HERE'S THE MONEY

CAPITAL FORMATION 2015

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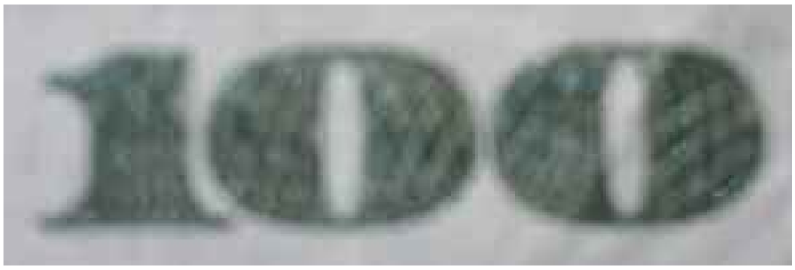

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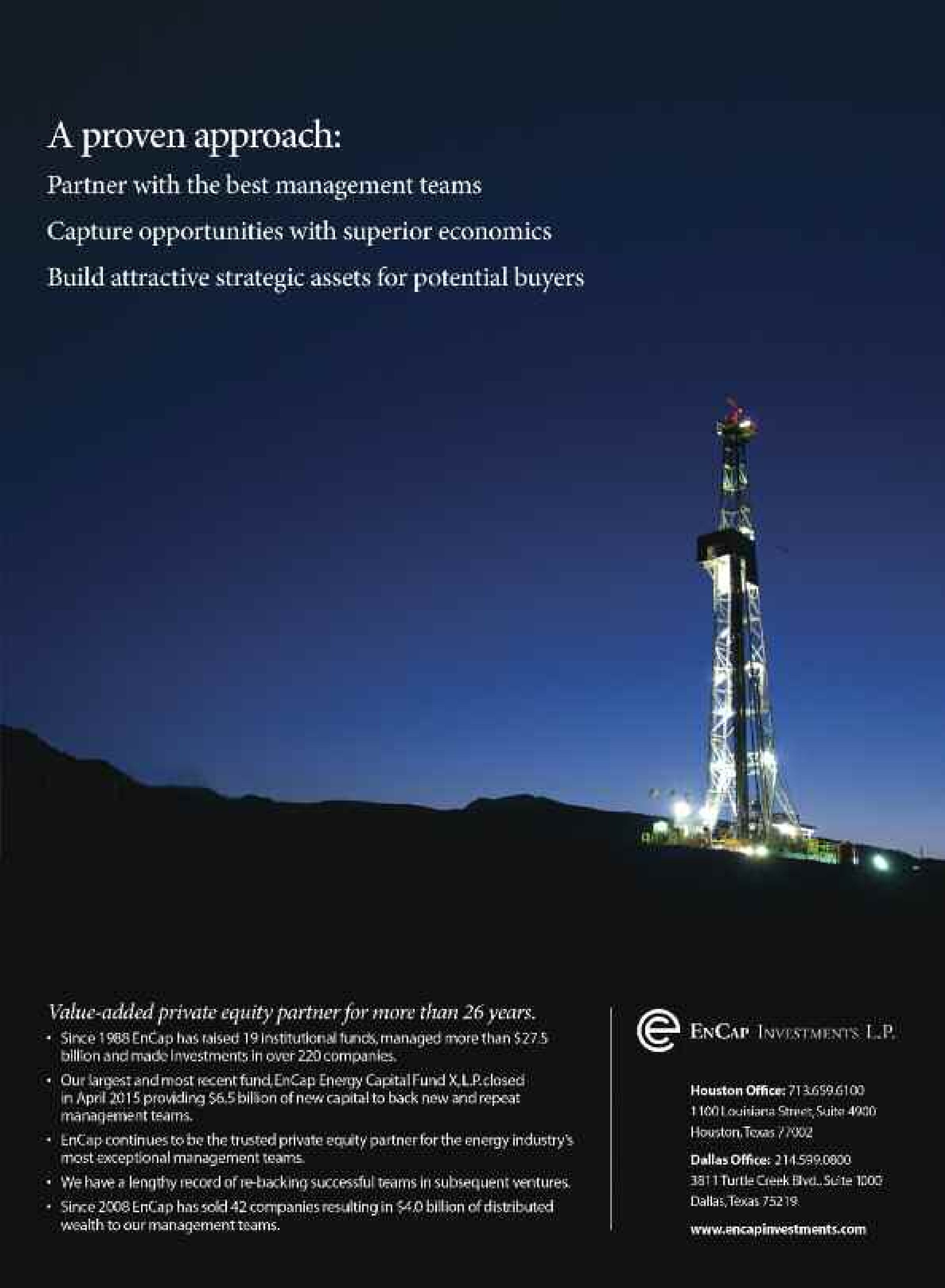
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CAPITAL APLENTY AWAITS UPTURN

I hate to use a cliché, but it really is the best of times and the worst of times in the upstream sector today. More public and private capital for oil and gas companies is available than ever before, as shown by the flurry of capital raises in the first quarter of 2015 (in spite of the commodity price downturn of the past six months).

Challenging times have called forth the best and brightest minds in E&P companies, and they are increasing their drilling and completion efficiencies dramatically, thus reducing costs.

If companies say they can make money with $50 oil, and they can access as much capital as needed, and in a slew of formats, then the coming upturn should be spectacular, whenever that occurs.

An incredible amount of private funds targeting energy—whether for investing in equity or distressed debt—is searching for new opportunities in the upstream and midstream arenas. Most of the E&P companies that have gone to Wall Street have not come back empty-handed.

But, making money with all this money is the trick. Lower commodity prices than we'd like have pummeled rates of return—but on the other hand, the new drilling and completion efficiencies have driven the breakeven price in every play lower and thus, improved the economics in most cases.

For now, though, necessity is the mother of invention as far as creative financing structures are concerned. Joint ventures and royalty interests, volumetric production payments and more are creative solutions used by E&Ps in partnership with traditional and new capital providers.

Cowen and Co. analyst Charles Robertson recently initiated coverage of the E&P space with these remarks in a mid-April report: "Capital market activity is not over. We estimate cash recycle ratios have lengthened by 12 months, with a median payback period of 33 months. Well returns have improved to levels similar to those of 2014, albeit at a lower absolute dollar return.

"Many operators will need additional capital to fund 2016 production given current commodity prices. We expect borrowing base redeterminations in the fall to reduce available liquidity and another wave of financing for debt-laden companies."

Indeed, as we approach the fall borrowing-base redetermination season, many E&P companies' growth in proved developed producing assets will be slow, or nil. Likewise their hedges may be rolling off and no longer effective. This could lead to liquidity problems and the need for second-lien or high-yield debt.

In addition to debt and equity offerings or debt-for-equity swaps, companies have done what they can on the operational front: reduce capex budgets, high-grade the well locations in the core of their plays that will be drilled this year, and negotiate with their service providers for cost reductions.

This special report will provide further insights into what capital providers are thinking at the moment and also give you ideas for various financing alternatives.

—Leslie Haines, Editor-in-chief

For recent articles on financial topics, see the following at **OilandGasInvestor.com**:

"Sorting Out Structures," on how financing structures affect profitability. September 2014

"Climbing the Convertible Curve," on convertible debt and equity trends. December 2014

"Counting on the Counter-Cyclical," on mezzanine finance availability, January 2015

"The Banks Take Stock," on commercial bankers' views. March 2015

"High Noon for High Yield," on how high-yield trends may have changed. March 2015

CAPITAL PROVIDER NEWS

In Case You Missed It

Kyle Hranicky was promoted at **Wells Fargo** as chief of its corporate banking group. He succeeds Mike Johnson, who will retire June 30, 2015, after 32 years at the bank. In his new role Hranicky will oversee a group that makes loans and provides asset, treasury and risk management services to corporate clients. Paul Cornell and Mark Green continue to head the investment banking and commercial banking energy groups.

Tim Murray has joined **Benefit Street Partners** as managing director and head of oil and gas origination, in Houston. It is the credit investment and high yield arm of Providence Equity. Murray was previously with Guggenheim Partners. Benefit recently closed Fund III with $1.75 billion. It focuses on direct lending to middle market firms.

Mutual of Omaha Bank appointed Randy Gartz and Brock Berilgen to its Houston commercial banking office as manager of corporate and commercial relationship banking, and senior energy lender, respectively.

Deloitte Corporate Finance LLC named Thomas W. Sloop as managing director of the Houston office, to lead the development of its oil and gas practice.

Michael McMahon, managing director of private-equity firm **Pine Brook**, relocated to the firm's Houston office from New York.

The 15-member A&D team of BMO Capital Markets, led by Miles Redfield, joined the Houston office of **UBS AG**. Tod Benton still leads BMO's investment banking group.

CSL Capital Management moved its energy-focused private equity headquarters to Houston from Greenwich, Conn. John Griggs heads the office. Charlie Leykum, managing partner and founder, relocated to Houston as well.

Private equity firm **Citrine Energy Capital Management LLC** launched in Houston and Dallas with three former senior officials from Natural Gas Partners: William (Billy) Quinn, Tomas Ackerman and Daniel Goodman. It will focus on small and mid-size investments of $25- to $75 million in upstream, midstream and oilfield services.

Capital One's Houston energy group announced that longtime head Jim McBride has retired. He was succeeded by Russ Johnson in energy investment banking and Bob Mertensotto in commercial banking.

Tudor, Pickering, Holt & Co. named Martin Houston chairman of TPH International in Houston. He will work with the firm's Calgary and London offices. Houston is former COO of BG Group Plc.

Riverstone Holdings LLC hired Christopher Abbate, Jamie Brodsky and Daniel Flannery to head its capital markets and credit activities in the New York office. Abbate, previously with Citigroup, will be managing director and lead the team. He has 17 years' experience in energy finance.

Houston-based **Millennial Energy Partners LLC** closed its upstream investment fund, Millennial PDP Fund V, in a private placement. It will consider opportunities from $1 million to $30 million.

EnCap Flatrock Midstream, San Antonio, has expanded by opening a Houston office led by managing director Sam Pitts, formerly with Citigroup's energy team.

For further information

For daily updates, news and additions to the directory of capital providers, see OilandGasInvestor.com and OilandGasInvestor.com/Sourcebook.

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A FINANCIAL BUFFET

Energy companies are dining on new and tried-and-true financing solutions during a period of uncertainty.

By Cliff Vrielink and Tim Chandler

The oil and gas business is one of the world's most capital-intensive industries. In recent years, energy companies typically have looked to three sources of financing: commercial lenders, debt and equity capital markets, and private equity. Since the freefall in oil prices that began in June 2014, these sources of capital have changed significantly and, for some, have become too costly or have dried up.

