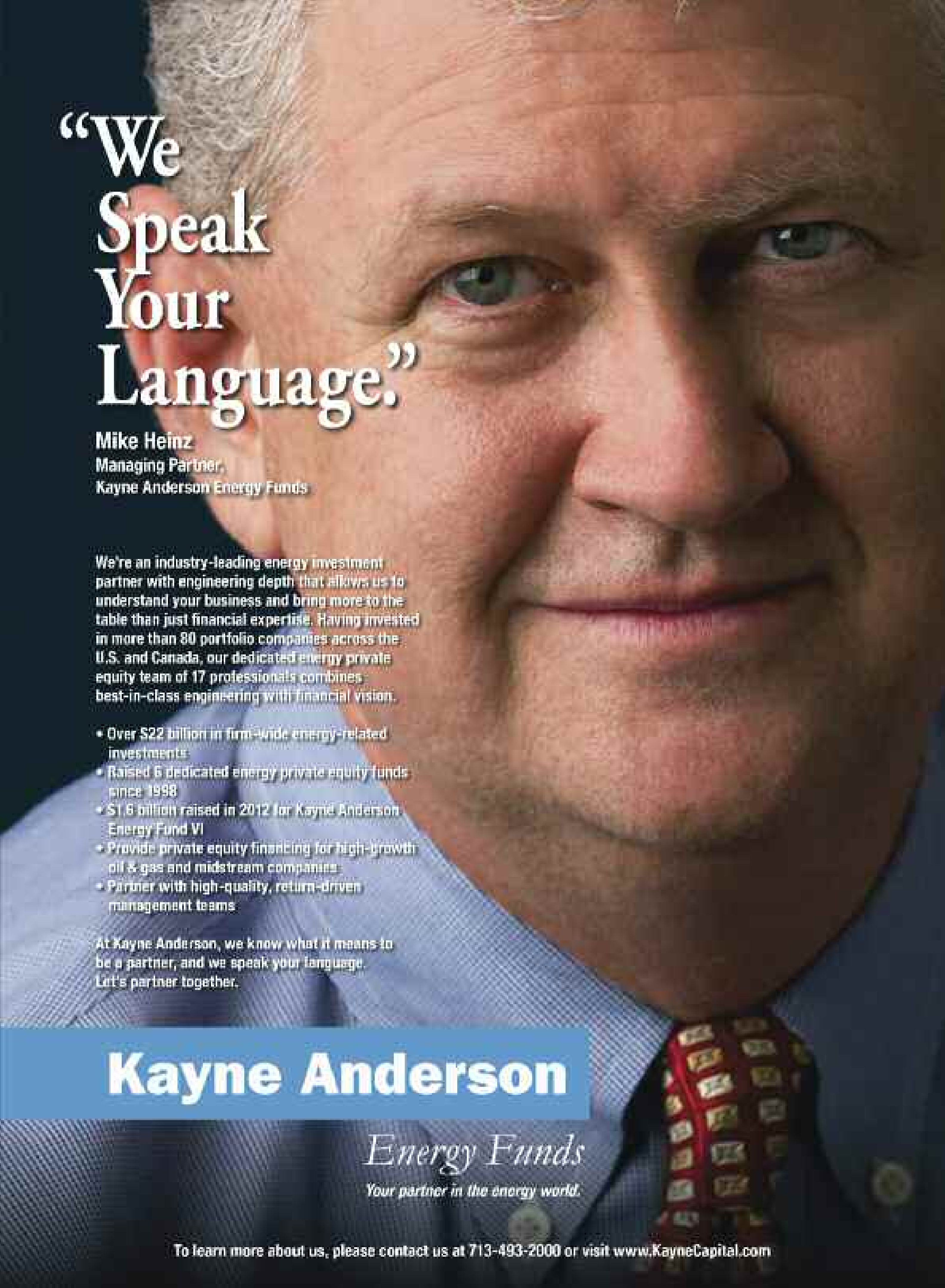
"Through your equity partners, you meet other potential partners and new deals come in through investors' own networks," she said. "Every time you meet with investors, you understand more about their investment needs, their valuation goals and funky site-specific issues they need to structure around. One plus one doesn't equal two; it equals 10."

As anyone will tell you who has gone into the marketplace with money burning holes in their pockets, sometimes spending the money is harder than securing the capital commitment in the first place. At press time, Covey Park was signing its first acquisition.

"In the past nine months, we have evaluated a large number of deals valued in total at more than $10 billion," Hilton said. "We saw a bit of a downturn of the market in 2013. There was a big difference between bid and ask price, but we think 2014 will be a bit better on the acquisition front. We've seen tremendous growth in companies that could become acquisition targets. But there's more private-equity money on the market than ever before and more competition to acquire assets."

Regardless of their competition, Hilton and the team remain focused on their strategy.

"We'll continue to be competitive, but internally, we talk about who our competition is, and every time we do this, we just end up wasting our time," she said. "You're never going to guess who your competition is. You just need to be confident in the number you're bidding." ■


"We Speak Your Language."
Mike Heinz
Managing Partner,
Kayne Anderson Energy Funds
We're an industry-leading energy investment partner with engineering depth that allows us to understand your business and bring more to the table than just financial expertise. Having invested in more than 80 portfolio companies across the U.S. and Canada, our dedicated energy private equity team of 17 professionals combines best-in-class engineering with financial vision.
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• $1.6 billion raised in 2012 for Kayne Anderson Energy Fund VI
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CONFIDENCE BUILDS IN CAPITAL MARKETS

The energy sector is displaying growing stability and strength, according to experts in investment banking, M&A and private equity.

By Chris Sheehan, CFA

An air of confidence is present—and seemingly building—in the energy sector capital markets. Whether references are to "secular" trends in energy, the "durability" of plays or the still-greater "scale" of private equity, it's hard not to come away with a sense of growing stability and strength. Even M&A—likened by some to "Waiting for Godot" for its oft-projected but unrealized appearance—is discussed in tones of expectation as opposed to hope.

"I would say the capital markets collectively—the investment grade, high yield and equity markets—have never been stronger," said Steve Trauber, head of global energy investment banking for Citibank.

"There's a lot of cash in debt mutual funds, both investment grade and leveraged finance. Banks are putting money to work; institutions are putting money to work. And notwithstanding recent volatility in the broader equity market, energy names continue to be very strong, as people believe there continues to be secular growth in the sector. Oil prices are strong, and gas prices are a lot higher now than at this time last year."

"I would say the capital markets collectively—the investment grade, high yield and equity markets—have never been stronger."

Steve Trauber, Citibank head of global energy investment banking

These factors have translated to confidence in the energy sector.

"There's a positive sentiment within the C-suite as regards the outlook for the business and therefore their confidence level and, as a result, their desire to think about and potentially engage in discussions about possible M&A transactions," said Trauber. "I think there's an underpinning of confidence that the economy is stronger, that the potential for a near-term significant downturn is less, and clearly capital is cheap and readily available. From a macro environment, it's conducive to M&A."

While many E&Ps have plenty of in-house inventory yet to process, others are still in a "transformative" stage and lack the same level of growth opportunities, Trauber said. In some cases, the mix of assets—oil and gas, or domestic versus international—may be preventing them from attaining what they consider an appropriate valuation, prompting companies to pursue further "rebalancing and recalibrating of their asset portfolios."

In the midstream sector, Trauber identified "a growing trend towards critical scale and mass," with companies becoming more acquisitive. After heavy corporate M&A activity last year in midstream, "midsized companies are

C-Corp Oil & Gas IPOs

Pricing Date	Issuer	Amount ($MM)
2/6/14	GeoPark	$98
1/28/14	North Atlantic Drilling	$125
1/23/14	Rice Energy	$1,050
1/16/14	EP Energy	$704
1/16/14	RSP Permian	$449
1/16/14	CHC Group	$340

Source: J.P. Morgan

"The constraint on growth for companies—the constraint on their ability to deploy capital—is in the ability to find management teams than can operate at scale."

Ralph Eads III, vice chairman, Jefferies & Co.

questioning whether they are going to be long-term survivors. Or, are they going to be viewed as bait by the larger companies, or even some of their own midsized companies that view them as the way to get bigger? They're asking themselves: 'Are we bait? Or do we have to buy?'"

For larger midstream players, where competitors have already made some acquisitions, conditions may result in "a little bit of a feeding frenzy in the race for scale," said Trauber. Those wishing to achieve greater scale may think, 'If I don't get interested in buying now, some of my top acquisition candidates may be gone. So I've got to look as well.'"

In M&A action last year, Citibank Global Markets acted as lead financial advisor to CrossTex Energy Inc. in its merger with Devon Energy Corp. "It was a great match," said Trauber. And in terms of ongoing M&A interest, "We're still seeing a high level of activity," he added.

Regarding IPOs, Trauber sees continued scope for E&Ps in high-growth basins to achieve better valuations by going public.

"Most companies with high-quality assets that have substantial development of those assets ahead of them will find a better value in the public market than in the strategic market," he said. "The buyside has become very sophisticated in analyzing development plans and arriving at a net present value based on discounted future cash flows. Strategic buyers are more likely to value assets based on a premium to acreage value, plus one or two years of cash flow growth, but are not willing to pay for a 10- or 20-year development plan. With typically limited initial cash flow, it's dilutive."

Like other observers (see April 2014 *Oil and Gas Investor*, "The Fashion Window Opens for IPOs"), Trauber expects companies launching IPOs to operate mainly in the high-growth basins of the Utica/Marcellus and the Permian. He also sees the potential for IPOs to originate from Canada's liquids-rich Montney play.

There may be additional demand for equity internationally—Trauber cites oilfield service companies offshore and Africa's E&P sector—as well as for the midstream sector as it continues the North American infrastructure buildout.

The shift to private capital

Ralph Eads III, vice chairman with Jefferies & Co., is similarly upbeat on the prospects for the energy sector in North America, and thinks private equity will play an even greater role, especially in taking early project risk.

He calls North American onshore resource development "the highest return large asset class in the world." As the better resource plays mature, "you're going to see the ability of these companies to both grow and generate free cash flow. That's never happened in our industry, except with the majors for maybe a decade when oil prices were on the rise," he said.

Eads reeled off a checklist of positives: good return on capital employed, strong topline growth, free cash flow generation. "There's nothing else like it in terms of an industrial business," he continued, "and I think it is durable." The key issue for E&Ps, in his view, is portfolio quality. "The guys with high-return portfolios are getting valued very well; and the guys with the less good portfolios are trying to figure out how to get a better portfolio. This is a world of 'haves and 'have-nots.'"

One notable change is in funding sources. "A lot of the financing activity is shifting from the public capital markets to the private market," he said. "There has been a huge shift in which private capital has become a really important component of how the industry finances itself. By my estimates, private-equity sponsors have raised roughly $50 billion of dry powder dedicated to oil and gas in the past 18 months. If you just lever that one to one, that's $100 billion of available capital dedicated to oil and gas."

Behind the move to private capital is an increased willingness to take on the aforementioned early project risk. "They've become more sophisticated.

Private capital is increasingly willing to come into an asset early in its life," he said. "Then, as the asset matures and becomes de-risked, they take it to the public market and monetize it at a profit."

