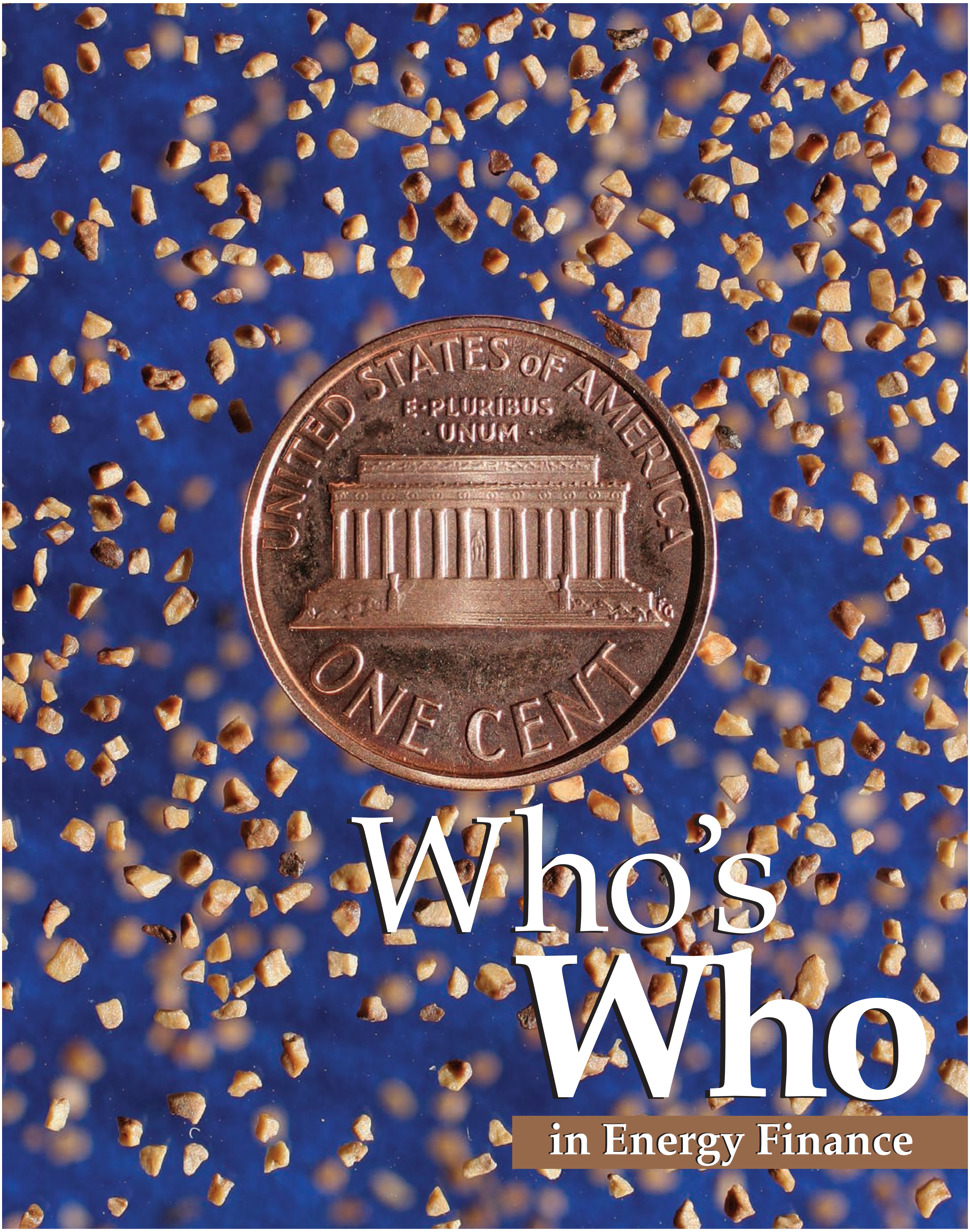
CAPITAL FORMATION 2017



A Supplement To

Oil and Gas Investor

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www.encapinvestments.com

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Oil and Gas Investor

1616 S. Voss, Suite 1000
Houston, Texas 77057-2627
713-260-6400
Fax: 713-840-8585
www.oilandgasinvestor.com

Executive Editor-at-Large
LESLIE HAINES
lhaines@hartenergy.com

Editor-in-Chief
STEVE TOON
stoon@hartenergy.com

Associate Managing Editor
ANNIE GALLAY
agallay@hartenergy.com

Contributing Editors
SUSAN KLANN
DARREN BARBEE

Corporate Art Director
ALEXA SANDERS

Production Manager
GIGI RODRIGUEZ
grodriguez@hartenergy.com

For additional copies of this publication, contact customer service at 713-260-6442.
custserv@hartenergy.com

Vice President
SHELLEY LAMB
slamb@hartenergy.com

Director, Business Development
NELLA VELDRAN
nveldran@hartenergy.com

Manager, Business Development
KEVIN HOLMES
kholmes@hartenergy.com

HARTENERGY

Editorial Director
PEGGY WILLIAMS

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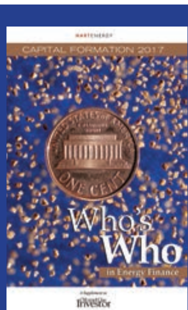


About The Cover

Proppants used in fracturing a well are small in size. This penny shows the relative size of frack proppant particles. These proppants are made from cured, resin-coated, walnut shell particles.

CAPITAL FLOWS AS OPTIMISM GROWS

One truism that has been reinforced in spades during the industry recovery underway is this: Never doubt the optimism of any oil and gas professional—or the providers of capital to same.

When the going got tough, they got going. I'm not saying it was easy, but they repaired balance sheets in all manner of ways. They doubled down on technical advances and best practices, thus enabling U.S. oil production to recover, and rise again. OPEC cartel members are scratching their heads in amazement now. At press time the EIA said U.S. output was back above 9 million barrels a day.

Investor appetite for oil and gas has not waned, but the money is now meant for growth again, not for emergency management. There are several IPOs in the Wall Street pipeline.