Many companies fear the prospect of lower borrowing bases under their reserve-based credit facilities later this year, and at today's lower share prices, others may be hesitant to sell equity in the public markets. While much of the industry has slashed costs and capital budgets, this is only a short-term solution. If commodity prices do not rebound in 2015, then as hedges expire, producers will face serious liquidity concerns.

A number of energy companies have moved quickly to amend their credit facilities. In some cases, lenders are willing to make changes to leverage and coverage ratios in exchange for concessions on borrowing base or other terms, particularly for borrowers with clear medium-term strategies.

One approach upstream companies have taken (such as Legacy Reserves LP) involves obtaining a "holiday" on testing compliance with the total leverage ratio for a period of one to two years, and substituting in its place a senior secured leverage ratio. This approach can help companies with significant amounts of unsecured notes to avoid a financial covenant default during a period of lower EBITDAX due to depressed commodity prices.

While this strategy does not provide new capital, it does help companies avoid defaults under their

COMPARING FINANCIAL STRATEGIES

	Survive The Short Term	Build Resilience	Sustain Development	Stay Opportunistic
Cut CapEx	●			
Amend Credit Facilities	●	●		
Exchange Debt	●	●		
Public Equity		●	●	●
Public Debt		●		◓
Second-Lien Debt		●	◓	
Asset Development Capital		●	●	
Asset Preferred Investments		●	●	●
Asset Joint Ventures		●	●	●
Insurance-Based Credit		●	●	◓

● Typically usable for this purpose ◓ Sometimes usable for this purpose

credit facilities and gives them a little more breathing room to focus on other strategic solutions.

Some E&P companies are exploring whether they can reduce their outstanding debt burden without having to raise equity. One strategy would be to take advantage of the drop in commodity prices (and the corresponding drop in the value of a company's outstanding public notes) by swapping out existing debt through an exchange offer for new notes, perhaps with additional exchange consideration in the form of equity or equity derivative securities.

This strategy makes sense if the existing debt is "bought out" at a valuation greater than its market price but less than its face value. If successful, this strategy could immediately reduce a company's debt load. While this seems like found money, the reality is that the process can be difficult, expensive and time-consuming (and can raise tax issues).

Additionally, success depends on several tactical elements. If, for instance, word were to leak out that a company is pursuing this strategy, then the discount in its bond prices might quickly evaporate. Another hurdle is that companies often do not readily know the identity of their bondholders, and often there is little liquidity in those bonds. As a result, it can be hard for companies to approach a few large holders in advance—even though that tactic would help ensure success.

For companies that have liquidity issues and need cash, some are turning to traditional means despite their recent higher cost. For example, publicly traded companies can issue more shares.

Public equity and debt. On first look, companies may dismiss this approach because today's stock prices (often 25% to 50% lower than June 2014) are perceived as too low. In practice, however, many companies are nevertheless accessing the public equity markets (Concho Resources Inc. recently issued equity at 27% below its 52-week high).

In fact, producing companies issued more equity in first-quarter 2015 than at any time since 2008. While motivations vary, some reasons for issuing equity even at current market prices include increasing liquidity in case things get worse, paying down debt to ensure that revised borrowing bases are met, or perhaps stockpiling cash for potential acquisitions. Some publicly traded companies are also issuing more public debt. However, bondholders are increasingly demanding steep pricing, collateral security and equity features.

Second-lien debt. Many borrowers were able, during the recent boom years, to negotiate relatively loose covenants in their credit facilities and high-yield indentures that permit them to issue more debt to other lenders so long as certain so-called "incurrence" tests, such as pro forma leverage ratios, are met. Although the credit facilities require the new debt's security to be junior to the liens benefitting the senior lenders, the new debt would be structurally senior to the public debt. As a result, the borrower could offer meaningful security to the new lenders so long as the borrower's aggregate asset value exceeded the debt to the senior lenders.

The cost of this debt is often relatively high due to its higher risk profile (pricing of 10% to 12% has become common), but the allure of more capital, without diluting equity, is likely to lead to more second-lien issuances throughout the oil patch.

Exotic ideas. Some energy companies are exploring more exotic debt-related structures such as insurance-based credit provided by large insurers such as Munich Re. In one such structure, an energy company would obtain a reserves-risk insurance policy in favor of its commercial lenders that is priced based on an insurer's actuarial calculations of the risks to reserves, as they migrate from proved undeveloped reserves (PUDs) to seasoned proved developed producing reserves (PDPs).

As a result, the energy company's commercial lenders would be able to offer a higher level of debt financing without increasing their risk profile, because the marginal risk from the increased leverage is transferred to the insurer. In theory, the total cost to borrow would be lower than other forms of equivalent financing (such as second-lien loans).

VPPs. Another insurance-based product is a volumetric production payment (VPP). While these have been used for many years, insurance companies may be able to take a longer-term outlook with regard to repayment and recovery, and may be able to advance at a much higher rate than traditional VPP buyers.

Term working interest. In this structure, an insurance company buys a working interest in a field for a given period of time. Once the term expires, the working interest would revert to the original owner. Insurance companies engaging in this space believe that because they have a different risk profile, alternative lenders, and use actuarial approaches to evaluating and pricing risks associated with proved oil and gas properties, they can provide alternative financing while materially reducing the cost of capital or facilitating access to new capital.

Cash and carry. Another "new" form of capital is a variation on a recent mainstay during the shale boom: development capital financing. Traditionally, this takes the form of a "cash and carry" deal where a new investor receives an interest in a group of assets from the existing owner, in exchange for upfront cash and a commitment to fund both the new investor's pro rata share and the existing investor's pro rata share of a development plan.

In this environment, several financial players have expressed a willingness to fund development in a variation to the "cash and carry" construct, but without the upfront payment feature. GSO Capital Partners LP, an affiliate of Blackstone, entered into a non-binding commitment to provide up to $500 million in financing to Linn Energy LLC. GSO would provide 100% of the capital needed to develop various grouped wells in exchange for an 85% working interest in those wells. Once GSO receives a 15% internal rate of return, then its working interest would decrease to 5%, and Linn Energy's working interest would increase to 95%.

This deal provides advantages to both parties; GSO receives a typical private equity IRR while Linn Energy obtains capital for well development. Linn surrenders much of its ownership in the near term, but if the wells are successful, it recoups most of its ownership.

This structure works particularly well for shale production because of the steep production declines of the typical shale well. Since a large percentage of production occurs quickly, the capital provider would get its capital back quickly while the producer obtains the capital to keep drilling, thereby avoiding a dramatic and potentially catastrophic decline in its aggregate production that would otherwise occur.

Preferred at the asset level. Some producers are exploring additional structures that, while less common in the oil patch, may not be unusual in other industries. One such structure is a preferred investment at the asset level. While setting up this structure involves more complexity than many in the industry prefer (navigating restrictions in debt instruments, third-party consent rights, "pref rights," and regulatory issues), it offers investors some desirable benefits. Chief among these is that an investor can focus on a particular field or group of assets—and insulate its exposure from other lower-performing assets.

To create this type of structure, an energy company could form a new subsidiary and contribute to it a particular asset or group of assets. The financial provider would contribute cash in exchange for a preferred security in the subsidiary, which could take the form of debt or equity, but in either case would provide the investor with a preference on distributions ahead of the parent company.

Joint ventures. A further strategy that may be pursued between industry players with complementary assets involves establishing a traditional asset-level JV to capture economies of scale and reduce cost.

For example, producers in the same basin may agree to share infrastructure or other development costs, while midstream gatherers or processors might realize considerable savings by upsizing one pipeline and sharing capacity instead of building duplicative lines.

Joint ventures often can involve significant complexity and negotiation around governance and the "what-ifs" (surrounding disputes over expansions or corporate strategy changes). However, by focusing on the asset level, the issues usually become more manageable.

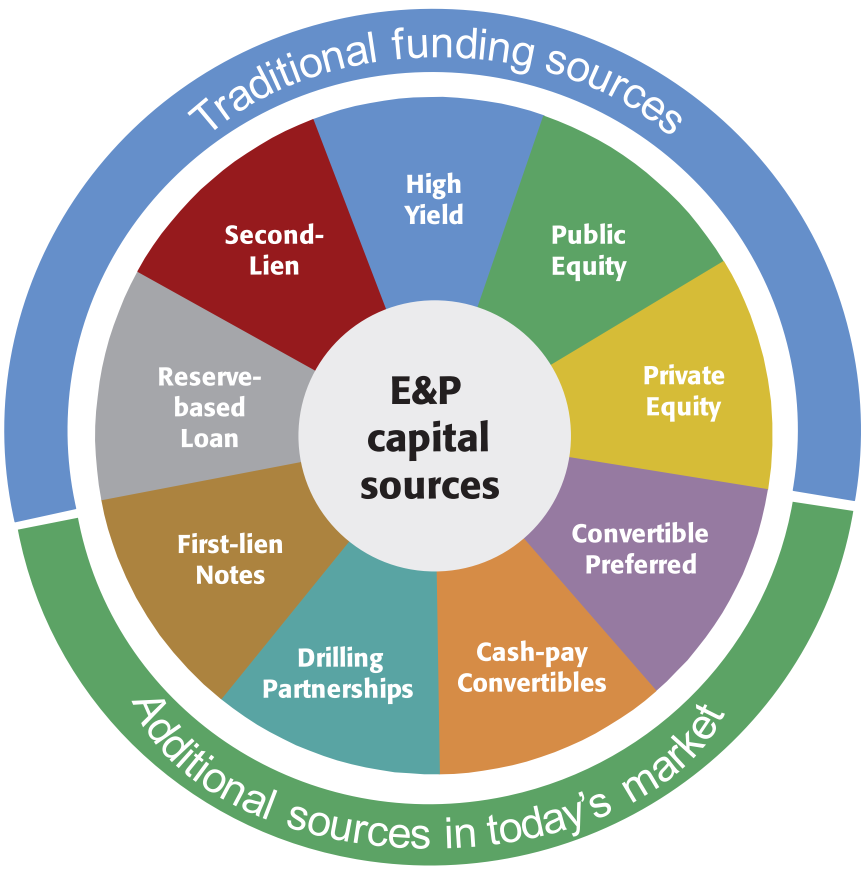
The longer commodity prices remain depressed, the more energy companies will struggle with liquidity issues. Although many today are issuing equity or second-lien debt because these approaches are fairly straightforward, at some point these alternatives become uneconomic and more complex structures will emerge.

Not only will companies search for more sources of capital, but numerous sophisticated financial investors are eager to invest in the energy industry. Private equity fund managers have recently raised or announced their intent to raise significant new equity funds focused on energy, both on the equity side (for example, Riverstone Holdings LLC and Natural Gas Partners) and the debt side (for example, Apollo Global Management and Goldman Sachs).