The scale of private equity—especially in the context of a single company—is in some cases remarkable, as exemplified by American Energy Capital Partners, headed by Aubrey McClendon.

McClendon is putting together a series of regionally focused portfolio companies, according to Eads. Already in place are subsidiaries focused on the Utica and the Woodford shales, and two or more other regional entities are in the pipeline. He projects that the company's enterprise value will likely reach $15- to $20 billion within the next 12 months.

"That's a scale that private capital has never acted on before—to finance an E&P from startup to an activity level that could be $15- to $20 billion."

It is in operations that limits could arise in putting capital to work, Eads said.

"The constraint on growth for companies—the constraint on their ability to deploy capital—is in the ability to find management teams than can operate at scale. The industry is suffering from a significant human capital constraint that becomes more and more evident all the time. It's the biggest constraint on the rate of growth of the North American industry," he said.

Midstream capital requirements are expected to remain robust, as infrastructure buildout continues in high-growth areas like the Utica/Marcellus, and facilities are built to support liquefied natural gas (LNG) and ethane cracker projects. Funding will come as MLPs continue to tap into equity markets, and as E&Ps strike deals with private equity, such as Gulfport Energy's agreement with MarkWest Energy Partners and The Energy Minerals Group in the Utica, said Eads.

Prospects for new E&P joint ventures with "strategic" overseas partners remain on the back burner, with much of the slack being taken up by private equity as "the new joint-venture buyers," said Eads, citing names such as KKR, Blackstone Group and TPG Capital.

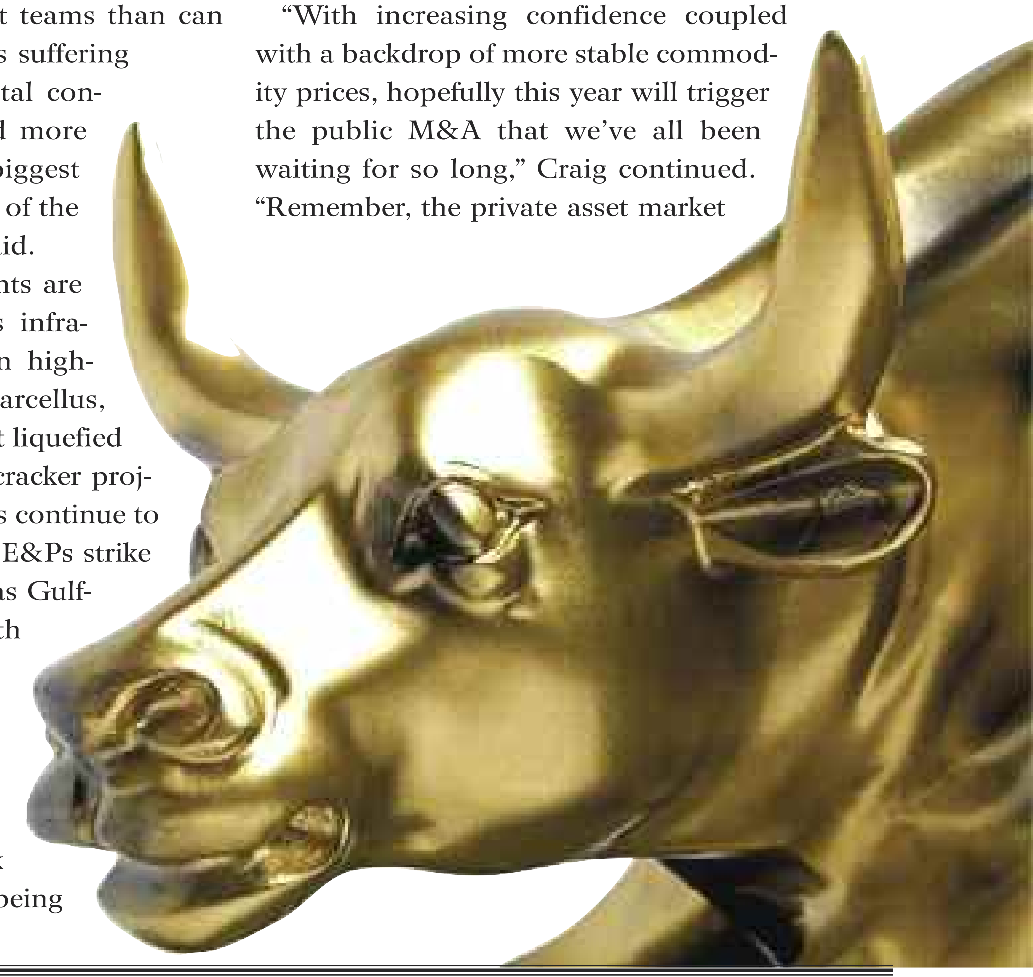
Will they pay promotes along the lines of earlier international joint ventures? Deal structures today involve "different kinds of promotes. But absolutely they will pay promotes," Eads said.

M&A uptick

Improved tone in the M&A market and "wide open" equity markets for issuers are contributing to a positive capital market outlook in energy, according to Nathan Craig, managing director in energy investment banking at J.P Morgan.

"There's been a material uptick in the amount of strategic dialogue we've been having with our clients over the past couple of years," said Craig. "Confidence is certainly up among our client CEOs, and usually that added confidence will breed an increase in M&A activity." And with commodities recently trading in a narrower range, getting buyers and sellers to agree on valuation tends to be easier, he added.

"With increasing confidence coupled with a backdrop of more stable commodity prices, hopefully this year will trigger the public M&A that we've all been waiting for so long," Craig continued. "Remember, the private asset market



has been very healthy; it is the public-to-public M&A activity that we haven't been seeing to date."

Recent asset market transactions involving J.P. Morgan include two acquisitions by Fieldwood Energy that immediately made Fieldwood a major player on the Gulf of Mexico shelf.

One, led by J.P. Morgan last September, involved a $3.625 billion loan financing package for Fieldwood's acquisition of Apache's Gulf of Mexico shelf assets. The package was comprised of three tranches: a $1.2 billion, five-year revolving credit facility; a $700 million, five-year first-lien term loan; and—in what is said to be the largest second-lien term loan ever to be raised—a seven-year, second-lien term loan of $1.725 billion.

With equity financing provided by private-equity sponsor Riverstone Holdings LLC, the transaction was remarkable in that "it was a clear demonstration of the depth of both the private-equity market and the institutional loan market," said Craig. "You marry oil and gas private equity, which seems to get larger and larger every year, with the very supportive institutional loan market fundamentals."

"IT'S REALLY ABOUT PULLING NET ASSET VALUE FORWARD. NO ONE WANTS TO HOLD THAT MUCH ACREAGE."

—***Josh Cummings,*** Johnson Rice & Co.

A second transaction was Fieldwood's $750 million purchase of Gulf of Mexico and Gulf Coast properties that the management team had previously sold to SandRidge Energy when they were with Dynamic Offshore. Also led by J.P. Morgan, the financing similarly included a second-lien term loan, which was priced at a tighter spread than that in the Apache transaction, resulting in an all-in yield of 8% versus 9.125% on the prior transaction.

In terms of equity issuance, the market is "wide open," with the upstream sector continuing to be the more active issuers, according to Craig. C-corp issuance early in the first quarter was outpacing last year's levels and included six energy IPOs totaling $2.8 billion. Meanwhile, MLP issuance came from 17 secondary offerings, totaling $5.2 billion, and was lagging behind prior-year levels.

"Confidence is certainly up among our client CEOs, and usually that added confidence will breed an increase in M&A activity."

Nathan Craig, managing director, energy investment banking, J.P. Morgan

For those E&Ps in favored basins weighing the benefits of an uplift in valuation via going public as opposed to a private sale of assets, the institutional market "likes to see pure plays that are focused on a single basin rather than a conglomerate portfolio," Craig observed. But even if you're in multiple basins, "given how supportive the IPO market is, you'd want to consider that as an option alongside M&A. And by running a dual-track process, if someone approaches you with M&A, you can always exit that way."

Improved valuations

At Johnson Rice & Co., Josh Cummings, co-head of energy investment banking, said improving capital market conditions in energy date back to first-quarter 2013, when energy in general began to find a broader institutional following.

"What really changed was seeing the long-only funds come back in and provide an underpinning of demand for the energy names, and that has allowed for substantially better execution in the capital markets. Obviously, energy stocks have performed reasonably well over the same period; it's probably been the best we've seen since the 2008 to 2009 collapse."

Improved valuations have come with better growth and improved risk-return metrics, he noted, allowing energy to attract a larger investor base.

"With the kind of growth profile people are looking for in terms of rising production, earnings and cash flow, the industry has been able to start getting pretty attractive valuations—and a pronounced period of expanded multiples—compared to where they've traded historically.

"You're not seeing the big swings from peak to trough that characterize so many cyclical industries."

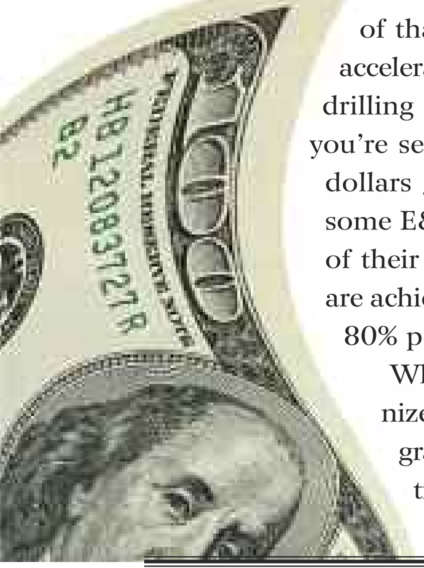
Josh Cummings, co-head, energy investment banking, Johnson Rice & Co.

"You're not seeing the big swings from peak to trough that characterize so many cyclical industries. And if there is less perception of risk—and you're still delivering good growth and returns—investors tend to worry less about timing as it relates to entering and exiting the stocks. They become 'investible' rather than simply 'trading' stocks."

The majority of Johnson Rice's client base is comprised of small/midcap energy companies. Many of its E&P clients have put together significant acreage positions in resource plays, with much of it now delineated between "core" and noncore positions. In some cases, with a small base of production and cash flow, acreage may translate into 20 to 30 years or more of inventory at current rates of drilling.

As a result, capital demand is mainly for "turning the drillbit to the right" and converting undeveloped leasehold into production, cash flow and reserves.

"It's really about pulling net asset value forward," says Cummings. "No one wants to hold that much acreage. The E&P's program has got to scale up to pull some of that present value forward by accelerating the conversion of those drilling locations. That's where you're seeing the bulk of the capital dollars go to work." He noted that some E&Ps—depending on the size of their existing base production—are achieving growth rates of 20% to 80% per year.



While institutions today recognize more widely these programs' ability to generate attractive, risked rates of return, Cummings cites Johnson Rice's early understanding of basin economics and its ability to articulate the "value proposition" of specific plays.

"We identified early on that the value proposition was a product not just of reserves, production or a multiple of Ebitda, but also a product of what an E&P could do with that unconventional acreage," said Cummings. "If we at Johnson Rice have carved out a niche, it's that we've been able to execute public equity offerings for early-stage companies that don't have much of a tangible metric today, but that we see developing one in the future."