Public and private capital continues to flow throughout the industry, from bankers supplying the middle market E&P companies, to new JVs that boost drilling budgets. Capital has been funneled to service companies (think fracking and sand suppliers) to the very largest E&Ps. We've seen overnight raises of $2 billion for Sanchez Energy Corp. to make an acquisition in the Eagle Ford. (See *Oil and Gas Investor*, May 2017.) We've seen private equity funding large teams dedicated to buying minerals, such as NGP's funding of Luxe Minerals LLC with a commitment of $425 million.

The SPAC model of raising money is alive and well. Silver Run Acquisition Corp. II raised gross proceeds of $1.035 billion recently. SPACs are a type of blank-check, shell company that raise public money to later be used for acquiring a significant amount of assets, or another company. (See our article on other SPACs in this report.)

In less than six months the pent-up demand for new issues has been relieved as Wall Street rolled out new offerings that have attracted billions of dollars to the oil and gas space. We've seen a string of IPOs for E&Ps: Wildhorse Resource Development, Kimbell Royalty Partners LP, Centennial Resource Development, Jagged Peak Energy; and for service stocks: ProPetro Holding Inc. (with a great stock symbol, PUMP) and Keane Group Inc. (likewise, with FRAC). Finally, there have been two midstream issues, that of Hess Midstream Partners and Antero Midstream.

At the same time, innovations or consolidation among capital providers are taking place. One example occurred earlier this year, in March, when veteran financier Charles Cherington announced that he has formed Argus Energy Managers, a new Houston-based holding company that has rolled up several boutiques. The total network now has about $1.7 billion of committed capital under management. The group maintains the lower and middle market space has been overlooked, and that the bigger the other private equity funds have gotten, the harder it is for them to place capital appropriately and earn the desired return.