The combination of tough economic conditions and savvy investors will surely lead to a number of tailored structures. ■

Cliff Vrielink is co-leader of the global energy practice of Sidley Austin LLP and a member of its executive committee. Tim Chandler is a senior associate in the global energy practice. Both are based in the Houston office.

SIGNIFICANT AMOUNT OF DEBT & EQUITY CAPITAL TARGETING THE E&P SECTOR



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A FLOOD OF MONEY

As oil prices flounder and gas demand teases, energy capital providers convened to discuss what it all means, and where the money will flow.

By Steve Toon

A flood of capital flowing toward investment in energy assets has piled up behind a dam created by commodity price volatility, and it's only a matter of time before the floodgates open, according to capital providers at IHS CERAWeek in Houston in April. These energy financiers gathered to hash out issues surrounding the drivers influencing their oil and gas investments in the present fluid marketplace.

The precipitous drop in oil price over the past year has dried up investment in scores of formerly ballyhooed, now sub-economic projects. Savvy investors are scrutinizing efficiency over growth like never before. This doesn't mitigate the fact that some $80 billion in private capital has flowed into the sector, nor the fact that eager investors have already this year plowed some $20 billion into the public debt and equity markets, anticipating an inevitable upswing in the sector.

These speakers at IHS CERAWeek represented investment banks, private equity and an investment manager. They include Gary Reaves, managing director, First Reserve; William Stevens, global co-head, SESG Group, HSBC Bank; David Foley, chief executive officer, Blackstone Energy Group; Nathan Strik, portfolio manager, Fidelity Research and Management Co.; Robert Tichio, partner,

> "WHERE THE STORY FOUR YEARS AGO WAS AROUND THE FANTASTIC MACRO TAILWINDS, EVERYTHING NOW IS SITUATIONALLY DRIVEN. IT'S NOT A BROAD MARKET WHERE YOU CAN POINT TO ONE SECTOR AND SAY THIS IS IT."
>
> ***—Robert Tichio,*** *Riverstone Holdings*

Riverstone Holdings; and Charles Leykum, founding partner, CSL Capital Management.

The following are excerpts of their observations on energy capital in the U.S.

CAPITAL AVAILABILITY

Gary Reaves, First Reserve: We've been surprised by the amount of capital that has flowed into the sector. We attribute it to a world that looks relatively unexciting right now, and energy looks exciting because of the downcycle. It appears to us that there is a lot of capital on the sidelines that is fearful of missing the upturn. [However,] the capital flowing into the sector will ultimately create a longer-dated recovery.

David Foley, Blackstone: With oil prices going down, we've seen the tide rush back into the U.S. upstream, for the most part. The analysis might be difficult, but the decision to do it is quite easy. We see the most capital washing up in the high-yield market and the public equity market, and that's why you're seeing the E&P companies do that, because it's there at the cheapest cost at the moment.

M&A activity has been down tremendously, but there have been a lot of these drive-by, high-yield issuances. The tide went out a bit in December on the capital markets, both equity and debt, then I've never seen the sector go so quickly from being fearful to greedy like crazy. We're seeing high-yield get done on drilling assets that would be one thing if they were buying existing debt for 60 cents, maybe unsecured. But they're coming in on a second-lien basis at levels we think that, if it were going through liquidation today, most of these being sold would be below where the new folks are coming in.

I don't know if these folks [investors] are just trying to rebalance because when prices went down, they became underweighted, and now they want to be overweighted, but I don't think they're doing enough underlying work on the breakevens of the assets they're financing.

Robert Tichio, Riverstone: A lot of deals are getting priced at very attractive rates relative to where the underlying assets suggest they should be in a normal market. This suggests debt and equity buyers either believe something about the asset base that those who are far more familiar with the localized basins or geographies don't believe, or they have a much more constructive view on prices than the futures market would indicate. Or, they're just not educated enough in energy to put their money to work.

Nathan Strik, Fidelity Research and Management: There is a large capital demand in energy, and as long as that's the case, capital is going to be available. It's not going to dry up. Energy is unique in the sense that capital likes to go to markets where there is collateral, and there's a lot of collateral in this industry. The value of that will fluctuate based on [commodity] prices, so the amount of capital will fluctuate as demand for capital fluctuates based on the oil price. But the reserves will be there in response to that environment.

The ongoing resilience of the supply side is an open question, but demand looks quite good so far, so maybe we'll have a recovery in the near term.

DIFFERENT THAN 2008

William Stevens, HSBC Bank: In 2008, the liquidity crisis actually compounded liquidity problems in the market. Where there are liquidity constraints [today], there are also sources of funding that were not available in 2008. Banks are more accommodating. The covenants that have been broken or are in danger of being broken are being waived.

Within banking, there is a wholesale review in the way E&P companies are being evaluated. Debt-to-EBITDA is a key covenant, but that covenant by itself in no way values an oil and gas company. There is a much broader view of reserves and resources that may supplement the value and [provide the ability] to repay debt over a longer period of time. That flexibility was not there in 2008.

Charles Leykum, CSL Capital Management: About $80 billion in capital has been raised over the last two years geared toward upstream primarily, both equity and debt. That's largely U.S. focused through private-equity funds and various credit vehicles. To put it in context, in the U.S. [the industry] will spend about $150 billion in 2014, and slightly less in 2015. We think that roughly half of all U.S. spending has been raised in an investment vehicle in the last couple of years. In reality, that pooled capital will be funded over five to several years, but it's a large number. Certainly, the last two years of capital raising have been dramatic.

Strik, Fidelity Research and Management: Some investors are drawing a lesson from 2008-2009, when there was a sharp snapback. Hope is very much alive. The fear of missing out is driving a lot of investments. You could paint a scenario where the price recovers to sub-$80 and languishes there for six to 18 months, and people's interests fade, making this vast amount of capital somewhat less available. But in the near term, I think equity will be available, and there is enough collateral and reserves that could be used as a funding source.

NATURAL GAS VS. OIL

Foley, Blackstone: To the investor in natural gas in the upstream side of the U.S., you need to be patient. It helps to have decent acreage and low-cost breakevens. Having a very long inventory of natural gas also helps. I wouldn't want to get through the next four or five years and have produced all of whatever I've got.

It's going to be a great four or five years for natural gas prices [beyond that], but it's going to take awhile for LNG exports, exports to Mexico, and a bit more power demand to create a step function change in demand, to lift gas prices anywhere above $4. I think it will be range bound in a not-very-attractive range for the foreseeable future. That creates pressure on upstream companies trying to continue to grow, and the separation of acreage by quality will get even more draconian.

We are an investor in the Marcellus and Haynesville. We like the Haynesville's proximity to export markets. You're going to get a much better netback versus the Marcellus, certainly the Rockies or Canada. That location is going to count for a lot. Having the takeaway capacity and a lot of drilling inventory in the core helps, and rig costs coming down will be helpful. That will get us through to the other end of it. We just need to be patient.

Tichio, Riverstone: We've shied away from North American natural gas over the last couple of years to oil projects. There are plenty of analogies to be made, in terms of plays where we've invested capital where we've seen an incredible drive of efficiency gains over the investment period, independent of moves in the commodity price, which is something we always look to achieve. But the business plan of accumulating acreage, putting four holes in the ground [and selling] is over.

DISTRESSED ASSETS

Reaves, First Reserve: During the first borrowing-base redetermination season this spring, the

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Nathan Strik, Fidelity Research and Management Co.

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David Foley, Blackstone Energy Group

banks have been fairly accommodating. You have a lot of hedges that are buoying things, that are going to be rolling off. That will be impactful to the fall redetermination.

A lot of people believe this is going to be a short-lived down cycle and that by the fourth quarter of this year, prices will have recovered. So a lot of companies are effectively getting a pass this time around.

BEST INVESTMENT OPPORTUNITIES

Foley, Blackstone: We look for companies that are going through transitions where we can add value, or a company that's misunderstood where something needs to get fixed or built or changed, and you can't do that just by buying stocks or a high-yield position. [If you're a public investor,] you can't effect that change. If we do our job right, we'll make more than if we just invest in public securities. And like everything else, this [time of] flush capital and low interest rates will pass.

Leykum, CSL Capital Management: On the services side, there are a lot of smaller opportunities where businesses are starved for capital. The huge credit and equity fundraising over the last two years hasn't filtered its way down to the smaller companies, and those are the companies that are actually suffering from [lack of] liquidity—family businesses and small, private companies that are getting lines of credit focused on borrowing bases.

So, despite the large capital raises over the last couple of years, I do still think there are pockets of opportunities.

Tichio, Riverstone: There are areas within North America that we are focused on from a strategy perspective as being relatively earlier stage in respect to either a play or opportunity set tracked to the efficiency frontier. The question is whether there are deals to be done around those assets or opportunities in those markets. In North America, we see a couple of places where we are working actively to pursue opportunities where, three to four years from now, there will be a new story told with respect to drilling and completion efficiencies. That is being clouded right now with the conversation around the macro.