With private equity abundant, is it competing with more traditional capital sources in markets serving small/midcap E&Ps? For a lot of private-equity sponsors, the model that's worked "extremely well" for them is to start with a management team and a clean slate, and "they don't want to be cluttered with legacy assets," said Cummings. "For a private company that already has a set of legacy assets, the valuation discussion can become a little harder for private-equity sponsors who would prefer to build out an initial position of their own and get an uplift in value."

How do financiers' projections for the current year compare with last year?

"We expect to be extremely active for the remainder of the year," said Cummings. "From where we sit today, I would expect it to be similar to last year."

Gray concurs. "Based on our pipeline of business so far, it looks like another robust, record-setting year, similar to 2013."

And as with other market participants, even as Citi's energy investment-banking group business in mid-April was outpacing the prior year's level, projections are for full-year performance to be "similar to last year." Partly, this reflects a natural conservatism early in the year. "It's a very, very robust environment," said Trauber. "Year over year we're up, but anything can happen in the back half of the year."

But actions also tell a story. Citi is actively hiring more energy bankers to accommodate rapidly rising levels of business.

"Activity continues to be extraordinarily robust," Trauber said. "The level is at a feverish pitch. It's never been busier." ■

FIXED INCOME FAVOR

A broad range of energy companies has stepped up to the new issue market.

By Chris Sheehan, CFA

Energy continues to find favor in fixed income markets, where the recent low interest rate policies of the Federal Reserve coupled with near-record low credit spreads foreshadow what could be another very robust year of issuance by the oil and gas sector.

Despite earlier fears of rising rates as the Fed "tapers" its bond purchase program, the interest rate environment has remained attractive, with the 10-year U.S. Treasury note yielding 2.72% at the end of the first quarter. This puts the 10-year rate in the lowest fifth percentile over the past 15 years, while credit spreads are at the lowest level since the financial crisis, according to Barclays data.

Issuers have not been slow to take advantage of the low interest rates. The new issue market has seen a broad range of companies—including major oil companies, midstream players, independent E&Ps and others—step up to the plate. Notably, even Exxon is reported to have placed a $5.5 billion issue, marking its return to the market after a 21-year hiatus.

Market participants note exceptionally strong issuance in this year's first quarter by the investment grade oil and gas sector. Through March, issuance by North American and international companies came to $21 billion, with a further $15 billion placed by emerging market issuers. Across all economic sectors, new issuance was also unusually high, outweighing first-quarter redemptions by a ratio of more than 1.5 to 1, according to Barclays research.

But issuance by the oil and gas sector extends much more widely than just to investment grade issuers. And in large part, this reflects investors' growing understanding of individual basins in resource plays, as well as their comfort with the sector as a "safe haven with yield," said Greg Hall, who heads up natural resources debt capital markets at Barclays.

"Investors are very bullish on the oil and gas industry at the moment. This is an industry where a lot of investors feel they understand what is going on in the Bakken, Eagle Ford and Marcellus, among others," said Hall. "They view oil and gas as a safe place to invest. You're talking about buying bonds backed by cash flows from hard assets in the ground, and that has an appeal to a lot of people."

The fact that energy issuance offers investors a chance to buy nonfinancial paper—in relatively short supply as compared to financial issuance—is also working in the sector's favor.

"There hasn't been as much nonfinancial paper as investors would like to buy," explained Hall. "As a result, investors will pay a slight premium. And that is one reason why we're back to credit spreads that are close to pre-crisis tights. Investors feel like they can get their arms around oil and gas plays, and they have a high degree of confidence that the debt will be repaid."

While interest rates were expected to trend upward as the Fed began its program of tapering, rates have been slow to move higher. Hall cites weather-related temporary weakness in the economy as well as a flight to safety due to geopolitical factors, notably in the Ukraine, as factors tending to hold rates down in the first quarter.

In addition, Hall noted the "strong technical backdrop in the new issue market," where a significant amount of bonds are due to mature in the first half of 2014 across the entire investment grade market. "This means investors are receiving a lot of cash, and they are incented to quickly redeploy this capital in the new issue market."

This partly explains why interest rates remained acquiescent in the first quarter—and why investment grade issuance across all economic sectors hit a record level of $292 billion.

"Because you had so much debt maturing in the first quarter—a lot of it five-year paper issued post-crisis in the first quarter of 2009—you had an incredible technical backdrop of money flowing into the coffers of investors," recalled Hall. "That, coupled with a weak economic backdrop and the concern over the Ukraine, added up to almost a perfect storm and continued to hold coupons down."

However, low interest rates are not expected to last for long. Barclays anticipates an "upward drift" in rates as the tapering program approaches completion in October of this year, and predicts the Fed will likely begin tightening around the middle of 2015. Barclays' rate forecast is for the yield on the 10-year U.S. Treasury note to rise to 3.40% by the end of 2014.

Locking in

Who has turned to the debt markets to lock in low rates of late?

In the first quarter, the midstream sector saw significant new supply, with about $10 billion in issuance, as master limited partnerships (MLPs) met refinancing needs and planned for heavy capital expenditures on infrastructure projects. At $10 billion at the end of the first quarter, midstream accounted for just under half of energy investment grade issuance.

Among the larger deals by MLPs were those by Enterprise Product Partners ($2 billion), Kinder Morgan Energy Partners ($1.5 billion) and EnLink Midstream Partners. EnLink Midstream, combining the assets of CrossTex Energy with substantially all the U.S. midstream assets of Devon Energy, placed a $1.2 billion inaugural investment grade issue.

Hall described Enterprise and Kinder Morgan as "bellwether issuers" who perceived rates to be lower than anticipated and, with fixed income markets "wide open," chose to come to market.

Also coming to market in the first quarter were several major international oil companies. Notable were issues by Total ($2.5 billion), Petrobras ($8.5 billion) and Pemex ($4 billion).

With oil and gas investment grade issuance in the first quarter already running at twice prior year levels, how will the balance of the year unfold?

Hall allows for a possible slackening from the current "breakneck pace" resulting from issuers' desire to act preemptively ahead of potentially rising rates and widening spreads.

"We expect issuance for the remainder of 2014 to be robust, as the debt market is likely to remain attractive. But, to some extent, we've probably seen some frontloading in terms of 2014 issuance."

Hall identified two "wild cards" that could influence the course of events in coming months: potential merger and acquisition activity and, additionally, shareholder activism.

"We've certainly seen a pickup in M&A activity," said Hall. "There's a high expectation out there that there will be some consolidation, especially in the midstream, much of which would be financed with long-term debt." ■

PRIVATE EQUITY DIVERSIFIES

The shale bonanza means energy has become structurally short capital.

By Gregory DL Morris

For all the new private-equity funds and investors—and the billions of dollars pouring into the oil and gas sector—energy is actually underweighted in the PE universe.

That assertion comes from one of the most experienced managers in the business, Alex Krueger, president of First Reserve Corp., an energy-only firm with more than 30 years' experience and $20 billion in assets under management. Reflecting on the growing presence of the big diversified houses with funds dedicated to energy, as well as the proliferation of boutique managers, he notes that PE is under-represented in energy investing just as energy is under-represented across private equity.

"Given the inflation in capital expenditures and operating expenditures in energy—levels have been in the high single digits or low double digits for several years—the need for capital continues to grow faster than the influx of investment. That is true even with the new funds from some major firms, and the new entrants at all levels."

First Reserve is doing its best to address both situations, with 80% of its assets in a series of funds that focus on buyout opportunities up and down the energy sector from exploration and production to midstream, downstream, equipment and services. Separately, 20% of the assets are focused on an energy infrastructure strategy that is playing out from its first such fund, focusing on long-term cash flow generators such as contracted pipelines, but also power, utility, renewables and even floating offshore production units.

Keynote companies that First Reserve has helped build in the past include such blue-chip names as National Oilwell Varco, Weatherford and Dresser-Rand.

"We like the idea of oil and gas evolving into more of a manufacturing process."

Alex Krueger, president, First Reserve Corp.

"Most of our growth has been in identifying long-term sustainable trends," said Krueger. "Of the more than 100 portfolio companies we've had, we have made over 375 add-on transactions. In exploration and production the opportunities continue to evolve as technologies are applied in new areas." He said those include the most advanced unconventional horizontal drilling and completion techniques applied to conventional vertical wells, or even enhanced recovery methods.

That approach extends to equipment and services. "Most of our investments are production related, ways of making drilling and completion more efficient," said Krueger.

"We like the idea of oil and gas evolving into more of a manufacturing process. We like to see technology applied up front for most efficient drilling and completion, then again for re-entry or enhanced recovery. That is more effective than looking for geology to overcome operating inefficiencies."

Beyond the cool factor

Apollo Global Management is one of the largest alternative investment managers in the world, and it just closed Fund VIII at the end of 2013 with $18.4 billion of aggregate commitments, of which up to approximately 20% may be dedicated to the energy sector. According to Greg Beard, senior partner and head of natural resources at Apollo, in that allocation, the big firm is sticking to its proven formula.

Fund VII (raised in 2008 with $14.7 billion), also allocated about a fifth of its capital to natural resources. In addition to its flagship private-equity funds, the firm also operates Apollo Natural Resource Partners (ANRP), which focuses on equity commitments of generally $150 million and less; it may also co-invest in some transactions alongside Apollo's larger private-equity funds. ANRP closed on $1.3 billion of incoming commitments in 2012, more than half of which has been committed to operating companies so far.

With Apollo's size and experience, it could shoot for the moon, but Beard said it retains a strong conservative foundation and keeps a consistent value bias in its upstream commitments. That hardly means being unadventurous, however. Indeed, given the valuations for acreage and operators in some of the hottest basins, value investors almost have to venture a little farther afield.

Most recently, Apollo-backed Caelus Energy Alaska closed its first transaction, the acquisition of Pioneer Natural Resources' Alaskan oil and gas business for $300 million in cash, subject to adjustments, plus other consideration. Caelus, based in Dallas, is led by CEO James C. Musselmam, who previously led Kosmos Energy, which discovered the 1 billion-plus barrel Jubilee Field off the West African coast; and Triton Energy, which was acquired by Amerada Hess for $3.2 billion. Apollo funds have the opportunity to invest up to $1 billion in Caelus in aggregate.

Beard emphasizes Apollo's equanimity through the first rush of the unconventional era.

"The 'cool' factor never really impressed us. We are much more interested in rate of return. Up to as recently as three or four years ago, we had significant investments in vertical development in the Permian, for example. Now most of our capital is going into horizontal developments, because we believe they will generate better returns. But if the resource boom had never come along, we believe we would have been doing fine drilling vertical wells in the Midland Basin."

Apollo was also not overly impressed in the early days of shale, when operators seemed to tout

"The 'cool' factor never really impressed us. We are much more interested in rate of return."

Greg Beard, head of natural resources, Apollo Global Management how much they spent on wells. That trend has reversed, and Beard is encouraged. "Industry is doing a good job now of finding ways of being more efficient, reducing costs per barrel or Mcf."

Which is not to say that industry, or PE backers, are spending less overall. "As an industry, we are going to be spending hundreds of billions of dollars drilling shale," said Beard. "Given the drilling inventories that upstream participants have, they are not keen to spend on infrastructure. Instead, they believe they need to put their dollars into the drillbit."