One partner in the group is Intervale Capital, which Cherington founded in 2006 to invest in oil field equipment and service companies. He's raised more than $1.3 billion since Intervale's inception and is investing from the third fund. The second is Bayou City Energy Management in Houston, which he co-founded in 2015, a boutique private equity firm focused on providing capital to small and middle market E&P companies. It's raised $1 billion since inception and is investing from its second fund. Third is Cibolo Energy Partners, which focuses on senior secured debt instruments.

"The smaller end of the market has been underserved and has more opportunities," he said during a panel discussion at Hart Energy's annual Energy Capital Conference in Austin in April.

Whatever the forms of capital and partnerships, plenty is brewing and this annual supplement is meant to give you a flavor for recent news and trends. Be sure to check oilandgasinvestor.com for constant updates on the companies, new ideas and new deals.

–***Leslie Haines**, Executive Editor-at-Large*

For information on specific financial deals, trends and capital providers, check the magazine archives and the Oil and Gas Finance Sourcebook *database at OilandGasInvestor.com.*

"Private Equity Craftsmen,"
On how Vortus Investments and Post Oak Energy Capital helped fund E&Ps. Aug. 2016

"Avenues Widen to Fund Acquisitions,"
On various structures and specific deal profiles. Oct. 2016

"Paring Risk in Private Equity,"
On staged financings and co-investment deals. Dec. 2016

"Crosscurrents in Energy Lending,"
On bank constraints and non-bank entrants to the sector. Jan. 2017

"Common Threads,"
On private equity players Mountain Capital, Trilantic North America and Prudential Capital. Mar. 2017

CLEANED UP NICE

With the industry's balance sheets scoured and investors eager for growth, IPOs, debt and equity raises are on tap for the remainder of 2017.

By Susan Klann

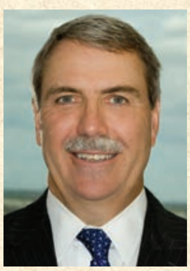
After a break-out year for equity capital markets activity in 2016, the oil and gas sector was primed for a robust 2017. Crude prices had rebounded strongly, and banks had put distressed oil and gas companies' balance sheets through the full wash cycle.

Some $40 billion in equity, $35 billion of that in the upstream space alone, had been raised, according to Paschall Tosch, global co-head of oil and gas investment banking at J.P. Morgan. The first E&P IPOs since 2014—Denver-Julesburg (D-J) Basin player Extraction Oil & Gas and Eagle Ford specialist WildHorse Resource Development Corp.—also signaled recovery.

"It was an exceptional year by any measure," Tosch said. "Investors who bought into the calendar of new issuance were up 30% to 40% on average."

Today, oil and gas continues to offer investors a "generational buying opportunity," Tosch added.

This January, Permian driller Jagged Peak Energy LLC; oilfield service provider Keane Group; Kimball Royalty Partners LP; and coal miner Ramaco Resources Inc. made it through the IPO window. ProPetro Holding Corp. followed in March. A cautionary note was inserted when crude prices retreated below $50 in late February and into March. New issues fell by 10% to 15%, and some investors rotated out of energy. But crude prices recovered, and by late April bankers were forecasting a strong performance for IPOs and the capital markets.



"A 'generational buying opportunity' lies ahead."

Paschall Tosch,
Global co-head of oil and gas investment banking, J.P. Morgan

At press time, some 15 oilfield service companies and a handful of E&Ps had confidentially filed or were working on filing for IPOs. Unlike last year, when a number of potential IPOs turned into sales, Tosch thinks most of this group will go public, because they are convinced of the long-term value to be created.

The determining factor will be whether crude prices stay in the $50s. "For companies contemplating going to market at $50 or above, the well-level returns are adequate for investors to achieve good growth," Tosch said. Oilfield service costs are another consideration.

After the heated capital markets of 2016, investors are more discerning in value.

Interest beyond the Permian

Private Permian and Scoop/Stack portfolio companies rotating to public hands drove much of the capital markets and A&D action last year, according to Tosch. "In 2017, we expect an increased level of Tier 1 (noncore of the core) asset sales to drive significant acquisition and leverage finance activity for PE buyers."