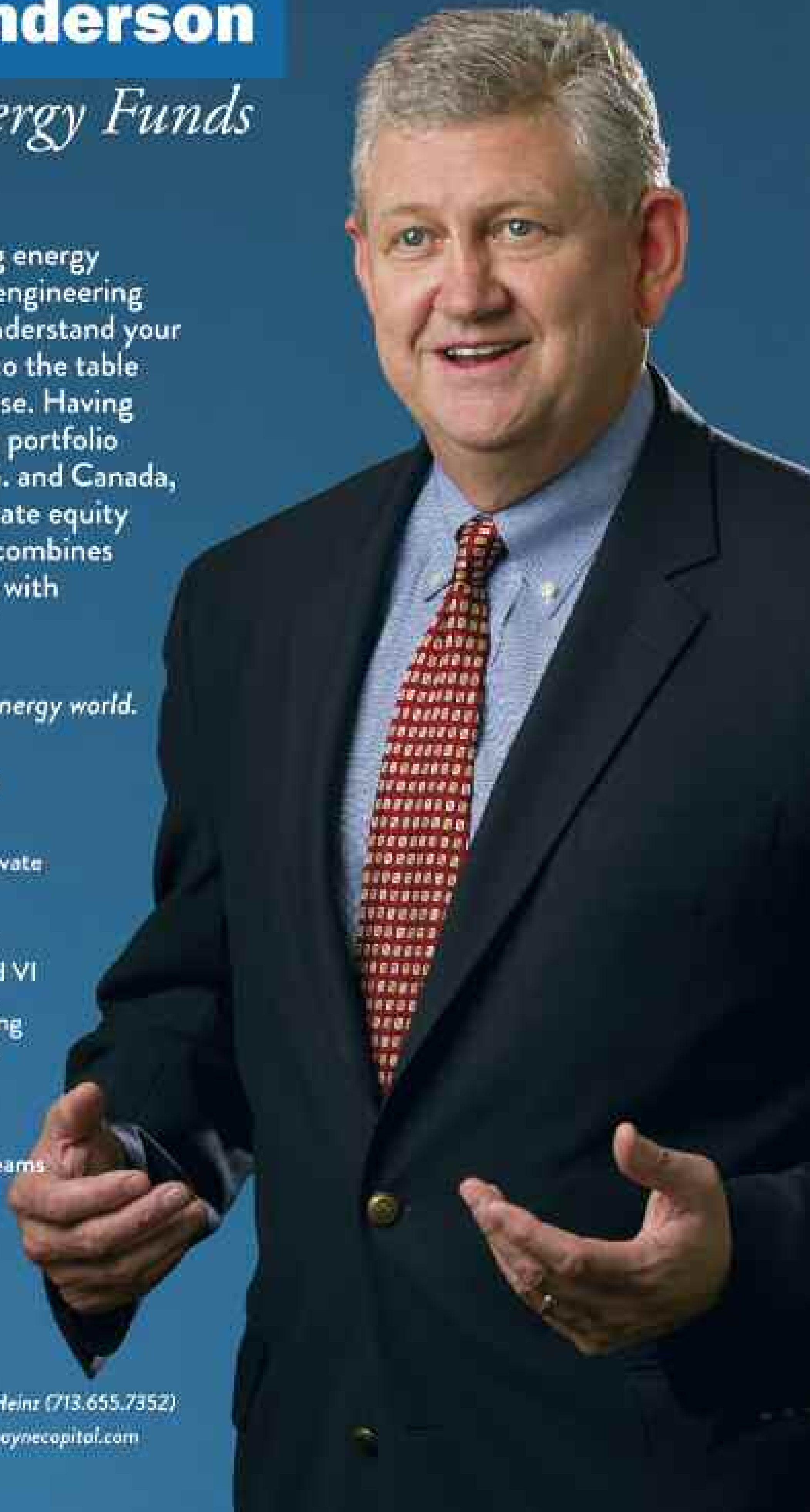
Where the story four years ago was around the fantastic macro tailwinds, everything now is situationally driven. It's not a broad market where you can point to one sector and say, this is it.

Reaves, First Reserve: About half the funds we invest right now are allocated to resources, and always have been. Historically, the split was about 50%-60% outside the U.S., and 40%-50% in the U.S. So, for us, it's less about how much resources are allocated within the portfolio, and more about shifting geographies. We're at about 60%-65% inside the U.S. [now].

We find the cycle times, and risk and resource base inside the U.S. compelling. We're not seeing home-run type investment opportunities, but for less risk we're happy to generate the same returns we always have, so we are spending more time in the U.S.

[But we're not placing] a lot this year, because we have a general point of view that it's probably going to get worse before it gets better. We're happy to sit on the sidelines for a bit of time, but we are still bullish on the U.S. resource opportunity.

Strik, Fidelity Research and Management: Price deck matters, and the absolute returns in the sector matter, but we put a lot of focus on the relative winners in the space. When we think about investments, it is extremely rare we would make an investment with less than a year's time frame. The capital intensity in this industry is so remarkably high, that focusing on returns on capital is paramount—management's ability to demonstrate a track record in allocating capital is hugely important. Irrespective of our price decks, we are looking for folks that are best positioned. ■



CAPITAL FOR SMALL-CAPS PICKS UP THE PACE

A select but experienced group specializes in smaller energy deals.

By Gregory DL Morris

Just as some upstream investors rediscovered the midstream as a result of the current downcycle, some big money is learning how to play small ball. To be sure, there are a few well-established specialists who invest through various vehicles in the market looking for capital of $100 million and down.

Notably, most of the small-cap investors are veterans of larger firms. The latest example is Citrine Energy Capital Management, a new energy private equity firm with offices in Houston and Dallas. Founded in April by former senior Natural Gas Partners (NGP) executives William Quinn, Tomas Ackerman and Daniel Goodman, Citrine will focus on small and middle market investments requiring between $25- and $75 million of equity capital in the North American upstream, midstream and oilfield services sectors.

"We believe that oil and gas transactions of less than $100 million are often less competitive and trade at lower multiples, particularly for companies pursuing an acquire-and-exploit strategy," said Ackerman.

At the founding of Citrine, the new firm announced a strategic investment agreement with NGP Natural Resources Fund XI, the most recent private-equity fund focused on natural resources, where the latter made an equity commitment available for investment from time to time directly in the future portfolio

companies of Citrine. The amount of the commitment was not disclosed.

"There are smaller operators that are undercapitalized to develop the assets they already have, and larger operators that are refocusing their portfolios away from smaller, conventional assets. We believe there are operators or management teams that can take advantage of the assets being made available as a result of these trends."

While Citrine will focus on reducing costs and operational efficiency for acquired properties, Ackerman is not critical of larger operators that are looking to sell. "You cannot fault the bigger guys; actually, they are doing what they are supposed to be doing: focusing on their core operations. That is how the food chain in this industry keeps going."

Ackerman notes that "we believe some older shale plays are becoming ripe for the acquire-and-exploit (A&E) strategy. And we are not talking about leasing and flipping. We are talking about refracs, compression optimization, well workovers. Conventional assets will be a big part of our business, but unconventional assets are starting to head into A&E territory."

For Citrine, the U.S. and Canada are fair game. "We are going to let the management teams lead us," Ackerman said. "They know the basins and the rocks."

"YOU DON'T NEED 100,000 ACRES TO MAKE A GOOD RETURN."

—Patrick Swearingen, *Energy Trust Partners*

Starting small, building big

Also working with smaller firms is Patrick Swearingen, senior vice president, Energy Trust Partners. "We find the smaller opportunities often below the radar screen and grow them. We are very focused on management teams that have knowledge in a particular basin, not a Permian team looking to move to the Bakken. We always start with the people, not the project, and look for the ones who know where the good rock is and how to produce it. They are not the type that wants to go public. They want to keep it simple, build assets and sell the company."

Energy Trust Partners, based in Dallas, with one professional in New York, seeks investments of $20- to $50 million, sometimes as large as $75 million. In all cases it prefers to be sole or lead investor. ETP is upstream only; it has a sister fund, Energy Spectrum Partners, that invests in the midstream. ETP is on its fourth fund, which has made three investments so far: two in the Permian, one of which is in Lee County in the Delaware Basin; and the third in northwest Oklahoma in what could be considered the Anadarko Basin.

"You don't need 100,000 acres to make a good return," said Swearingen. "If you have good rock you may only need a few thousand acres. With respect to the investments we've made so far, we believe our teams have found such good assets that we could potentially have exits in the next year or so, even at current prices. It might seem that we focus on assets, but the people always come first. It is their experience and their skills that find and produce the assets."

Bringing an old tool to a new need, Marshall Lynn Bass, president, ARM Energy Resources in Houston, explains that his firm invests in non-operated working interests in development projects, typically through joint ventures.

"We certainly did not invent the non-op WI approach; it has been around forever, but it has new relevance," Bass said. "There are two things that are different now. For small operators, the capital-intensive nature of some of these plays presents challenges. If operators try to drill in accordance with their balance sheets, they might not be the most efficient in the basin, which puts them at risk of getting priced out and ultimately bought out."

For institutional investors the non-op WI model is newly attractive as well, Bass explained. "For institutional investors the access points for small-cap E&P operations tend to be higher risk. But we are different from the standard debt-and-equity model. It is not a fit for every E&P, but it provides non-debt growth capital for operators and a lower-risk entry for investors."

Non-op and project finance

ARM does not invest in existing production, because it tries to be "bank friendly," said Bass. "We are not debt, so there are no liens. This allows E&Ps to keep their senior debt in place. We finance growth with a medium to long-term holding period. We really view non-op WI as an advantage."

That assertion may come as a surprise to some, Bass acknowledged. "Non-op has been a bad word in the PE space, and even in the public markets, for a long time. And it is true that bad things can happen if interests are not aligned with the operating partner. But we feel that belief highlights the difference between our capital and traditional PE."

As one example Bass cited a family in the Marcellus that owns the shallow rights, but a big unconventional developer farms in to the deep rights. "The family was keeping up with their share of the deep development, but they can't when pad drilling raises the bar. Traditional PE generally won't touch that situation, but we can help."

In other situations, Bass said, "if an operator is seeking a capital partner, to bring in traditional PE usually means someone is going to control your board and someone is going to tell you when to sell, or perhaps merge you with another E&P in their portfolio."

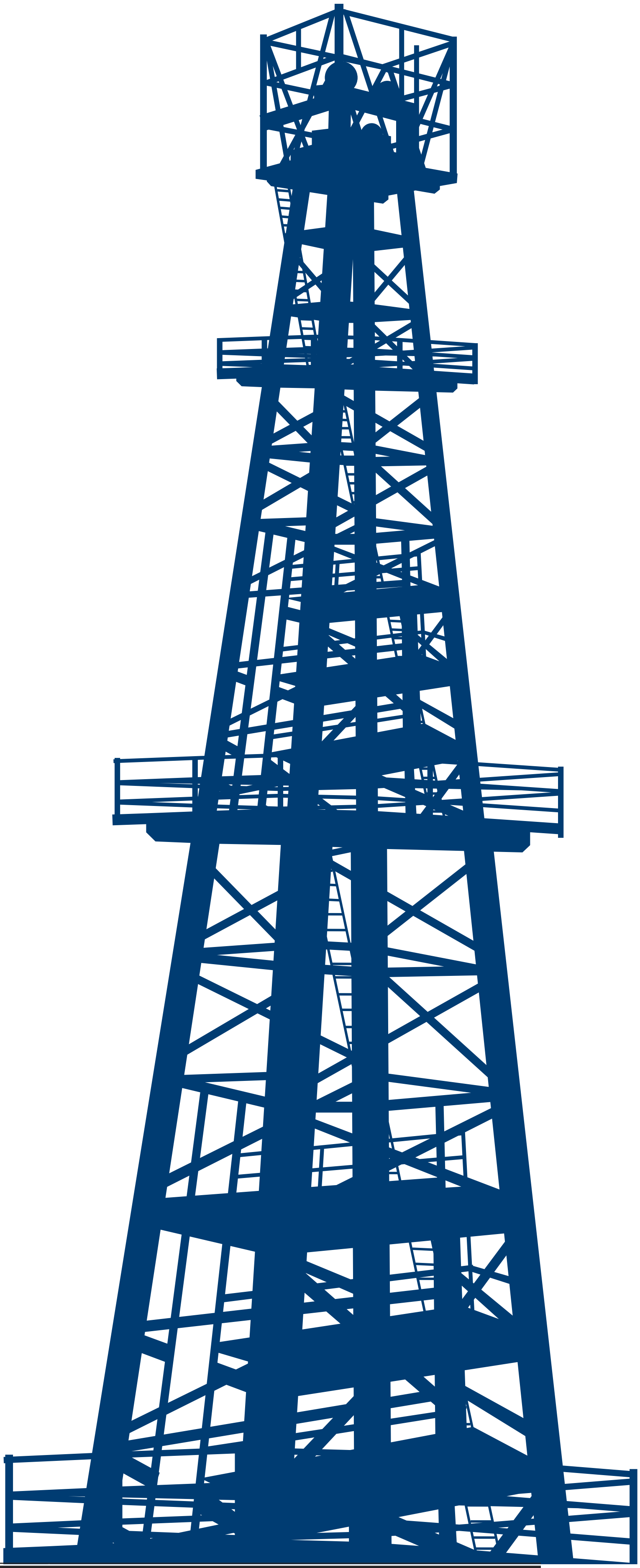
In early May ARM was in the process of closing its first deal in the midst of what Bass calls "a tough market for small companies." But he sees hopeful signs.