That opens other opportunities for midstream operators and the PE funds that specialize in that segment. The emphasis upstream on efficiency and focus continues to stoke the acquisition and divestiture market. "Last year the upstream A&D market was approximately $50 billion, and we believe that is likely to continue, maybe even grow," said Beard.

Returning to the theme of value, Beard notes "a big disparity between the high-growth operations that may carry valuations of 15x EBITDA, and others that can run as low as 4x. Clearly it appears the market is favoring focused players with fewer, more concentrated operations over ones with exposure to multiple basins."

"Execution, however, is what sets great teams apart from good teams… ."

Danny Weingeist, managing partner, Kayne Anderson Energy Funds

Gone to Texas

This spring marked one important closing and one even bigger opening for Pine Brook, a $5-billion private-equity firm specializing in energy and financial services. In February it closed Fund II at $2.435 billion, well above the target of $2 billion. Then late in April, the New York firm opened a major office in Houston.

Pine Brook's Houston team will support the firm's investments in the region, including

Common Resources III, Green Bancorp, GR Energy Services, Community Trust Financial and Stonegate Production. The office will be staffed by Michael McMahon, a founding partner and managing director of the firm; senior advisors Richard Stoneburner and Martin Houston; and Claire Harvey, a vice president on the energy investment team.

"The PE market in general is reacting to a very large and very attractive opportunity in oil and gas," said Rich Aube, managing director of Pine Brook's energy investment team. "From a capital standpoint, the industry has changed completely. It used to be a source of capital. Operators were long cash and short investment opportunities. Now that has been reversed."

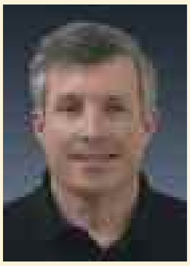
Since inception in 2006, Pine Brook has formed 29 companies, 16 in the energy sector. The majority have been upstream, primarily in North America. The firm has also formed two services companies that were created by the emergence of resource plays. Brigham Exploration, Elevation Resources and GR Energy Services represent three recent investments. Brigham and Elevation are primarily acquire-and-develop operators while GR is a services company. Pine Brook's investment professionals have led some notable investments over the course of their careers including the IPOs of Antero Resources, Bill Barrett Corp., Kosmos Energy, Newfield Exploration and Targa Resources.

"Downhole completion and production services are two specific areas in services that look compelling to us," said Aube. "In more recent years, we've formed companies that are active in development opportunities as the industry has become long inventory and short capital, particularly in the Permian Basin. We have also started to take our business internationally. Some of the best rocks in unconventional plays are actually outside of North America, particularly in South America, and we have an asset we are pursuing in Colombia."

Pine Brook is also looking north. "Canada is also an excellent spot and a major focus of attention," said Aube. "Capital markets have been insufficient for providing the amount of support required to develop the plays in Canada. Just as in the U.S., there is an unconventional resource revolution in western Canada with many historically productive plays being rejuvenated by the application of the new technologies.

"So, we're going into Canada with private-equity capital know-how and with strong management teams as partners. So far, we have completed two investments in Canada, both of which are in our latest fund. One of the investments is focused on liquids-rich gas plays and the other is focused on thermal heavy oil."

Across all asset types and geographies Aube has observed "a heightened sophistication by investors about what is being produced by which operators in which plays." As evidence, he notes that an increasing number of producers have adopted three-stream reporting to detail exactly their liftings in crude, NGLs and gas, rather than lumping production into one BOE or Mcfe number.



"We are still of the view that gas is range-bound."

Peter Leidel, principal, Yorktown Partners

The year of execution

More than a few operators have referred to 2014 and into 2015 as "the year of execution," having delineated their acreage and set their drilling budgets. For Kayne Anderson Energy Funds, this year and next are looking like "the year of realizations," said Danny Weingeist, managing partner.

"Fund VI, which closed in 2012, is almost fully committed, so we will probably be launching Fund VII early next year, but otherwise, we are mostly looking at realizations." Kayne Anderson Capital Advisors has about $26 billion in total assets under management with about $22 billion of that in energy.

Of the 16 management teams Kayne has backed in Fund VI, approximately half are repeat teams.

"Also, about half of these teams are lease-and-drill, while the other half are acquire-and-exploit," Weingeist said. "It used to be that a team could lease acreage, delineate the asset by drilling 10 to 20 wells and then sell. Now, most buyers already have large inventories of drilling opportunities, so in order to interest them, our teams need to further de-risk the asset, which may mean drilling 60 to even 100 wells."

This trend means some additional capital and potentially longer hold periods. "Technically, yes, there is some risk any time you are holding an asset longer—there is asset risk and commodity risk. The first 20 wells are the riskiest. Once you have figured out how to drill the wells, complete the wells and are comfortable with your reserve estimates and economics, the asset risk is reduced.

"If you have to drill four times as many wells that doesn't mean four times as much equity will be required. It could be that only twice as much equity is needed. In drilling these additional wells, there is less asset risk but more market or commodity risk."

Looking ahead to Fund VII, Weingeist does not anticipate Kayne changing its M.O. much. "We've been very fortunate to have backed good teams. That has made our teams and our investors money. We've also been very fortunate that we've seen good deal flow over the years. Execution, however, is what sets great teams apart from good teams and good teams apart from mediocre teams. One way to mitigate execution risk is to back teams that are experts in specific basins.

"We love the idea of backing the number two or three guy from one of the district offices of a large independent, who on day one has a team he has worked with for years. That team will know that basin exceptionally well and be able to optimize that acreage into something that will be very attractive to potential buyers."

A solid position in one area is almost exclusively onshore for Kayne. "You never say never, but offshore is about as close to never as we are going to get. We

"We are almost all unconventional with a bias toward liquids."

Chris Manning, energy partner, Trilantic Capital Partners

want to know, before we are in too deep, what sort of an asset we have and you simply can't do that offshore. That most likely means Texas, the Midcontinent, the Rockies, Louisiana and the Gulf Coast."

Dry powder for liquids plays

It may be difficult to remember that the sector was not always a darling of PE managers or investors. One of the early pioneers was Yorktown Partners, based in New York and co-founded by Bryan Lawrence, Howard Keenan, Peter Leidel and Tom LaCosta. The firm has $4 billion in assets under management, all in energy. That is primary upstream, with some midstream "and a piece of coal," according to Leidel.

Usually the most impressive number for a PE fund is its total assets, but for Yorktown's latest, it is the ordinal: Fund X was raised in May 2013 with $1.6 billion, of which almost a quarter has been committed. Yorktown works on a two, or two and a half year, cycle, which gives a good idea of how long Leidel and his team have been in the game. Fund IX was closed in October 2010 with $1.272 billion, of which more than 90% has been invested. "We still have a bit of powder in that fund," he noted dryly.

The long cycle time is certainly not for lack of opportunity. Quite to the contrary it is a mark of discipline, he said.

"We have tried to maintain consistent focus and strategy, and to back good management teams. We were early entrants to most of the major shale plays, but to enter established basins today would be very expensive from the perspective of either acreage or production."

The recent focus for Yorktown has been upstream, where existing vertical developments are shifting to horizontal drilling. That does not nec-

Across all asset types and geographies, **Pine Brook managing director Rich Aube** has observed "a heightened sophistication by investors about what is being produced by which operators in which plays."

essarily have to be unconventional development strictly speaking, just "applying horizontal techniques to established fields," explained Leidel.

The other sector of interest is the midstream, but not gas E&P. "We have not yet recommitted to gas," Leidel said. "We are still of the view that gas is range-bound in the $4- to $5 per Mcf band, which is just not that attractive in most basins." Regardless of the asset or opportunity, Yorktown, like many PE firms, prefers to back just one upstream and one midstream operator in each basin; more that one is possible in larger geographies such as the Permian.

Unconventional

Trilantic Capital Partners closed its fifth institutional fund, Fund V North America, in December 2013 with $2.2 billion. "We still have fresh capital available for commitments," said Chris Manning, energy partner. Trilantic allocates capital from its fund into four distinct sectors: energy, business services, consumer and financial services. No more than one third is in any one area.

The energy allocation of Fund IV was approximately 25% to 30% out of a pool of $1.9 billion that was closed in 2007. Notable names that Trilantic has backed include Antero Resources, Enduring Resources and TLP Energy.

"We are almost all unconventional," said Manning, "with a bias toward liquids. We are very focused on not exposing capital to multiple teams in the same basin. That was the strategy when we started, and is still the strategy today: bias toward liquids one team per basin."

The bias is just that, a preference, not a prohibition. "Capital needs to identify attractive risk-reward opportunities," he said. "If we can find an all-black-oil opportunity, great. But some combination of oil, liquids, and gas can be attractive as well."

Manning explained that the bias is not just from Trilantic, but also from the market. "Buyers prefer easier rather than harder," he said. "There is always the diversification argument, the upside argument, but in deals we see buyers going for simple rather than more complex. People want something targeted, often to fill a specific need in their portfolio." ■