The upstream IPO pipeline is relatively diverse right now: several Haynesville Shale entities, a couple of Scoop/Stack, a Marcellus Shale and a southern Midland Basin E&P may test the market, Tosch noted. "Technological improvements that were highlights in the Permian and Scoop/Stack are beginning to migrate to other basins," attracting attention from investors. In the Scoop/Stack, a number of PE-backed companies are expected to monetize.

There is widespread interest in how offeringsM-

"Reserve-based lending has revived and hit rates for bank syndications are heating up."

Mike Lister,
Managing director and energy group head, J.P. Morgan

focused on natural gas like the Haynesville will fare. "These areas participated in the renaissance of technology and are drilling with great rates of return that are very competitive with the Northeast and sometimes better, because of the lack of basis differential," said Tosch.

Debt financing rebounds

While 2016 was the year of equity, 2017 will be heavily driven by debt financing, according to Tosch and Mike Lister, J.P. Morgan's head of energy and power, corporate client banking.

"There's a new efficiency now, with companies emerging with clean balance sheets and getting back to business, executing their strategy and talking about adding rigs. It's a healthy phenomenon," Lister said.

"Teams are reorganizing and senior bank lenders are willing to do well-structured but regular-way exit facilities. That will only help banks' balance sheets and the market in general."

The high-yield market was dead until the third and fourth quarter of last year, when companies with Double B ratings or strong blue chip status began to access it once more. It's a key market for the industry, Lister noted, with oil and gas making up 10% to 30% of total high-yield issuance, depending on the quarter. Fourth-quarter 2016 had a significant increase in oil and gas high-yield issuances totaling $15.6 billion, more than the previous three quarters combined, followed by a strong first-quarter 2017 of $11.3 billion in issuances.

Today high yield is open to a wider universe of companies. "We're seeing larger deals get done and more storied credits, albeit at higher rates. Just the fact that there is market access is a turning point," Lister said.

J.P. Morgan recently led a $1.5 billion offering for Ascent Resources (Utica Holdings LLC). The deal came with a coupon of 10%.

Revised OCC lending standards during the downturn resulted in the writedown of many banks' loan books and loan-loss reserves being taken last year. Some traditional energy lending banks retreated or exited.

"Over three to five months we've seen a resurgence of banks coming back to the market," Lister noted. "When we write the story of this downturn, I think people will find that the senior secured reserve-based loan, the structure that's been around for 40 years, was stress tested meaningfully over 18 months and fared well. The structure does work. Hit rates on syndications are going up."

A healthy food chain

The early spring retreat in commodity prices dampened enthusiasm across the board.

"If you had asked me before the recent downturn in commodity prices about the outlook for M&A, I'd have said we were on pace for a record year in 2017," said Jon Marinelli, managing director and head of U.S. energy for BMO Capital Markets. The firm was lead financial advisor to Spectra Energy Corp. in its sale to Enbridge Inc. last spring for US$28 billion, the largest energy M&A transaction since the Exxon/Mobil merger.

"We'll still have a great 2017; the pullback had slowed things down temporarily. With the firming back up of prices, we have seen activity levels return to where they were earlier in the year," he added.

BMO's investment and corporate banking group in Houston has been involved in the majority of E&P acquisition financings since the market reopened and has been one of the more active banks in the equity market. George Serice, managing director and head of U.S. energy corporate banking, said the acquisition finance market reopened with Terra Energy Partners LLC's purchase of WPX Energy Inc.'s Piceance Basin assets, announced in February 2016. BMO helped underwrite the debt financing and advised Terra.

The lending market continues to build. "We will add in the neighborhood of 18 to 20 new lending clients through our first two quarters of this fiscal year," Serice said.

He agreed with other bankers that this downturn was notable not only for its severity but also for the OCC guidelines the federal government imposed. "In some situations, they are affecting capital structures as far as where we put debt, whether at the operating company or the holdco level. I don't think the guidelines have reduced our business."