"The mood has changed. Some people are laying down rigs and just waiting it out, but others need to drill to preserve acreage, or because they are on the track to go public and need to maintain some level of activity. Other operators want to acquire. So while there is still a downturn in the industry, we like the opportunities it has presented."

Project financing is another essential component of downcycle small-cap investing.

"Often we are lumped in with mezzanine firms, but we really are not," said Stuart Rexrode, president, BlueRock Energy Partners, Houston.

"It is a different type of structure, a temporary overriding royalty interest, as opposed to a loan with an equity kicker. We require a producing asset, but we advance more dollars than a bank typically would for the same asset because we take risk on development upside, usually development drilling.



But we also fund refracs, water floods and workovers. We can be ideal for someone who needs more than a bank can offer, but doesn't want to sell away upside."

In many cases BlueRock invests with producers that may not be attractive to banks for some reason, or need more capital than a bank line can provide. "Also, we try to be a lot more flexible, especially within the structure of the deal," Rexrode said.

"It is not just a matter of what is cut at the time of the transaction. We are partners. We understand there can be challenges. Ours is no-covenant, non-recourse temporary risk capital right alongside the producers."

Partners until payout

Given the nature of its investing, BlueRock sees a lot of possible transactions and deal flow. "Typically those are conventional oil plays. Others are minority working-interest horizontal opportunities, where someone needs $3 million to $10 million to be able to drill their share of a well or two. Our transactions lately have been mostly conventional oil, infill drilling, workovers, and refracs."

One unconventional investment recently has been with a Houston operator that is working in the Woodbine. Another is in the Kern River Basin in California. "We also did a shallow oil play in Kentucky," said Rexrode.

"We are really trying to get the message out across the Lower 48. We are being very opportunistic. Many of our referrals come from people who do business of $20 million and up. We do $20 million and down."

In this segment of the industry, there is not much in the way of direct competition. There is flexibility for BlueRock and for its producer partners. If the project is a booming success, the payout is quick. "If the project is not a tremendous success, then we just remain partners for a longer period of time until payout or a take-out," Rexrode said.

That flexibility means that BlueRock can be the good guy in down markets. "Times like these can be our finest hours," he said. "Some producers may be struggling. Their portion of the revenue is all or mostly going to cover expenses. Some may even be coming out of pocket. We assess the situation and may give some relief or even remit back some of our proceeds. We have no interest in putting our partners out of business. We want to keep them and their projects alive."

Five States Energy Capital is celebrating its 30th anniversary this year, having been formed during the oil and gas industry collapse of 1985. The firm invested in producing working interests in both oil and natural gas during its first 20 years. The portfolio became weighted to natural gas in the late 1990s/early 2000s, but seeing the early success of unconventional development in the Barnett Shale, Five States sold all of its gas properties in 2006 and 2007. It has been investing very cautiously since then, said Arthur Budge, president and CEO.

The focus today remains on the Permian. "We are West Texas and New Mexico guys," said Budge. "And we want to stay small. The sub-$100 million market is a very inefficient space. And many of the producers in the Permian Basin see Five States as a peer rather than just a financial shop.

"We have partnered with Midland independents for over 30 years, and want to keep investing with private, independent operators. We expect to have our current fund fully committed this year. We will either reopen and expand this fund this summer, or form a new fund later this year, so we can continue to make new commitments."

The role Budge sees for Five States is to invest when operators need to pay down senior debt yet still need development capital.

"In some cases private independents become non-compliant with their bank debt, then the banks want all the money to pay down the facility, starting a downward spiral. If all their cash is going to the bank, they can't maintain and grow their production, and they can't develop the best opportunities they have to rebuild out of the downturn. We are also willing to buy some of their working interests but allow them to retain operations."

Budge is excited by the resurgence of the Permian because the long history provides plenty of entry points and new opportunities for smaller operators. Even large independents are making divestitures to allow for continued development of their core assets, providing additional opportunities as those operators consolidate and rationalize. ■

WELL ARMED, PRIVATE EQUITY HUNTS FOR DEALS

Billions of dollars are flowing into the energy sector today. Private equity investors are not seeing many bargains yet, but fully expect more to come to market if low commodity prices persist.

By Peggy Williams

The money available to U.S. oil and gas companies is astonishing: more than $16 billion flowed into the energy sector in first-quarter 2015, two-thirds in high-yield issuances and one-third in public equity raises. This has shored up balance sheets and is enabling E&Ps to join the hunt for opportunities, predicated on the theory that low commodity prices will deliver great bargains to the market later this year.

But there's more. Private equity funds are also in the hunt, with estimates varying between $40- and $65 billion raised and ready to deploy—to shore up, or outright buy, liquidity-challenged smaller E&Ps, or provide growth capital to stronger

> "CAPITAL STRUCTURE IS KEY TODAY."
>
> —***Doug Swanson,*** managing partner, *EnCap Investments*

companies that might be armed with a shopping list. However, as of yet, the hoped-for bargains are not widely appearing. Private equity investments take many forms, from backing a start-up E&P to investing alongside an established private or public company to fund additional drilling.

"We think the worst of the downturn is yet to come," said Carl Tricoli, managing partner and co-president of Houston-based Denham Capital. Tricoli spoke in early April in Austin, Texas, at Hart Energy's Energy Capital Conference. He participated in a panel discussion on private capital in energy. "We're not seeing a lot of bargains yet."

That's because in the recent spring round of borrowing-base redeterminations, companies benefited from aggressive 2014 drilling programs. The flush of drilling increased their booked reserves, helping to offset lower commodity prices. "If the price environment doesn't change as we move into 2016, we will have much more difficult borrowing-base redeterminations. That's when we're going see more of a target-rich environment," said Tricoli.

Panelist Doug Swanson, managing partner, EnCap Investments, agreed. "We do think that the longer this downturn is protracted, the better the opportunities will be."

Nonetheless, Houston-based EnCap has already uncovered a couple of unique opportunities this year, investing $1 billion. (One was mineral acquisition and one was a marketing transaction in which EnCap backed a team that was very familiar with an area and had strong operational expertise.) Meanwhile, the group recently closed on its 10th fund with $6.5 billion.

The view of the institutional investor community—the limited partners that join such funds as EnCap or Denham—is also optimistic.

"Overall, when examined on a price-to-marginal-cost perspective, many commodity prices today are below marginal costs," said Austin-based panelist Mark Warner, senior managing director, natural resources and emerging markets investments, University of Texas Investment Management Co. (Utimco).

"We see the whole world going through a reset. It's not just energy, it's occurring across the commodity markets. What we are going through is not necessarily going to be over quickly or easily."

The entrepreneurial portion of the energy industry has historically been pretty good at adjusting to cycles, said Warner. "We're seeing that adjustment right now—it's dynamic and there's volatility in equity markets both from an issuance and a trading perspective. On the private side, the opportunity set is beginning to present itself, but our sense is we're very early into that stage."

And, when opportunities do come they will not last long. With the amazing depths of the discretionary pools of capital available that are poised to capture distressed opportunities, when those opportunities do come to market they will be "arbed" away relatively quickly.

"Capital structure is key today," said EnCap's Swanson. "Our portfolio companies have very little debt, so they're able to be patient and wait

SELECT RECENT PRIVATE EQUITY RAISES

Fund	Date	$ Billions
EnCap Energy Capital Fund X	Apr. 2015	6.5
GSO Capital Partners	Feb. 2015	2.0
Riverstone Global Energy & Power Fund VI	Feb. 2015	3.0
Blackstone Energy Partners II	Feb. 2015	4.5
KKR Global Infrastructure II*	Feb. 2015	2.0
Carlyle International Energy Partners	Feb. 2015	2.5
ArcLight Energy Partners VI	Feb. 2015	2.5
NGP Natural Resources XI	Jan. 2015	5.3
Energy Spectrum Partners VII*	Dec. 2014	1.2
Warburg Pincus Energy	Oct. 2014	4.0
First Reserve	Oct. 2014	3.4
Macquarie Infrastructure Partners*	Oct. 2014	3.0
Pine Brook Capital Partners II	1Q 2014	2.4

**All or primarily midstream; may include roads and rail. Source:* Oil and Gas Investor

SELECT RECENT PRIVATE-EQUITY INVESTMENTS

E&P Company	PE Provider	Amount ($ Millions)	Focus
Crossing Rocks Energy Partners LLC	Natural Gas Partners	N/A	TX, Midcont.
Treadstone Energy Partners II LLC	Kayne Anderson	100	TX, Midcont.
Sierra Oil & Gas	Riverstone Holdings, EnCap	525	Mexico
Anadarko Petroleum Corp.	KKR & Co.*	N/A	Eaglebine, E TX
ExL Petroleum	Quantum Energy Partners	500	Permian Basin
Tug Hill Inc.	Quantum Energy Partners	450	A&D in U.S.
Three Rivers Nat. Res. Holdings III	Riverstone Holdings	500	Permian Basin
Double Eagle Energy	Apollo Global Management	N/A	A&D in U.S.
American Energy Minerals Holdings	The Energy & Minerals Group	500	Onshore mineral interests
Atlantic Resources Co. LLC	Denham Capital	N/A	Permian Basin

**KKR is a non-op working interest partner. Source: Oil and Gas Investor*

for the right opportunities, whether that's beginning to drill again aggressively or make acquisitions."