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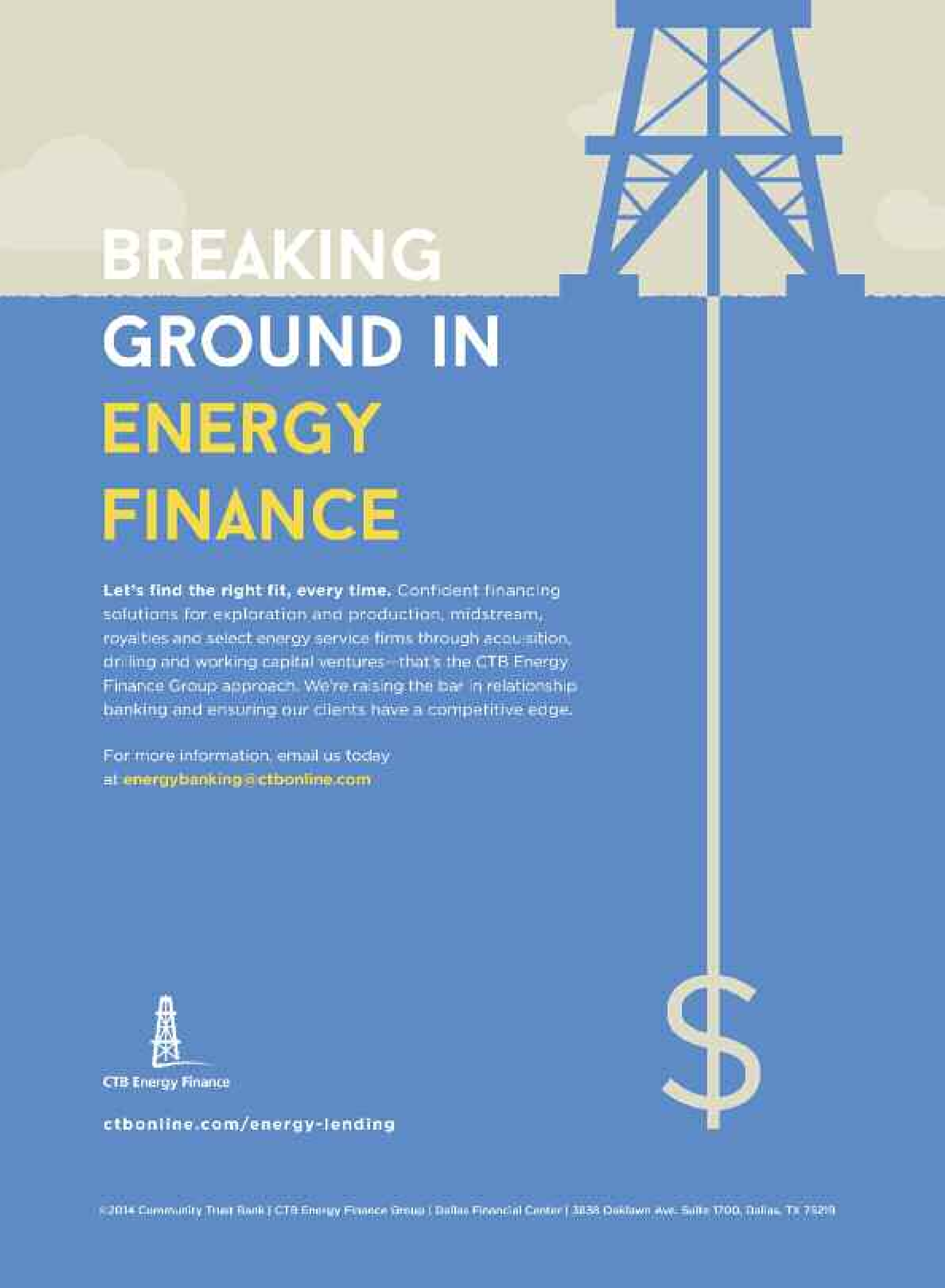
ATHLON ENERGY $515 Million Follow-on Equity Offering Co-Manager February 2014	RSP PERMIAN $449 Million Initial Public Offering Co-Manager January 2014	GULFPORT ENERGY CORPORATION $424 Million Follow-on Equity Offering Co-Manager November 2013	DIAMONDBACK Energy $123 Million Follow-on Equity Offering Co-Manager November 2013
GOODRICH PETROLEUM CORPORATION $174 Million Follow-on Equity Offering Co-Manager October 2013	SANCHEZ ENERGY CORPORATION $254 Million Follow-on Equity Offering Co-Manager September 2013	OASIS PETROLEUM $1 Billion Senior Notes Offering Co-Manager September 2013	plymouth petroleum has completed its sale of certain assets in the Midland Basin to an Undisclosed Buyer Undisclosed September 2013
TRIANGLE PETROLEUM CORPORATION $82 Million Private Placement Of Common Stock Sole Placement Agent August 2013	TRIANGLE PETROLEUM CORPORATION $108 Million Follow-on Equity Offering August 2013	DIAMONDBACK Energy $185 Million Follow-on Equity Offering Co-Manager August 2013	Rosetta RESOURCES $342 Million Follow-on Equity Offering Co-Manager April 2013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BULLISH ON BARRELS

At the smaller end of the capital-markets spectrum, raising capital becomes a team sport.

By Carl Goltermann and Adam Connors, *Northland Securities*

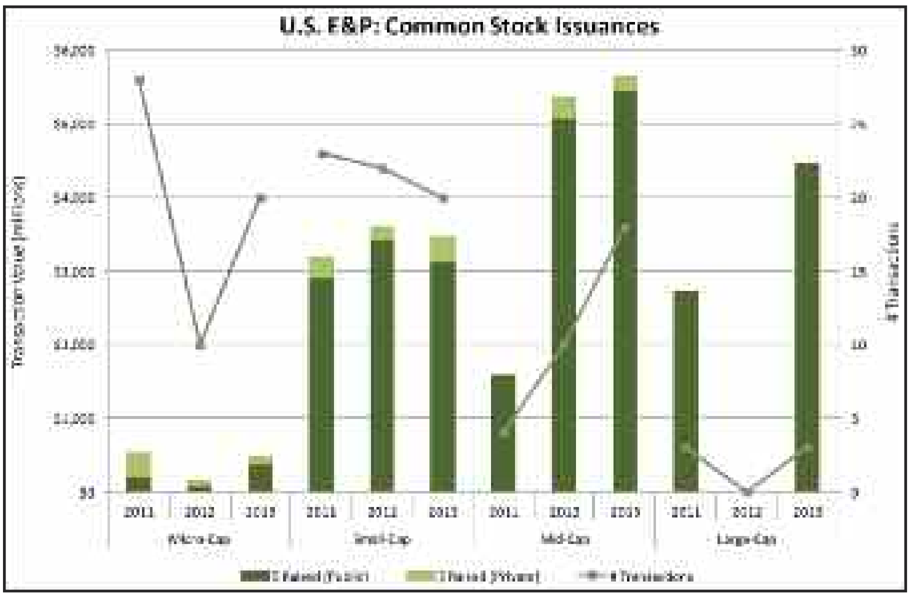
As the macro economy continues to lift itself out of the doldrums of the worst economic crisis since the Great Depression, a continued bright spot is the momentous shift toward energy independence here in the United States. Much of the progress can be traced back to the relatively recent advent of engineering hydrocarbons out of the ground via unconventional extraction methods. As typical with engineering business models, a theory was developed, tested for effectiveness and feasible economics, and then rolled out in mass production when all litmus tests were met.

The U.S. E&P industry has been going through this transformation for the last few years within multiple basins. Many E&P companies have proven their models and moved into mass production by demonstrating their ability to multiply an investor's dollar via interest payments or equity appreciation.

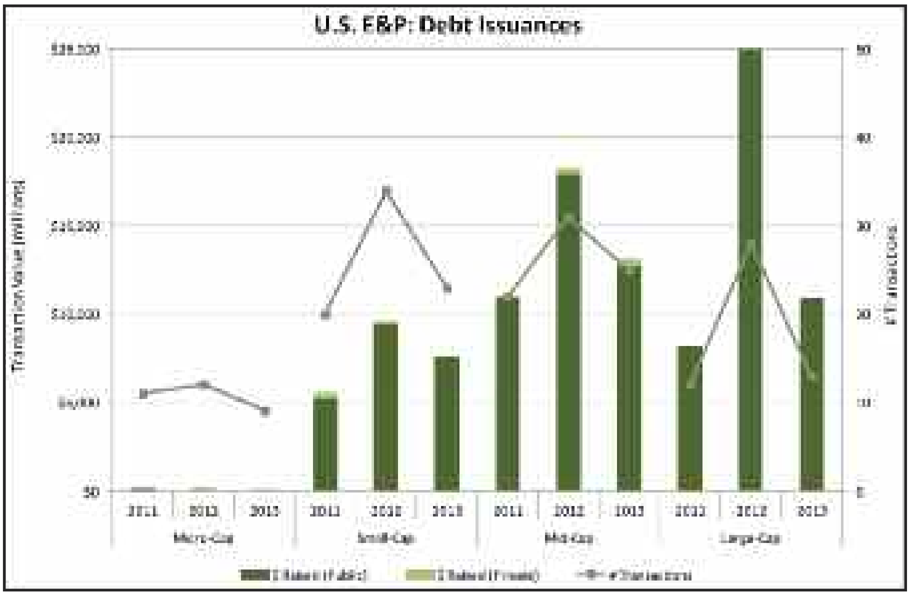
In order to identify the latest trends in the flow of capital and see where companies of different sizes have had success garnering investors' attention, we separated capital issuances during 2011-2013 into common stock, preferred stock and debentures, as well as by market capitalization. Following investor demand over the last few years has been a great demonstration of the capitalistic engine, with none more centric than the young, nimble small-cap enterprises that have established a new or enhanced method of extracting hydrocarbons from the ground and raising more than their share of capital.

The following definitions are used throughout this article: micro-cap is a company whose market capitalization is less than $250 million; small-cap is less than $2 billion; mid-cap is less than $10 billion, and large-cap is any company whose market cap is greater than that. Public issuances include S-1 or S-3 filings with the SEC. Private issuances include private investment in public equity (the so-called PIPE structure), the Rule 144A offering, the Registered Direct Offering, or the Confidentially Marketed Public Offering (CMPO).

From 2011 to 2013, we saw a decline in the number of small-cap common stock issuances, while mid-cap issuances steadily increased, mainly because small-caps were the fastest companies to outgrow their market capitalization group. Some 31% of the capital raised by mid-caps in 2013, and 18% in 2012, was by companies that had raised capital as a small-cap the prior year.



Part of the decline in the number of small-caps raising money was offset by five IPOs in 2011 and three in 2012. While we did not see the same shift of companies from micro-cap to small-cap, one of the large-cap



issuances in 2013 was by Cobalt International Energy, which had raised money as a mid-cap in 2012.

Not surprisingly, micro-cap companies have had the most difficult time raising equity capital. They tend to be unknown to the Street, have little to no research coverage, typically lack readily registered shares due to SEC or other securities law constraints, and are often not listed on a national exchange.

Going from a micro-cap to a small-cap and beyond tends to be a very team-oriented sport, as many in-house resources available to their larger peers are not available to the more entrepreneurial micro-caps. Successful micro-cap companies require aligned partners, such as legal counsel, investor relations experts and investment bankers, to "sponsor" them and help hone their story, determine the most appropriate sources of capital, and begin to introduce them to the fundamental investors who will be accretive to their growth story. Without this sponsorship, micro-cap companies have a difficult time increasing their size at the same rate as their larger, more established peers, and are often left questioning the enormous cost of being an SEC-reporting public company.

In conjunction with the activity by corporate issuers, it was also interesting to see the large number of E&P master limited partnership (MLP) issuers over the past three years. MLPs made up 34%, 47% and 31% of small-cap transaction value and 50%, 49% and 39% of mid-cap transaction value in 2011, 2012 and 2013 respectively. There were several MLP debt issuances during this period as well, but not nearly as high of a percentage of capital raised as on the equity side.

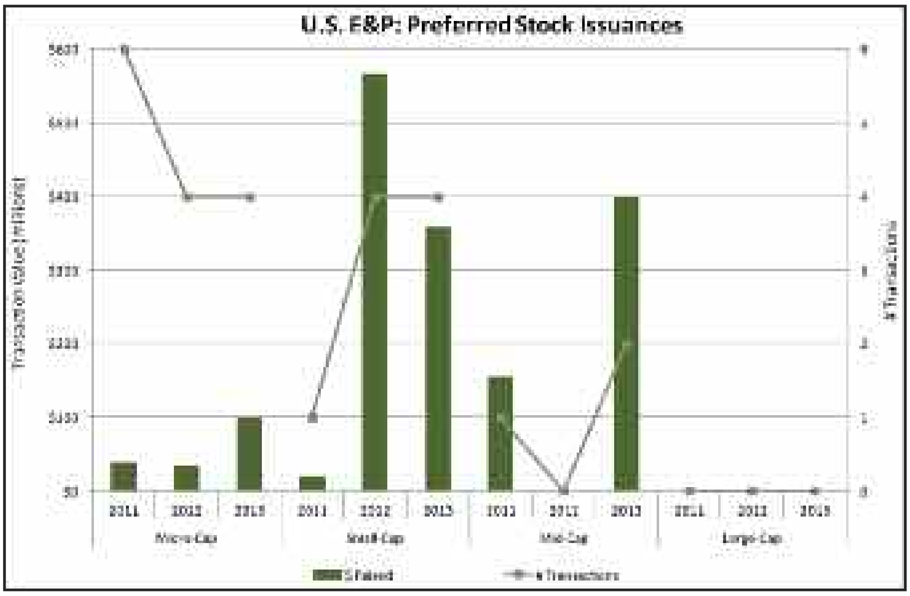
ANOTHER CONSEQUENCE OF THIS LOW INTEREST RATE ENVIRONMENT IS THAT INVESTORS HUNGRY FOR HIGHER YIELDS ARE LOOKING BEYOND INVESTMENT-GRADE DEBT TO EITHER JUNK BONDS OR PREFERRED STOCK.