"The A&D market is getting interesting."

Jon Marinelli,
Managing director,
BMO Capital Markets

"New OCC guidelines may affect how capital is structured, but haven't affected BMO's business."

George Serice,
Managing director and head,
U.S. corporate banking,
BMO Capital Markets

BMO was an active bookrunner on the WildHorse Resource Development IPO that closed in December with close to $400 million in net proceeds and on Parsley Energy Inc.'s recent $886 million equity offering to fund Permian acquisitions, and it was a bookrunner on Parsley's $1.1 billion equity offering that helped finance its purchase of Double Eagle Energy Permian LLC assets.

Its lead role on Resolute Energy Corp.'s $165 million equity offering in December, which refinanced a BMO-arranged second lien term loan, exemplifies how some in the industry have coped with the downcycle, Serice said. "It's a case study of a company going through the cycle, refocusing its asset base and fixing its balance sheet. It's done amazingly well through the depths of the downturn."

With most of the equity offerings completed to repair balance sheets, equity offerings are now mostly in support of M&A. "The A&D market is getting interesting," Marinelli said.

Since 2016 there have been 105 deals in the Permian, and there are currently 21 deals being publicly marketed in the basin. "We are starting to see more activity in basins outside the Permian; for example, we recently were the exclusive advisor to Exco Resources Inc. in its $300 million sale of Eagle Ford assets," Marinelli said.

Signaling high yield's comeback, BMO was bookrunner on bond deals in April for Ultra Petroleum Corp. and the Ascent Resources Utica Holdings offering.

Ultra is a new client for BMO, which joined with two other banks to finance the E&P's emergence from bankruptcy. For Ascent, also a new client, BMO was a joint lead arranger on its bank facility.

The IPO pipeline

"There is a healthy IPO backlog," Marinelli said.

"We expect activity to accelerate in the next two to three quarters."

As the Permian pipeline clears, there has been enormous support from the equity markets for financing Permian M&A. Outside of the Permian, more of the IPO backlog should go public vs. a trade sale because consolidation is less advanced.

It all comes down to the economics of the specific basin and the prospective company's position. "Is there a growth and return story that the public markets will embrace? It's not every basin, but it's certainly spreading beyond the Permian and the Scoop/Stack," said Marinelli.

Noting the Haynesville weighting in the current lineup of IPO filings, "From a banker perspective, returns and growth profiles in that basin are compelling," said Marinelli. "It could be setting up for an alternative for investors versus the Permian trade. We think that thesis will be tested in the next two quarters with one or two IPOs."

Rebound in confidence

James Kipp, managing director and group head with Wells Fargo Securities in Houston, said investors have a tremendous appetite for quality names and stories. "I think we'll see a modest uptick in capital markets activity in 2017, driven by increased M&A," he said.