In the meantime, EnCap's portfolio companies are reexamining their strategies and portfolios, and also taking a pause to let service costs come back in line with the low commodity price environment. "They're looking to making bolt-on acquisitions and at diversifying their asset bases, but to date the opportunities are somewhat limited."

"PRICE IS ONLY ONE DYNAMIC… THE RETURN CRITERIA ARE THE SAME."

—***Carl Tricoli,*** managing partner, *Denham Capital*

What works today

For Denham Capital, investment objectives remain much the same now as in the days of $100/bbl oil. "Price is really only one dynamic in the whole equation. The return criteria are the same," said Tricoli.

Denham looks at assets that are going to work in all sorts of price environments, focusing on margin. "We want assets that are low on the cost curve where there's enough margin to sustain a wide variety of price environments. In particular, we're looking for assets that have a lot of serendipity associated with them, such as multiple horizons, and where there is potential for drops in the cost structure. We look at all the things that go into creating value."

Today's U.S. energy market has evolved into a margin management business, agreed Warner. "I'm old enough that when I got out of college as a petroleum engineer, we didn't talk about margins. It was a completely different business." Now, it is all about manufacturing and margin.

EnCap has a similar story; indeed its return hurdles haven't changed for the past 10 years. It still looks to generate 2:1 on its investments and a 25% rate of return.

"At the end of the day, we're looking for the best management teams that have a solid track record of value creation," said Swanson. "The basins that were in the top quartile for economics 12 months ago are the only basins economic today. So, we're focused on plays like the Permian and some parts of the Midcontinent in the Stack and Scoop areas that appear to be economically advantaged to other plays.

"Whether prices are flat or going up or going down, it's about being able to buy it right, how you enter, how you exit, and the ability to drive down costs and prove efficiencies in the properties." ■

OPTIONS IN A 'NEW WORLD' OIL MARKET

Holding out for $70 WTI? Macquarie Energy Capital ("MEC") has a solution.

"There are oil producers that have a near-term need for stretch or subordinated debt or development capital," says Paul Beck, Executive Director and Head of Macquarie's upstream investment and loan group.

"Some are experiencing credit-facility stress from their banks and trying to survive this low-price cycle." And they still have drilling-capital needs. "The margins on their production are not as substantial as in the past few years and they're anticipating a reduction in their borrowing bases. They may not intend to accelerate drilling, but they may need to hold some of their acreage for later. That's where we come in.

"We've had quite a ride since opening the office in 2002," relates Macquarie's Beck. "In my thirty years in the oil and gas business, the roller coaster ride over the past fourteen has had the wildest swings. We've seen crude oil prices cycle from $25/bbl to almost $150/bbl, then drop to around $35/bbl only to cycle up again to north of $100/bbl and now back down to ~$50/bbl. Natural gas prices have oscillated from around $2.00/Mcf up to over $10.00/Mcf, back down to around $2.00/Mcf and then recently shot up to around $5.50/Mcf only to collapse back to around $2.50/Mcf.

"We are in a period of market realignment following a North American 'shale storm' that prompted OPEC to shun price support in lieu of gaining market share. Given this historical perspective and our demonstrated ability to execute transactions from one extreme to the other, we are excited to see what the future holds."

In its 13th year now, MEC has closed some $5 billion of transactions primarily via its Houston office, but with significant contributions from its offices in Calgary, London, Sydney and Singapore. The group has expanded its product offering to include participation in conforming reserve-based loans where it can bring its vast physical and financial derivative capabilities to bear, in addition to now offering preferred equity for drilling investments and private equity commitments alongside experienced PE sponsors.

To examine potential investment and credit transactions, MEC has 15 petroleum engineers and technicians, and two geologists on staff. "We are very technically driven," Beck says.

"That allows us to be more aggressive in our transaction confidence and more collaborative with prospective clients. We are a financial partner that functions more like an industry partner. We bring that added value to our relationships. We built our business that way from the beginning."

This spring, the group closed a large restructuring for a private Permian producer, in addition to being in various stages of due diligence for several development projects that are still viable, particularly with the significant reduction in capital costs and the recent bump in crude oil prices. These initiatives are in addition to Macquarie's continuing to fund development and acquisition opportunities for its existing clients.

Also worth noting, the Energy Capital team is just one component of the full-service energy platform at Macquarie, which includes an industry leading Energy Markets Group, that actively trades both physical and financial contracts in natural gas, crude oil, NGLs, coal and electricity. Also of note is Macquarie Tristone's A&D group, that actively markets assets for the industry, targeting transactions valued at $100 million and up. And Macquarie Capital's investment banking advisory group specializes in M&A and raising debt and equity capital for the industry. ■

GHS GLOBAL HUNTER SECURITIES

Seaport Global

TheSeaportGroup

Seaport Global Securities LLC (SGS) brings together two firms, *Global Hunter Securities LLC* and *The Seaport Group LLC*, with over 250 sales, trading, banking and research professionals who combined have traded over $150 billion of securities and participated in 190 investment banking transactions with a total transaction value of $33.2 billion in the last three years. **Seaport Global provides experienced investment banking services and top-quality credit and equity research to over 500 companies in a range of markets.**

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  - *GHS Well Watcher*
  - *Gulf Coast Weekly*
  - *MLP/Infrastructure Weekly Comp Sheet*
  - *Shipping Daily Market Scorecard*
  - *Weekly Crude Oil Scorecard*
  - *Weekly Natgas Storage*
  - *Weekly Industrials Insights*

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  2015 Conference Date: June 23rd& 24th

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    - Restructuring/Bankruptcy
    - Strategic Alternatives
  - Public and private debt placements
  - Public and private equity placements

$200,099,984 SYNERGY Follow-On Equity Offering Sole Book-Runner Seaport Global February 2015	$775,000,000 First-Lien Term Loan B Due 2019 Joint Book-Runners GHS TheSeaportGroup July 2014	$500,250,000 DIAMONDBACK Follow-On Co-Manager GHS July 2014
$450,000,000 NewGulf Acquisition of Halcón Resources East Texas Assets Buy Side Advisor GHS May 2014	$365,000,000 NewGulf Senior Secured Notes Joint Placement Agents GHS TheSeaportGroup May 2014	$135,000,000 NewGulf Subordinated Notes & Warrants Joint Placement Agent GHS May 2014

Selected Transactions

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Head of Corporate Access
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STRINGS ATTACHED

Foreign-sourced financing brings its own rewards and challenges.

By Aaron Ball, Blackbriar Legal Advisory Services Ltd.

Small-cap E&P companies can be attractive targets for investors because, on a dollar-for-dollar basis, they can offer superior rates of return and a wide diversity of assets and opportunities. Additionally, they typically have a narrower focus and management teams with deep experience in a particular play or geographic area—thus making them more effective operators than their larger counterparts.

However, special difficulties plague small-cap E&Ps in finding capital to fund their drilling needs, to say nothing of expansion through acquisitions or start-ups. During the current downturn, lenders and investors have become more selective. The most common forms of traditional financing are senior debt from a bank through a conventional borrowing base, revolving credit facility (to provide working capital or develop existing assets) and term loans (funding to acquire assets).

Revolving credit facilities and term loans are secured by a mortgage or deed of trust on the assets—and as they say, “therein lies the rub.”

Small producers accustomed to using these face declining revenues at the same time that they desperately need funds to drill and develop assets acquired when commodity prices were much higher. Since they typically have fewer assets, this can mean traditional sources may effectively remain “off limits,” because commodity price drops have stripped away the value upon which such funding methods rely. This is especially true for small companies without substantial, current cash-flow from operations (start-ups); having

> "IN CONTRAST TO THE FAST-PACED U.S. DEAL MARKET, FOREIGN INVESTORS' EVALUATION AND DUE DILIGENCE PROCESS CAN BE PAINFULLY SLOW."
>
> —***Aaron Ball,*** managing partner, *Blackbriar Legal Advisory Services Ltd.*

limited operations or low production; or low investment diversity (risk concentrated in a small number of assets).

Foreign direct investment

These challenges have forced E&P companies to become more creative in their approach to finance. Such innovation means seeking alternate sources and, for some, foreign investment. To many producers, such investment may seem like "manna from heaven," especially when foreign companies or funds are eager to enter the U.S. market and come with substantial cash on hand. Further, many foreign investors are often willing to overlook the restrictive factors used by commercial banks and pay a premium to enter the market.

However, obtaining foreign investment dollars comes with its own share of strings attached. Cultural differences can be the single most difficult element for small E&Ps to overcome when dealing with foreign investors.

In contrast to the fast-paced U.S. deal market, foreign investors' evaluation and due diligence process can be painfully slow—sometimes resulting in lost acquisition opportunities. This is especially true for Chinese fund managers, who have a fierce aversion to risk and often seek security and decision-making control disproportionately large to the size of their investment. Their top-down management style reserves most significant decision-making only to people at the highest levels.

Accustomed to quick and nimble decision-making, U.S. management teams get frustrated easily when told that decisions that would normally be their call must be passed up the chain to the foreign corporate office for review and approval—often by senior management who may have little or no understanding of the U.S. market or industry customs, and whose idea of a quick decision might be weeks instead of days.

Even European companies, which more closely resemble their U.S. counterparts, may place what U.S. E&Ps consider an excessive focus on risk analysis at the expense of potential upside, sometimes making movement even on small transactions difficult. The consolation prize for a longer courting and approval period with foreign investors, however, is often, in the case of purely financial investors, a more hands-off approach to management when compared to the oversight exercised by a U.S. private-equity firm.

Special considerations

Foreign investors also come with their own share of special regulatory considerations. For many small companies, the attractive side of foreign investment can be a reduction in offering-related compliance obligations for securities law purposes. For example, foreign investors are excluded from certain of the notice and filing obligations imposed on private placement offerings, potentially lowering the cost of raising capital compared to a domestic offering.

Conversely, U.S. law imposes a number of restrictions on foreign ownership of domestic oil and gas assets that require more careful consideration of how the deal is structured. For example, oil and gas mineral interests on federal lands may be purchased only by U.S. citizens and by those who have "declared their intention to become U.S. citizens."

Citizens of another country whose laws, customs or regulations deny similar privileges to U.S. citizens or corporations are also prohibited from owning any interest in any lease of federal "mineral lands" (including offshore leases in the Outer Continental Shelf). Regulations permit only citizens, resident aliens, domestic corporations or associations of one or more of these groups to obtain such leases. (Similar restrictions apply to the ownership of aircraft and sea-going vessels, which may implicate both E&P as well as oilfield service companies.)