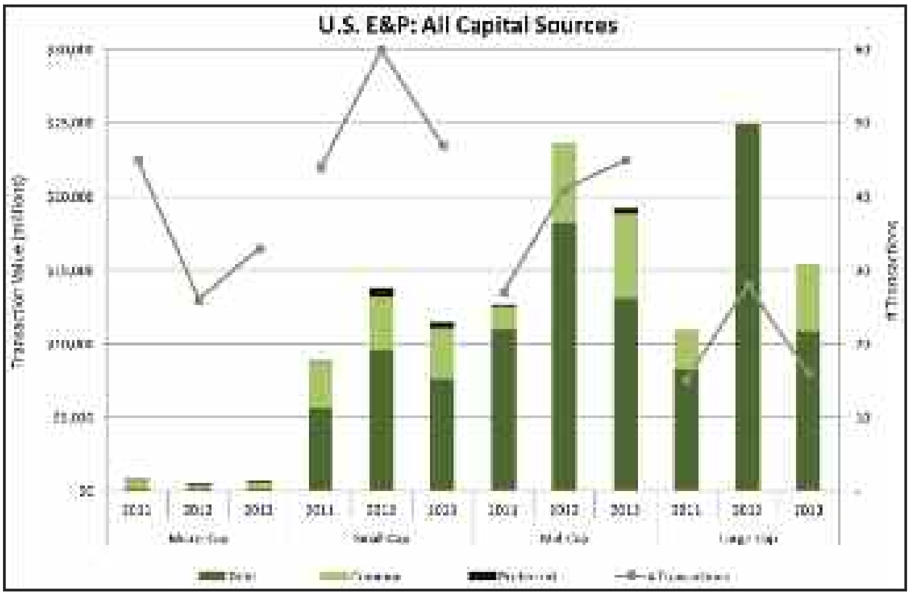
Debt

Debt usually has the lowest cost of capital for growing enterprises, but rarely has it been as low as it has been over the past three years. With interest rates being artificially held down by the Federal Reserve Bank to stimulate growth and increase lending, it is not surprising that corporate debt financing is being utilized by one of the more profitable industries—oil and gas.

New issuances of debt experienced a significant ramp in 2012, a year in which the rate on the 10-year Treasury never went above 2.37%. Each E&P market capitalization group experienced an increase in both the number of issuances and the total capital raised via debt securities.

The debt market also had a strong year in 2013, especially considering the rate on the 10-year Treasury rapidly increased from 1.63% to 2.59% between April and June. Until the Federal Reserve increases the Federal Funds Rate to a more normal level, or commodity prices fall enough to challenge the viability of using leverage,





debt will continue to be the logical source of capital, especially among larger companies. The low issuance cost and overall cost of capital is too attractive to be ignored.

Preferred stock

Another consequence of this low interest rate environment is that investors hungry for higher yields are looking beyond investment-grade debt to either junk bonds or preferred stock. From an E&P issuer's perspective, preferred stock has a few advantages over similar-yielding junk bonds: it can be structured as perpetual in nature, is unsecured, has lighter covenants, and often does not carry a penalty for missing a payment.

Like debt, preferred stock can also have a call, floating rate, and/or conversion feature, providing ample flexibility.

Preferred stock issuances tend to be much more of a retail-oriented product, resulting in smaller transaction sizes in the $5- to $50-million range, on average. Smaller companies are therefore more apt to issue preferred stock, with micro-caps having preferred stock issuances comprise 5%, 9% and 14% of total capital raised in 2011, 2012 and 2013, respectively. However, small-caps have been the most successful with the preferred structure from the perspective of total capital raised, with over $900 million sold by issuers from 2011 to 2013.

Going forward, the energy space, especially domestically, will continue to require inordinate amounts of capital to continue the shift toward a more self-reliant nation. The engineering model in the oil and gas space is one where the exploration risk is removed and it becomes a matter of determining the most effective drilling and completion methods, evolving these methods to reduce costs, and then manufacturing the play as efficiently as possible. Those that can demonstrate this, on the scale to attract institutional quantities of capital, continue to have access to seemingly unlimited growth capital to fuel their future. ■

Sources: FactSet Research Systems, PlacementTracker. This is not a recommendation to buy or sell any products discussed in this article. The opinions expressed in this article are those of the authors, they may change without notice, and they do not reflect the opinion of Northland Securities Inc., member FINRA/SIPC.

A PREFERRED OPTION FOR MLPS

Issuing preferred equity offers a "third financing tool" to MLPs.

By Chris Sheehan, CFA

Reminding CFOs that there's a "third option besides just debt and common equity" is how Seth Appel, co-head of energy investment banking at MLV & Co., often presents the idea of a preferred equity issuance by a master limited partnership (MLP). Of late, more energy MLPs have been acting on the idea, with some $351 million of preferred equity issued in early 2014 and more on the way.

Perhaps the most notable example of this "third financing tool" used by an MLP was Vanguard Natural Resources' issuance of $175 million in preferred shares in March of this year, carrying a 7.625% dividend at issuance. This was effectively an endorsement by Vanguard, which last June raised some $63 million, with a 7.875% dividend, in what was the inaugural issue by an MLP of a nonconvertible perpetual preferred.

"Once Vanguard did its $175 million follow-on offering, then everybody realized you could do this in size," said Appel.

Closely following Vanguard's move was midstream MLP Atlas Pipeline Partners, which issued $126 million, and upstream MLP Legacy Reserves LP, which issued $50 million, in preferred. Notably, the Legacy issue incorporates an innovative "fixed-to-floating rate" feature. The preferred issue pays a distribution of 8% of par value per annum through April 2024; it then moves to a floating rate equal to three-month Libor plus a spread of 5.24% per annum.

What are some of the market factors driving the rising popularity of preferred issues as a new asset class, or pool of capital, for MLPs?

First, of course, is the Federal Reserve policy of holding down interest rates, under which five-year certificates of deposit barely yield 80 basis points, while the rate on the 10-year U.S. Treasury note has hovered around 2.65% to 2.75% of late. This has fostered demand for alternative yield vehicles among both retail and institutional investors.

Why offer a preferred instrument in an MLP when the underlying common unit already offers a healthy yield and, moreover, potential upside from gradually rising distributions over time?

"People tend to assume that the common units themselves should be adequate to satiate the retail investor demand," said Appel. "But the preferred is not a proxy for the common units. The preferred is a proxy for the underlying senior debt that the retail investor can't readily access."

Appel cites several obstacles facing retail investors trying to transact in the corporate bond market. Not only is the market "not very transparent," but it also trades in $1,000 increments with "extremely wide" spreads. "For the retail investor, buying a debt instrument directly is very difficult."

By contrast, the preferred units offered by MLPs typically trade in $25 increments and, more like a stock, are relatively easily transacted and monitored on an exchange. "Importantly, it gives the retail investor an ability to invest in what they view as the debt of an MLP," observed Appel.

For issuers, preferreds have the advantage of providing a less expensive cost of capital, while avoiding issues of dilution and pressure to grow distributions on the common units. For example, both Vanguard and Legacy Reserves raised money through preferred issues at yields that were approximately 80 basis points and 135 basis points lower, respectively, than the yields on their respective common units at the time of issue. And with more than $175 billion of debt and equity issued by MLPs in the past three years, the preferred offers the MLP CFO a new pool of capital to access.

As with Legacy Reserves, the possibility of issuing a preferred to raise an amount smaller than $250 million—the size typically necessary to

"Importantly, it [preferred units] gives the retail investor an ability to invest in what they view as the debt of an MLP."

Seth Appel, co-head of energy investment banking, MLV & Co.

attract institutional interest in a high yield offering—can be an advantage in terms of flexibility. Also worth noting is the practice of the rating agencies generally to consider a preferred of this type as equity (50% equity by S&P; 100% by Moody's).

Relative to their respective debt yields, Vanguard's latest preferred issuance and the subsequent preferred deal by Legacy Reserves were priced at about 130 basis points and 140 basis points, respectively, over levels prevailing for their senior notes.

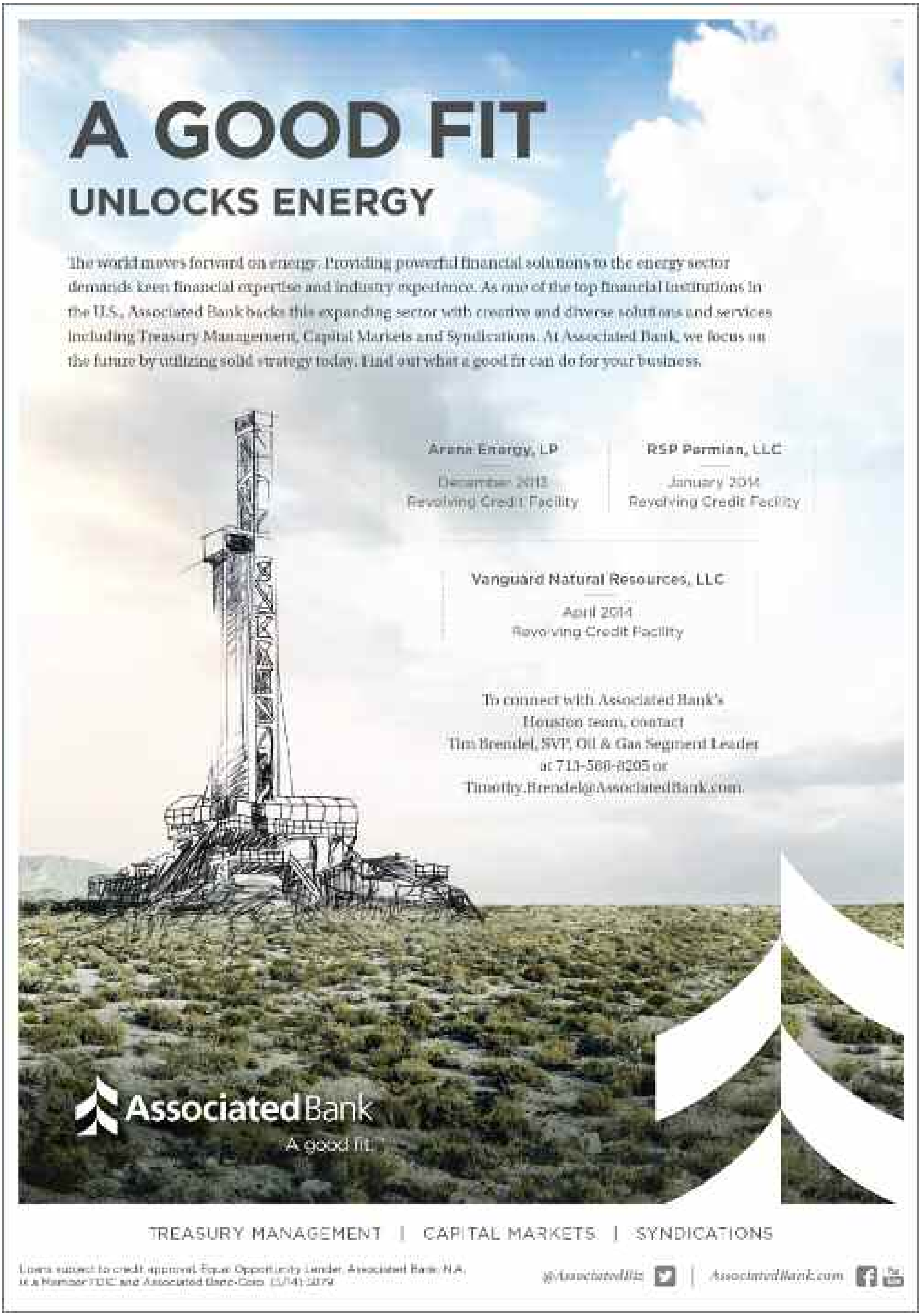
For an investor in an MLP's preferred issue, the latter's structural seniority to the common unit typically offers a considerable margin of comfort.