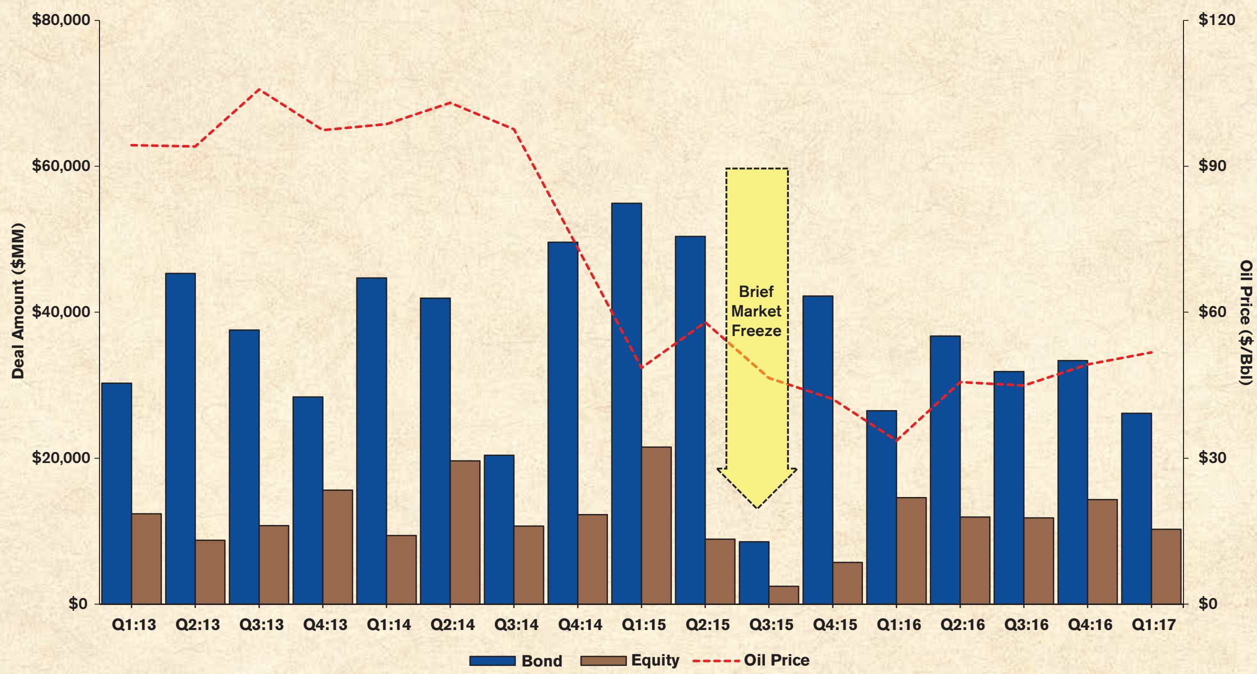
"More IPOs and M&A activity will occur this year."

James Kipp,
Managing director and energy group head with Wells Fargo Securities

Wells Fargo has been active in recent high-yield deals, though Kipp noted that "the bond market is not much of a friend to a company seeking to improve total leverage. You're just substituting another debt instrument for bank debt—it doesn't reduce overall leverage. However, it may provide the benefits of longer maturity and more favorable covenants than the bank facility."

The bank led an offering of high-yield notes for Exterran Corp. subsidiaries in early April that was upsized from $300 million to $375 million. "There was significant investor demand around that," he said. Similarly, Wells Fargo was a joint bookrunner in a senior note offering for Cimarex Energy Co. in April that also was oversubscribed, raising about $750 million.

PUBLIC EQUITY & DEBT IN THE UPSTREAM WORLD:
BACK ON THE RISE AFTER A BRIEF "CLOSE"



Source: Company data, PLS, Seaport Global Securities

"The round of restructurings last year and into this year has resulted, in some cases, in a new group of equity investors—hedge funds—with bondholders becoming equity investors. I think you'll see more companies that emerge from restructuring activities as likely candidates for consolidation, with more capital markets activity to fund those acquisitions," he said.

On the IPO front, Kipp thinks the pace will step up in 2017, specifically with some "re-IPOs" for companies exiting bankruptcy and going through an IPO process to raise new equity.

"We have a number of situations where we are actively engaged as underwriter or positioned to be engaged as a lead or active bookrunner for oilfield service companies," he said. "I wouldn't be surprised to see over a dozen potential IPOs in that particular sector."

Whether more IPOs hit the market in the second and third quarters depends on whether there is conviction that the spring hiccup in crude prices was nothing more than a pause. For PE-backed companies, the crux is whether there is a higher premium to be achieved in the IPO market than through an outright sale.

"The premium that many folks use is about 20% to do an IPO versus a sale," he said. "The problem for private equity is that in many cases it would still be holding a large equity position that is subject to market uncertainty. In many cases, the preferred exit strategy is still a sale."

Beyond commodity prices, the ability to access capital turns, as always, on how companies are positioned, have managed their cost structure and leverage, and their opportunity set. "Investors are more focused on how their money will be spent," Kipp said.