The most notable regulatory restrictions on foreign direct investment in oil and gas apply to entities owned or controlled by foreign governments, such as national oil companies (NOCs) or private companies in which a foreign government has a controlling interest. It may seem unlikely that a small oil and gas company would be the subject of investment by a NOC or government-controlled entity. However, keep in mind that many such government organizations rarely take the form of a standalone company. It is common for government ownership or control of a foreign energy company to exist as a large conglomerate, including separate investment funds, research and oilfield service companies, and engineering and construction firms, among others.

Depending on the size of the government affiliate, such entities may, in an effort to grow revenues, seek out their own entry point in the U.S. market, even if their parent or affiliate companies have already done so. Dealing with an instrumentality of a foreign government heightens the potential restrictions on foreign-sourced investment.

The U.S. president is authorized to block foreign acquisitions of U.S. companies that might threaten national security. Authority for investigating such prospective transactions was delegated to the Committee on Foreign Investment in the U.S. CFIUS includes representatives from federal agencies such as the departments of State, Defense and Commerce. CFIUS first impacted upstream oil and gas in 2005 when it reviewed (and the president subsequently blocked) the acquisition of Unocal by state-owned China National Offshore Oil Corp. (CNOOC). Following this, Congress imposed even stronger review standards, specifically identifying "energy security" as an element of national security, thereby firmly affixing CFIUS oversight to a larger universe of upstream oil and gas transactions.

Even so, foreign investment holds tremendous potential for small oil and gas companies that are prepared for its challenges and limitations. Companies that seek foreign investment for U.S. operations will likely find that, once they have acclimated to operating under a new set of rules, there are many advantages over sole reliance on domestic funding sources. ■

Aaron Ball is managing director with Blackbriar Legal Advisory Services Ltd., Houston.

SHAKING HANDS

There have been several recent examples of U.S. independents sourcing foreign capital for drilling carries. Here are two:

In July 2014, Swift Energy Co. closed on a deal with PT Saka Energi Indonesia (Saka) to fully develop 8,300 acres of Fasken area properties in the Eagle Ford Shale in Webb County, Texas. Swift sold a 36% full participating interest in Fasken to Saka for $175 million, with $125 million (subject to adjustments for interim operations) to be paid at closing and $50 million in cash to be paid by Saka over time, to carry a portion of Swift's field development costs incurred after the Jan. 1, 2014, effective date.

At closing, Swift Energy received approximately $147 million, composed of the initial $125 million cash consideration plus Saka's share of capital costs, net of revenue, since the effective date of the transaction. Approximately $38 million remains of Saka's original $50 million drilling carry obligation, which is expected to be fulfilled during calendar-year 2016.

In early 2013, Pioneer Natural Resources Co. sold a 40% stake in its Wolfcamp play in the Permian Basin to Sinochem Group for $1.7 billion. This deal included a $500 million cash payment and $1.2 billion pledged for part of Pioneer's share of drilling and facilities costs over six years. ■

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A FAMILY AFFAIR

Albeit quiet and hard to find, this capital source can be very savvy and very loyal.

By Chris Sheehan, CFA

Family offices can be as varied as the forebears who built the family wealth in the first place, which their descendants now strive to preserve for future generations. And some of them—perhaps a growing number—invest in energy.

"It's a complicated area in that just about every family office is unique," said Martin Fleming, managing director with Black Dutch Management LLC. "When you talk about family offices, it encompasses a very broad spectrum. There's a huge range."

Much may turn on the definition and size of a family office. They can vary from being quite modest in size to an entity as large as the Tisch family's, which has large interests in Loews Corp., a majority investor in NYSE-listed Diamond Offshore Drilling Inc., noted Jay Snodgrass, principal with EnerFi Capital, Dallas, an advisor on raising capital in the upstream sector with a focus on family offices.

In addition, it is not unusual for family offices to span several generations since the initial wealth was created.

Weighted to energy

Houston-based Petro Lucrum Inc. has a rich, multigenerational history and its wealth was originally earned from its oil and gas activities, according to president Timothy Smith. Today, its portfolio is still weighted heavily to energy, which accounts for over half of its assets, including interests in more than 1,000 wells. Petro Lucrum acts in many ways like an E&P, although it often sets up special purpose vehicles to operate specific portfolio assets.

Petro Lucrum's overall portfolio includes both liquid assets such as equities, fixed income instruments and master limited partnerships; and hard assets such as direct investments in energy, real estate and manufacturing. In energy, it has been active in the E&P and oilfield services sectors. The E&P focus has been on assets primarily in

"In prior cycles, they've always wished that they had invested more."

Timothy Smith, president, Petro Lucrum Inc.

Texas and Louisiana along the Gulf Coast and in Kansas and Oklahoma in the Midcontinent.

E&P deals typically include producing properties with development upside. Petro Lucrum's "sweet spot" in terms of deal size is $25- to $75 million when acting alone. However, it frequently invests under a "club" arrangement with other family offices and co-investors, in which case transactions are larger, in the $50- to $250 million range. Debt, if used, would be additive. Petro Lucrum typically generates deals internally or sources deals through a network of industry relationships.

"We rarely bid on a deal that's on the market or being represented by an investment bank. Ultimately, it's our relationships that drive our deal flow," said Smith, adding that such a network of relationships constituted a "competitive advantage."

Historically, Petro Lucrum's oil and gas properties have mostly been conventional in nature, but it has moved away from this core strategy at times, including its participation with Devon Energy Corp. in unconventional force-pooled properties in Oklahoma. It also has worked with other established operators in unconventional plays where Petro Lucrum typically already has its acreage held by production from conventional zones.

Originally, such assets were acquired to exploit conventional targets, but have become of increasing interest for their unconventional potential, noted Smith. If logging and core data from drilling down to conventional targets helps support the geological interpretation of an unconventional play, for example, an established operator may farm in and as operator exploit the unconventional targets. Petro Lucrum is building a significant position in east-central Texas that may attract such a strategic partner, he said.

The principals on whose behalf Smith runs Petro Lucrum are described by him as risk takers who are inclined to invest "aggressively" in the current downturn. "In prior cycles, they've always wished that they had invested more." Assuming a better commodity pricing environment, said Smith, Petro Lucrum targets internal rates of return "in excess of 25% to 50%, in line with "industry levels."

That said, when industry conditions are "hot," the principals are "typically very cautious of a potential downcycle," said Smith. A discipline that Petro Lucrum adheres to is to hedge out most of its production for at least two years, and longer, if feasible.

As E&Ps look for alternative capital sources, family office funding may align with their need for smaller amounts—say, $10- to $50 million—that are below threshold levels for private equity, said EnerFi Capital's Snodgrass. The funding, however, can be highly diverse in its objectives, ranging from providing strong cash-on-cash returns to building an in-house E&P company, or providing foreign investors with a vehicle to own a North American hard asset.

Family offices, given their "theoretically indefinite life," usually have a much longer time horizon than that of many investors, and act accordingly, said Snodgrass.

"Most are not focused on, 'How can I exit my investment in three years?' Instead, they're looking to build projects that can generate strong cash-on-cash returns over the long term, and also provide some long-term growth," he said. "They're not looking to prove up an acreage play and then flip it."

Somewhat like a foundation, the No. 1 priority often is capital preservation, noted Snodgrass. "They'll gladly give up increased returns in exchange for greater capital security," he said. "They want to make sure that the wealth is available for the next generation and the generation after that."

Matching up family offices with appropriate assets will depend on their chosen strategies, according to Snodgrass. For example, one family office he advised wanted to essentially build its own E&P company. Another wanted a more passive vehicle, such as a joint venture with an experienced operator that had an existing project in hand. E&P managements whose stock options during the downturn have lost their value may be attracted by a new home with fresh upside, he said.

Another option for a family office is to buy non-operated working interests, providing it adequately safeguards the investment with "at least a basic infrastructure to manage the back office and ensure expenses are in line and rights are maintained," said Snodgrass. "It's not rocket science; it's book-keeping. But you 've got to be on top of it, because it can be overwhelming if you are not set up for it."

Family offices from overseas are also showing interest in U.S. oil and gas deals. According to Snodgrass, this is often due to their comfort in owning "real assets," as well as the fact that—with the exception of the U.S., Canada and parts of Australia—"you really can't own reserves privately" in most countries. Interest is coming from Europe and Latin America, he said, citing a Venezuelan family with a long history in the oilfield service sector evaluating opportunities in the U.S. E&P sector.

Despite turbulence in commodities, increasing numbers of family offices seek investments in energy, according to Fleming of Black Dutch Management. The trend is for "more involvement, but also more caution," requiring varying levels of risk to match up with appropriate suitability standards.

In Fleming's view, family offices often fall into one of two "basic buckets." One is made up of families that typically made their money in oil and gas and can independently evaluate what constitutes a good deal in terms of drilling or even exploration ventures. The other involves a professional asset manager, who may already own real estate and is looking to increase an underweight position in energy, but isn't equipped to evaluate, say, capital calls on an oil and gas transaction.

The latter group may be attracted to royalties, "because that's a passive-oriented investment and doesn't require making active investment decisions," said Fleming, formerly a senior vice president at Noble Royalties, Dallas. "You don't have to decide whether to AFE [authorization for expenditure] or not, to consent or not, to pool or not. You effectively make your investment and watch it produce cash flow."

Black Dutch Management itself is "not a pure family office," said Fleming, but rather "straddles the space." The principals typically pool their own capital to make investments up to a certain size, and bring in families as co-investors in larger deals. They also invest in "more institutionally oriented products."

Typical deal size for Black Dutch Management is in the "middle market" range of $5- to $75 million. The oilfield sector has been an area of emphasis of late due to "more distressed seller opportunities" than in other areas. In addition, the principals are evaluating operated working interest opportunities. "And I'll always look at royalty packages," added Fleming.

An entrepreneurial bent

Greenway Family Office, based in St. Louis, also has an above-average weighting in the real asset space, an area that it has expanded under the guidance of Christy Conners, who joined in late 2012. The family office works with some 15 families, whose wealth has mainly come in the current generation.

These families tend to be "more entrepreneurial in nature," according to Conners. And with economic conditions for business owners or entrepreneurs generally more closely correlated to the stock market, the families' overall portfolios can carry an asset class that is "more heavily weighted to the real asset space." Their portfolios generally also have a low income requirement, she added.

The trend is…"for more involvement, but also more caution."

Martin Fleming,
Black Dutch Management LLC

"We will look at deals of almost any size."

Christy Conners,
Greenway Family Office

Family offices will "gladly give up increased returns in exchange for greater capital security."