"In the MLP space, it's all about the distribution and yield. MLPs will do anything they can to avoid cutting the distribution," said Appel. And using the example of Vanguard, which pays out about $200 million in distributions to common unit holders annually, "you can't pay out a penny of the common unit distributions until the preferred distributions are paid. So you have a nice $200 million insurance policy."

Why add the "fixed-to-floating rate" feature in the Legacy Reserves preferred offering?

"Fixed-to-floating is there to provide protection in an increasing interest rate environment," Appel stated. "Generally, when you go from a fixed to floating, it serves to protect the underlying price of the preferred, because it will eventually revert to being a floating instrument. Every three months it's going to reset. That means, all things being equal relative to spreads and credit quality, you're basically protecting that $25 liquidation preference."

Appel recalls when the common wisdom was that the retail investor would show little interest in a preferred. But with that demonstrably proven otherwise, "it's definitely catching fire now," he said. ■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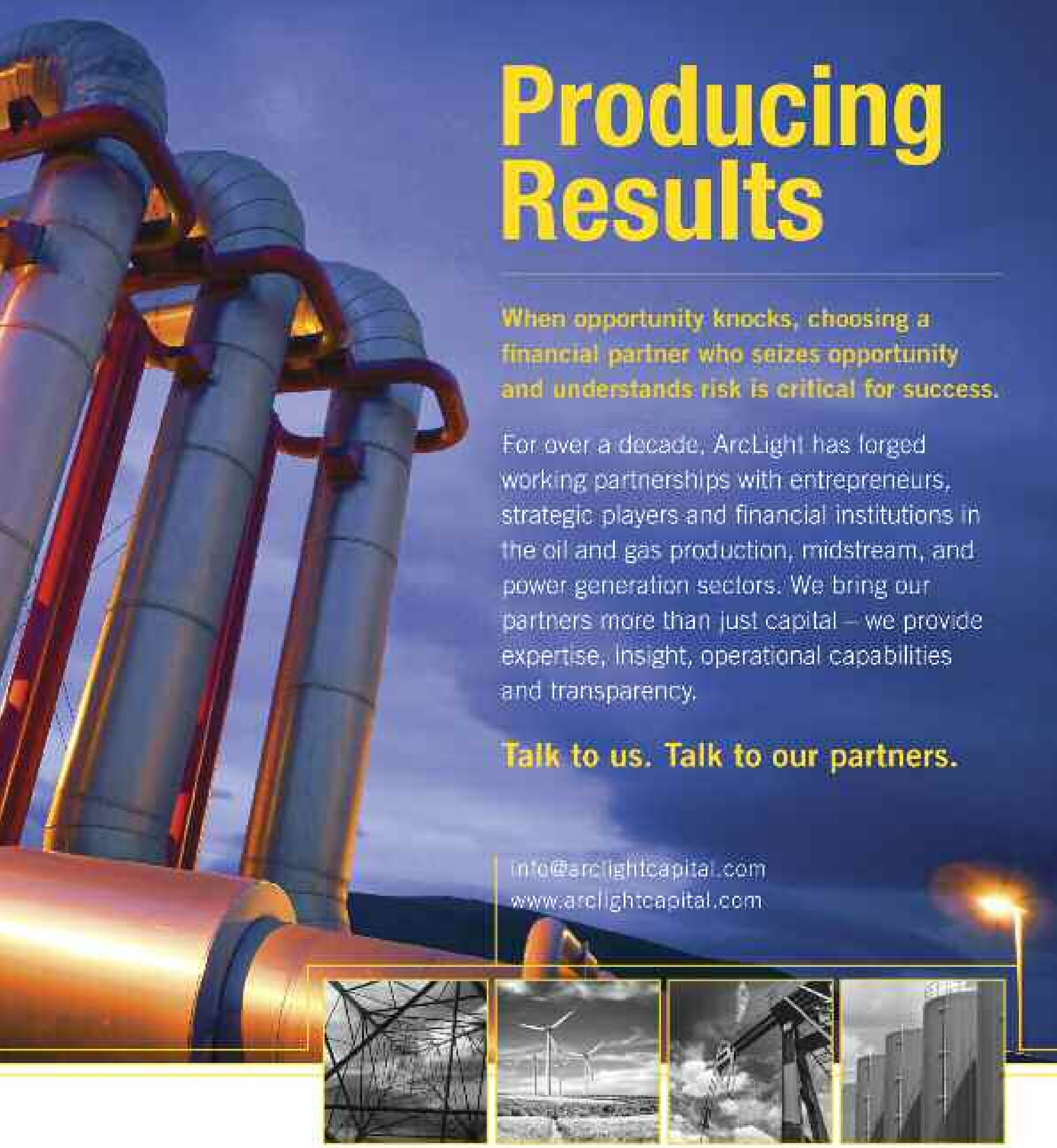


ROTH RAMPS UP

Roth Capital adds oil and gas to its portfolio for investment banking.

By Leslie Haines

Roth Capital Partners LLC, based in Newport Beach, California, is undergoing a sort of renaissance through its focus on small-cap growth companies, and more recently, its move into a sixth industry vertical, the oil and gas sector. The other verticals include healthcare, business services, consumer, industrial and clean tech and tech media.

"We're just planting our flag," says Alexander Montano, managing director, who joined last October to lead the oil and gas franchise.

Since Montano came on board, Roth Capital has been involved in secondary offerings for Diamondback Energy Inc. ($216 million in February 2014) and Ring Energy Inc. ($57.5 million in December 2013). Currently it is advising Houston-based, privately held Yuma Energy Co. on its pending merger with California-based Pyramid Oil Co. to in effect go public.

The move into oil and gas had been considered for some time. "We have a whole world of growth-stock investors as clients that have been seeking exposure into the energy space," said Byron Roth, chairman and CEO.

"We've done a lot of deals with biotech and it's interesting to me that biotech and oil and gas both have very big appetites for capital—and in both cases when they are successful, they need additional capital. This is something we've been thinking about for a while and we definitely have had this on our radar for a few years.

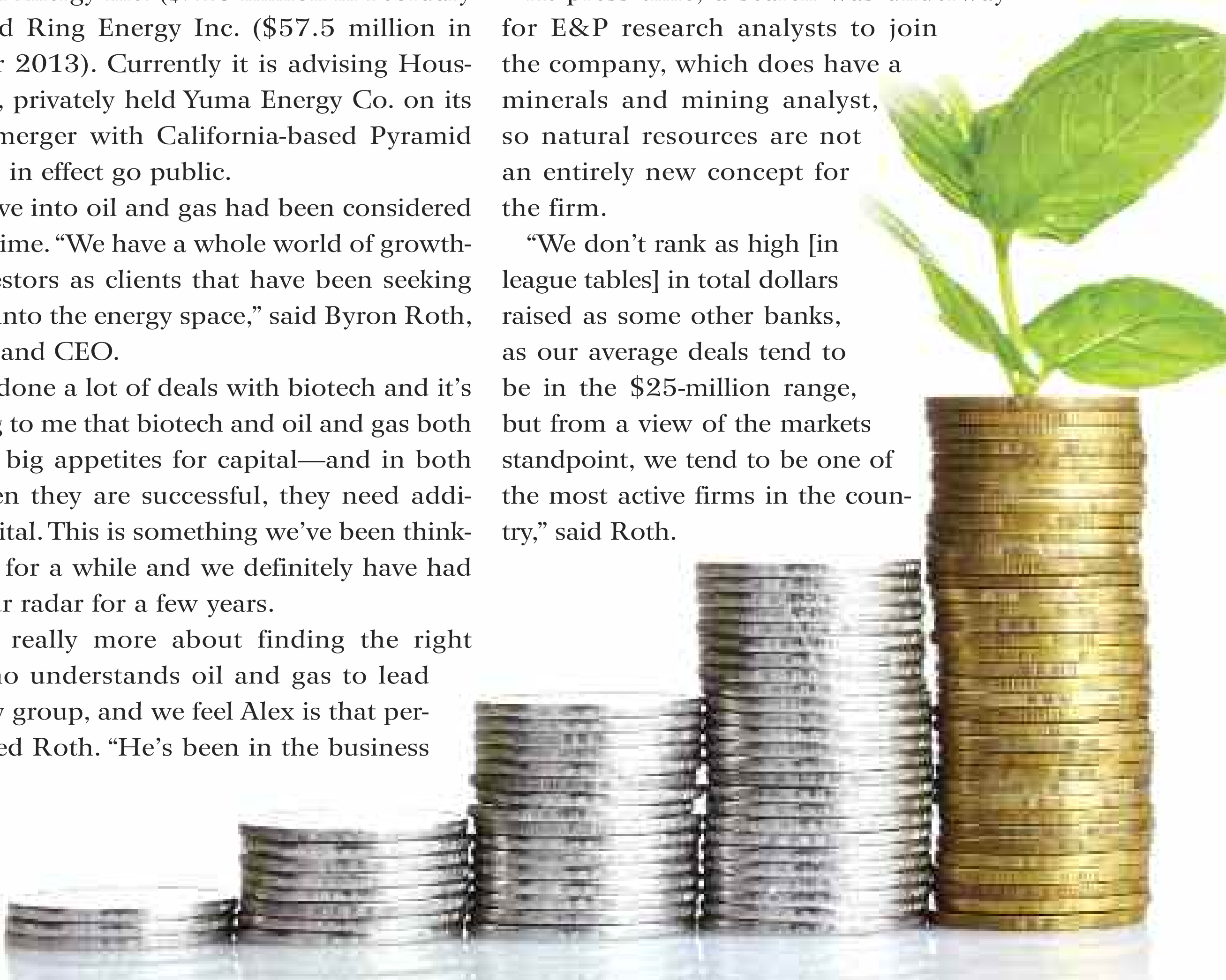
"It was really more about finding the right leader who understands oil and gas to lead the energy group, and we feel Alex is that person," added Roth. "He's been in the business

Roth Capital Partners has had the energy industry, with its huge appetite for capital, on its radar for several years, according to **chairman and CEO Byron Roth.**

a long time up the street from us and his Rolodex has a lot of people he's done business with before. Now it's about building out the team."

At press time, a search was underway for E&P research analysts to join the company, which does have a minerals and mining analyst, so natural resources are not an entirely new concept for the firm.

"We don't rank as high [in league tables] in total dollars raised as some other banks, as our average deals tend to be in the $25-million range, but from a view of the markets standpoint, we tend to be one of the most active firms in the country," said Roth.



Alex Montano, Roth Capital Partners

In 2013 the firm participated in 99 capital formation transactions (public and private) in its "legacy" industries, and led 45 of those deals (45% of the total), so on average two deals a week. So far in 2014, the firm has participated in 49 capital formation transactions and has led 20 (41% of the total). Now oil and gas will be a greater part of that track record.

Employing nearly 150 people, the firm has for 22 years focused on finance, research, sales and trading around small and micro-cap companies.

"We have all of the infrastructure in place here; now we need to add an energy component," said Roth. "You can't control the public markets and which sector is going to be hot, but you can control what you're covering and add another vertical to your offerings. Everyone here knows how to get deals done and when we're in deal mode, the entire firm kicks in to help."

Roth completes an average of two or three deals per week, so that kind of bench strength and market intelligence about the state of the capital markets will be useful for Montano as he continues to increase the firm's presence in the oil and gas industry.

"Our sales force is touching base with the buyside so much, we generally know when the window is about to open or close, and this translates into value for our clients," added Montano.

Roth held its 26th annual small-cap conference in March with more than 700 institutional investors in attendance. "The feedback I got from the 12 E&P companies that presented was very positive. They met so many new investors they hadn't seen before," said Montano.

"What's interesting to me is that Roth has been around a long time and does what it does very well. We've gotten a strong response from Byron and his team. We've talked to a lot of investors who are interested in oil and gas." ■

IS AN MLP RIGHT FOR YOU?

The shale bonanza means energy has become structurally short capital.

By Greg Matlock

Over the past couple of years, a broader interest in yield-based investments, coupled with disparities between buyers and sellers on underlying asset values, has placed an increased emphasis on accessing public funds.

Market demand for public entrants has continued to gain momentum in the oil and gas space (including the upstream sector), resulting in a heightened interest in master limited partnerships (MLPs) and C corporation IPOs (traditional and non-traditional, including the "Up-C structure"), as well as other structures. The increasing popularity of corporate and non-corporate IPOs in recent years, particularly in the energy space, mirrors the rapid growth in domestic energy production.

With interest in public monetizations at an all-time high, many company executives and board members are considering accessing capital through the public market. Similarly, in today's economic environment, they often face pressure from investors to evaluate the availability and benefits of certain public market transactions—however, the decision to move forward (either as an MLP, a traditional publicly traded corporation, or otherwise) isn't always simple. A thorough, objective evaluation is critical at this stage.

What is an MLP?

In its simplest form, an MLP is a publicly traded limited partnership, or a limited liability company, that pairs the tax benefits of a partnership with the fundraising ability and liquidity of a public company. MLPs typically consist of (a) a general partner, who manages the operations of the partnership and often holds a small percentage (e.g., between 0% and 2%) of the

THE MLP HAS A UNIQUE ROLE IN TODAY'S ENERGY MARKETPLACE, ESPECIALLY FOR E&P COMPANIES.

outstanding partnership units and may own incentive distributions rights (IDRs), and (b) limited partners, who provide capital and hold most of the ownership, but have limited influence over the MLP's operations.

MLPs do not pay U.S. federal income taxes; conversely, each partner includes its distributive share of MLP income when computing its U.S. federal income tax—thus, MLPs avoid the double taxation generally applied to traditional corporations and their shareholders.

The primary results of this flow-through structure are often increased cash flow and a lower cost of capital for the MLP; however, in order to maintain that single level of tax for federal income tax purposes, there is a requirement that at least 90% of an MLP's gross income must be "qualifying income"—that is, derived from certain activities in natural resources, real estate or commodities, among others.

In a traditional MLP, the MLP communicates to its interest holders the intention to make minimum quarterly distributions of cash (MQDs), the amount of which plays into the MLP's yield and impacts the point at which sponsors start receiving IDRs.

Conversely, upstream MLPs may choose to go the route of a "variable pay" MLP, whereby the public is not promised an MQD and shares in the upside (and downside) of operations; however, under the "variable pay" MLP format, the sponsor would generally not receive any IDRs. While certain upstream MLPs have chosen the "variable pay" structure, many upstream MLPs remain in the "traditional" MLP format.

Benefits of an MLP

Today, E&P companies (among a host of other companies) are evaluating MLPs for a wide range of strategic reasons, most of which fall into one of the following six categories:

1. Potentially lower cost of capital
2. Opportunity to create a strategic growth platform (i.e., funding strategic growth via an alternative source of acquisition capital)
3. Desire to improve valuation of the sponsor entity
4. Ability to set valuation for the sponsor's retained assets
5. Partial liquidity—the monetization of certain assets
6. Potential to access a different class of investors

For a variety of reasons discussed here, the decision to form an upstream MLP is a complex one that requires thoughtful consideration and long-term strategic analysis.

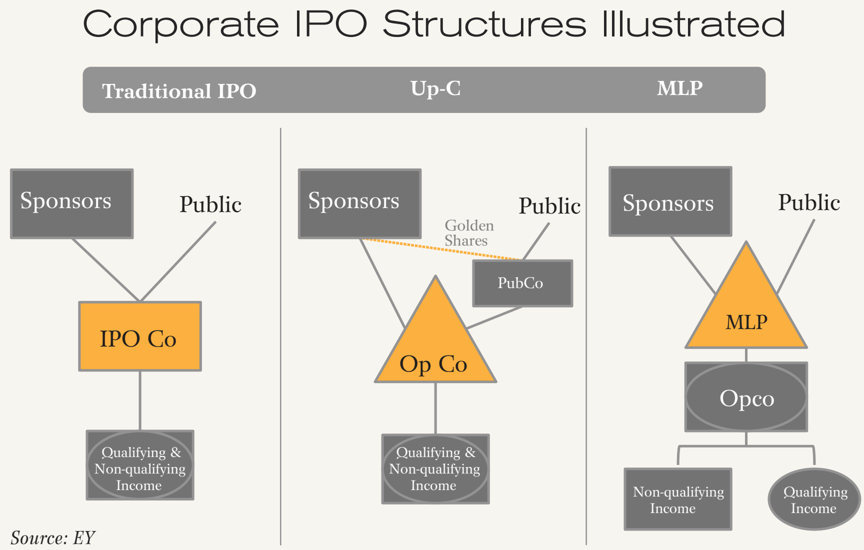
E&P public market transactions

Overall in 2013, E&P equities exhibited solid performance, and that trend is largely expected to continue throughout 2014. Although a number of upstream MLPs are present in the market, many of the latest upstream IPOs have been C corporation IPOs, with a few using the Up-C structure. As discussed here, an increased disparity in private transaction valuations versus the implied valuation from public transactions has made accessing public funds for E&P companies an increasingly intriguing proposition.

For E&P companies looking to go the MLP route, a number of specific factors must be considered, principally the need for steady, increasing cash flow over a long horizon.

As noted here, MLP investors expect stable, increasing cash flows; however, companies engaged in E&P activities don't always have stable cash flows, especially in the midst of a drilling program or depending on the duration of the field at play. Consequently, E&P companies that do access capital markets using an MLP typically have limited exploration activities in very mature basins with long remaining reserve life, and increasingly, ownership or investment in wells once the production rates have steadied.

Upstream MLP companies typically target low-cost operations (e.g., sponsor-operated properties



Source: EY

or cost-advantaged agreements) and have either significant properties with low decline curves or enough assets (future "drop-down" assets) to stagger and smooth out production, taking into account the varying decline curves.

A high ratio of proved developed producing (PDP) reserves to proved undeveloped (PUD) reserves is common, as MLP investors are generally focused on the growth story and the reserve base (PUD base) to see if long-term stability is feasible.

MLP versus corporate IPO

E&P companies, especially those focused in the shale basins, generally require a significant amount of capital to fund aggressive and complex drilling programs. Although there is no legal requirement for an MLP to distribute cash to its unitholders, there is generally a market requirement that MLPs distribute all "available cash" to the unitholders.

Although there is some flexibility as to how "available cash" is defined for each specific MLP, as a practical matter, they are typically not the preferred vehicle for warehousing cash to fund future drilling programs for this reason.

As a result, a corporate IPO may be preferable in a variety of circumstances, namely the following:

- The asset base lacks a significant amount of mature, long-lived, producing properties.
- Significant exploration or capital expenditures are planned or required.
- Company management does not have a long-term strategy of continuous aggressive growth.

Consequently, the corporate IPO route typically provides management with additional flexibility with respect to retained earnings and reinvestment in core properties. Similarly, publicly traded corporations are traditionally valued on prospective earnings growth (as opposed to a yield-based valuation). For these reasons, an MLP may not be preferred for an asset package made up of mostly offshore U.S. properties.

The Up-C structure

A number of recent upstream IPOs have been corporate IPOs, with a subset of such IPOs going public in what is referred to as the Up-C structure. Although the nuances of the structure can be complex, the Up-C structure generally refers to a structure whereby the sponsor and the publicly traded corporation own an interest in a lower-tier operating company that holds the assets.

As the sponsor exchanges interests in the lower-tier operating company for public company stock, the public company receives a step-up in tax basis, while passing on a portion of the future tax benefit of such step-up to the sponsor through a tax receivable agreement. Due to the complexity of reporting and administration, careful consideration and planning is necessary to evaluate whether the Up-C structure is appropriate.

Why choose an MLP structure?

An MLP may be the right capital markets vehicle for an E&P company, depending on the presence of the key factors described here. Principally, these factors include the presence of a stable cash flow profile, and a solid growth story. The planning, modeling and timing considerations of the drop-downs become increasingly important in an upstream MLP given the decline curves in certain basins (and certain areas within basins).

In order to fully understand the impact of an MLP IPO (both on a stand-alone basis and compared to a corporate IPO)—and to properly anticipate and prepare for the challenges involved—senior management should undertake a thorough study that tests assumptions (best and worst case scenarios, and iterations in between), and validates approaches.

Because of the wide range of options available to sponsor companies related to which assets are transferred to the MLP (and when), the analysis should include detailed modeling of various tax, valuation, and capital structure scenarios, as well as identification of a strategy for the ultimate downside: how will you unwind or otherwise exit the MLP (or other vehicle) if changing conditions require it? How will you achieve growth in varying economic environments?

The MLP has a unique role in today's energy marketplace, especially for E&P companies. It offers a wealth of benefits to both sponsor companies and individual investors, while providing a low-cost, alternative form of capital for expansion and growth. For certain E&P companies, an MLP IPO can be an important step to unlocking current value, as well as creating future value; however, careful planning is critical from a strategic and implementation perspective. ■

Greg Matlock is a senior manager in EY's Transaction Advisory Service–Transaction Tax practice, and has also served as the Tax Sector Resident for EY's Global Oil and Gas Center. His practice focuses on U.S. federal income tax planning and structuring for business transactions, with particular emphasis on oil and gas investments.

The views reflected in this article are the views of the author and do not necessarily reflect the views of the global EY organization or its member firms.

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