Jay Snodgrass, EnerFi Capital

Deals typically include producing properties with some development upside. Size can vary widely.

"We will look at deals of almost any size," said Conners.

For example, if all 15 families take part in a deal, it is not a prerequisite to have at minimum a $15 million transaction for each to have $1 million apiece. If the transaction has merit, Greenway can do a deal with 15 families taking $250,000 apiece, for a deal size of $3- to $4 million, according to Conners. Also, it can do larger transactions if it brings in other family offices as co-investors. In addition to sourcing its own deals, Greenway participates in other family offices' deals—key to acquiring quality assets on a consistent basis.

"Gaining access to find producing properties can be difficult. If you don't have contacts and connections, it can be hard to get in the deal flow," said Conners.

For E&Ps possibly seeking new sources of capital, the family office network can also be difficult to break into—especially in light of family offices' reputation for discretion in their activities.

"That's the most challenging part," observed Snodgrass. "But if you do find them, it can be a very attractive, low-cost source of capital."

Unfortunately for those seeking new sources of capital, however, family offices are often best-known for being discreet—so much so, they are hard to find.

Adds Fleming: "I think of family offices as being harder to break into, but more loyal and more patient in terms of timing." ■

RESTRUCTURE OR RECAPITALIZE?

Low commodity prices are forcing E&Ps to make choices. Some experts are devising innovative ways to go forward. Play offense and defense, they say.

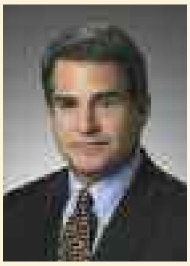
By Susan Klann

The "R" words have reentered the daily lexicon of upstream companies.Recapitalization is a watchword in 2015, with more than $20 billion raised in the capital markets as of press time, to help E&Ps buy time and regain their footing. Other producers are restructuring or forming innovative partnerships to manage through the downturn. In either case, the goal is to reassure investors and financial backers while positioning to emerge stronger, refocused on core strengths and able to seize opportunity in the next upcycle.

The topic of restructuring drew an attentive audience at *Oil and Gas Investor's* Energy Capital Conference in Austin in early April. Leading the discussion was Alvarez & Marsal managing director Dean Swick, who has guided more than 100 upstream, midstream, downstream and service companies through out-of-court and in-court restructurings.

Swick said the bottom has been reached.

"We are already headed into a new cycle where there are unique and wonderful opportunities awaiting the sector," he said.



"Equity holders may have a different view than management. You'll need to have responses…"

Dean Swick, managing director, Alvarez & Marsal

The magnitude of the pain still being felt by E&Ps is evident in the numbers, however: Energy issuances that are trading at or below 50% of par approximate $10.5 billion, or 55% of all high-yield bonds trading in this range, said Swick, who called the amount "staggering."

Whether recapitalizing balance sheets or restructuring, companies should consider three phases. The levels of distress, timing and uncertainty will determine the emphasis placed on each.

Stabilization and initial evaluation. Critical to this phase is management of liquidity.

"I compliment the industry on how it is dealing with uncertainty," Swick said. "Clearly, cash is king, and you see that in efforts to preserve liquidity and to bring additional capital in.

"But digging deeper into what liquidity management means will uncover some aspects that are unique to oil and gas," he said. "I have never financed or worked with a producer that didn't think it was the best operator around. And I love that. If I put money to work with someone, I want them to believe they are the best. But there is a working capital burden that goes with that belief, and it is the carried nonoperated interest."

Swick urged producers to unlock working capital liquidity by paying attention to AFEs and LOEs. "These are often forgotten, and during frothy times, projects are sometimes kicked off before AFEs are collected from nonop partners. We often find there is past-due AFE collection stemming from lax efforts to collect payments or from items that are in dispute," he said.

"It's the same with LOE expenses. Both of these are a huge burden on an operator's balance sheet, and present some risk. If you are paying attention to working capital and digging into liquidity issues, you'll be ahead of the game and you'll extend your liquidity runway."

In other instances, larger companies may be "AFE'ing to death" a smaller independent, or it may be a situation where an operator doesn't have capital but its nonop partner wants to move more rapidly and outspend it. "This can be troubling," he said. "So managing liquidity has both offensive and defensive aspects."

It's also important for companies—particularly public entities—to speak consistently, and with one voice, when talking externally. "Channeling your communications through one voice or person will remove uncertainty and give observers confidence that you know what you are doing," he said.

"We make sure that at least once a day the C-level executives are meeting so everything is coordinated and heading in the same direction."

Incentives should be in place to motivate executives based on the current environment and objectives. The driver in today's climate might be cash flow or it might be cost reduction, he said.

Assessment and planning. In the next phase, "focus on the business," he said. "Be brutal in assessing what is core and noncore to your business." Look at the left-hand side of the balance sheet and decide which assets you need and which can be monetized or targeted for reduced investment.

Competing interests will surface, he said. "Equity holders may have a different view than management. You'll need to have responses to maximize value for all stakeholders. You'll want to ask yourselves, 'How can I survive this and be the healthiest company when I come out of the downturn, as well as positioned to take advantage of opportunities?'"

While the amount of capital in the market for E&Ps currently is "fabulous," he said, "I do worry that companies are not looking at their business carefully enough. Don't burn the capital on things that don't work in this environment or that won't have value when the recovery comes."

Final steps in assessment and planning are determining the risk/reward for each stakeholder group; the fulcrum security or capital partner; and finally, changes to the right-hand side of the balance sheet.

It is a sequential approach, he said. "You have responsibilities to many different stakeholders, but don't let one drive your interests. It may have a pivotal position, but as a management team you must do what is best for the company to survive today and be positioned for the long term."

Growth and recovery. Even once you have a plan, you must keep your eye on the business, he said. Monitor production rates and understand costs to gauge whether you are achieving improvements. "If things aren't going right, stop, reassess, realign and go forward," he said. "Remember, it's a messy, sloppy business, with uncertainty, but if you remain flexible on the back end, you will have the best probability of success."

Innovative partnerships

John T. Young Jr., senior managing director of the energy advisory services group at turnaround specialist Conway Mackenzie Inc., Houston, told *Oil and Gas Investor* recently that "the struggle operators face today is how, in a liquidity-constrained environment, they can continue to bring production online."

To that end, he's working on two projects involving ventures among distressed E&Ps, large service companies and private-equity investors.

"There's a real push away from drilling the $20-million Tuscaloosa Marine Shale well toward workovers and more conventional drilling," he said. "Companies are thinking, 'Let's get the low-hanging fruit, let's go do some sidetracks in existing wellbores.' I think the real jewel in services right now is anyone with a good fleet of service rigs. The push is to focus on low-risk drilling that can enhance existing production."

The structures are similar to the DrillCo deal announced earlier in the year between Linn Energy and its private-equity backer, Quantum Energy Partners, with the latter funding development drilling on Linn's acreage. "What I'm doing optimizes the economics better," he said. "We are taking it to the next level by integrating the large integrated drilling company into the mix."

Distressed E&Ps need capital infusions to develop prospects, create reserves and extend their borrowing capability. "They need more PDP on the balance sheet, and many of them have no way of doing it by themselves in a capital-constrained environment," he said. The structures he is working on could free up from $50 million to $500 million for drilling programs.

"It's a great way for an operator to partner up with service, with support of a fund, and potentially retain

DECISION POINTS

Several factors largely determine whether recapitalization or restructuring/change of control is the better way forward. Recapitalization is likely to be an out-of-court process unless a change of control is involved.

On the flip side, if key stakeholders are not supportive of the core—if the company and its stakeholders and creditors can't define near and long-term value—then it's time to look at restructuring, Alvarez & Marsal's Dean Swick said. Restructurings are likely to be an in-court process and are time-consuming and expensive.

Recapitalization factors:

- Sufficient support for management
- Support of the fulcrum security or other key stakeholders
- Belief that improved core asset(s) focus and cost structure can be realized
- Incremental second-lien debt combined with some or all of the following: A reduced level of first-lien funded debt, acceptable borrowing base redetermination and covenant reset, selective asset sales, additional equity
- Bridging to 2017 and beyond with long-term view of commodity prices

Restructuring factors:

- Too many challenges with core asset base characteristics
- A change of control is desired
- There is insufficient support from the fulcrum security holders
- Conversions of debt to equity or auction of an asset base have occurred.

"These ventures keep the existing lender in place because it enhances collateral value."

John T. Young Jr., senior managing director, Conway Mackenzie Inc.

a reversionary interest so it can get back in later," Young said.

The service and supply company contributes expertise and services; private equity pays for services and other providers; and the E&P kicks in the drilling prospects.

All parties would seem to benefit. In a down environment, the service company needs to have its equipment utilized, just as operators need drilling capital. And the private-equity group benefits from the service company's margins with the additional component of an equity return.

Interest in such arrangements is sharp: Young said private equity and other financial investors are lined up for the next deal.

"These ventures keep the existing lender in place because it enhances their collateral value," he said. "There's a net profits interest component so the private-equity group and the service group get a rate of return, and then the working interest reverts back to the operator once the return threshold is met."

Value is also embedded in having the service company performing the due diligence. "Private equity enjoys an equity return on a project that has been fully vetted technically by a leading service company, so there is a perceived higher return on an investment where the firm can take a moderate to mild risk," Young said. "This enhances underwriting for the private-equity firm as it leverages the service company's resources."

The restructuring expert sees more focus on conventional drilling on the horizon, at least by capital-constrained operators, who are looking to get the 30% left behind in the conventional well. ■

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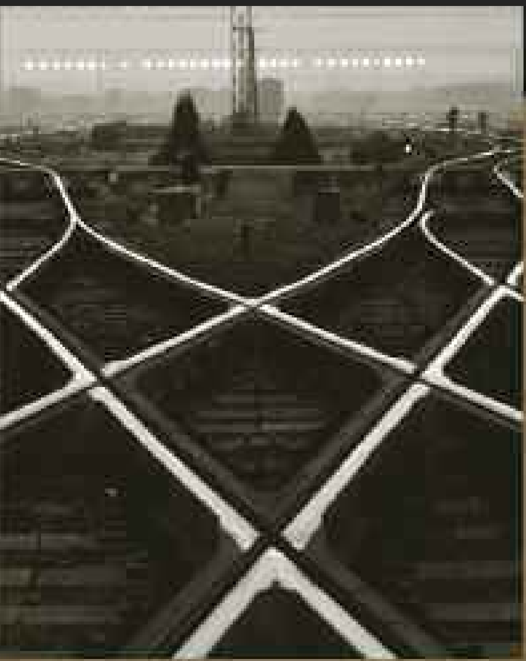
ACROSS THE ENERGY VALUE CHAIN



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