"Rather than substituting equity for debt, in some cases they want to see their capital used to exploit additional drilling to add incremental value. If you're talking to the equity capital markets desk or from a coverage perspective, when a company has a use of proceeds around continuing a drilling program or in the context of an acquisition, there is more investor receptivity."

Beyond the Permian and Scoop/Stack, Kipp sees the Marcellus and Utica as continuing to command capital, along with the D-J and other basins. "We're seeing some deals in the Eagle Ford, and we're working on one for ConocoPhillips on its San Juan Basin assets. There's a lot of activity taking place, a strong representation of people feeling more bullish."

View from an advisor

Petrie Partners LLC typically participates in the capital markets as an offering advisor or in a traditional co-manager role, according to co-founder Andy Rapp, based in Denver. The firm advised Cheniere Energy Inc., Southwestern Energy Co. and PDC Energy Inc. on prior financings and was a co-manager for Resolute Energy Corp.'s equity offering in December and on Jagged Peak Energy's public debut.

Rapp thinks the oil and gas sector could see several more IPOs in E&P and oilfield services this year. But uncertainty remains.

"At $30 oil, consensus was there was much more upside than downside. When it's plus or minus $50 and the forward strip price is flat for five years, there are opinions in both directions. There could be similar upside or downside; it might be better to wait and see."

"There was a lot of pent-up demand to invest coming out of the downturn."

Andy Rapp,

Co-founder, Petrie Partners LLC

Rapp agrees that capital is available for a more diverse set of players than in 2016, when Permian fever dominated. "Last year, if you had a Permian-focused or D-J Basin-focused player, the equity markets were wide open; you were being rewarded and not taking a proportionate discount for dilution. Rather, you almost had your stock price appreciate through the offering because it represented more liquidity and the ability to accelerate development and either acquire more assets or drill more quickly.

"It was a unique market because there was a lot of pent-up demand to invest, but that demand needed to find the right high-quality names coming out of an abrupt correction in commodity prices."

Petrie Partners advised SM Energy Co. on its $785 million sale to Oasis Petroleum Inc. in the Bakken last fall. "Oasis was able to do a large equity add-on simultaneously, and it gave the market a chance to revisit all that Oasis was doing in terms of improved completions and economics and type curves," said Rapp. "It was a catalyst for a fresh look at other high-quality basins. The Eagle Ford still has a lot of potential. Less-in-favor oil basins are getting attention on a selective basis."

Refreshed, the industry is looking at a bright second half. ■

HOW TO PITCH YOUR STORY

This veteran financial advisor and capital provider shares his thoughts on the best way to pitch your deal.

By Leslie Haines

Seeking equity, debt, joint venture dollars for your first deal? Whether for an acquisition or to fund a start-up E&P, approaching capital providers can seem daunting. How do you get in the door? It's like facing a .300 hitter in the bottom of the ninth inning with the score tied. You want to throw a fastball right in the heart of the strike zone, and you'd better not throw a wild pitch.

To find out how to tailor the right pitch to the right capital provider, we spoke with Rob Lindermanis, principal at Bay Capital Corp. in Houston. He has been a capital provider for many years at several companies, as well as an advisor and financial intermediary. Lindermanis connects people with oil and gas ideas with people who have capital to invest. He has seen literally hundreds of pitch books during his career.

Investor What's your best quick advice: what should a group seeking capital do first?

Lindermanis Make it short and simple. What is the story, and how do you tell it concisely?

Investor So what should the pitchbook look like?

Lindermanis I'm a firm believer that you need to give them enough information to make an initial decision—to see if this is something worth exploring further—but not too much. Your technical group wants to include maps and logs and so on, but that's better saved for later, when you get to stage two or three. Capital providers are very busy, so no one wants to read a novel.

When I have my capital provider hat on, I need to see maybe 15 to 20 pages that I can review, so I can get back to you in a timely manner. I should be able to look at this and decide fairly quickly: Is this something I want to explore further? Are these people I should spend some time with? If so, let's schedule a meeting or a call. Or, I don't think this is a fit, the numbers don't add up for me.

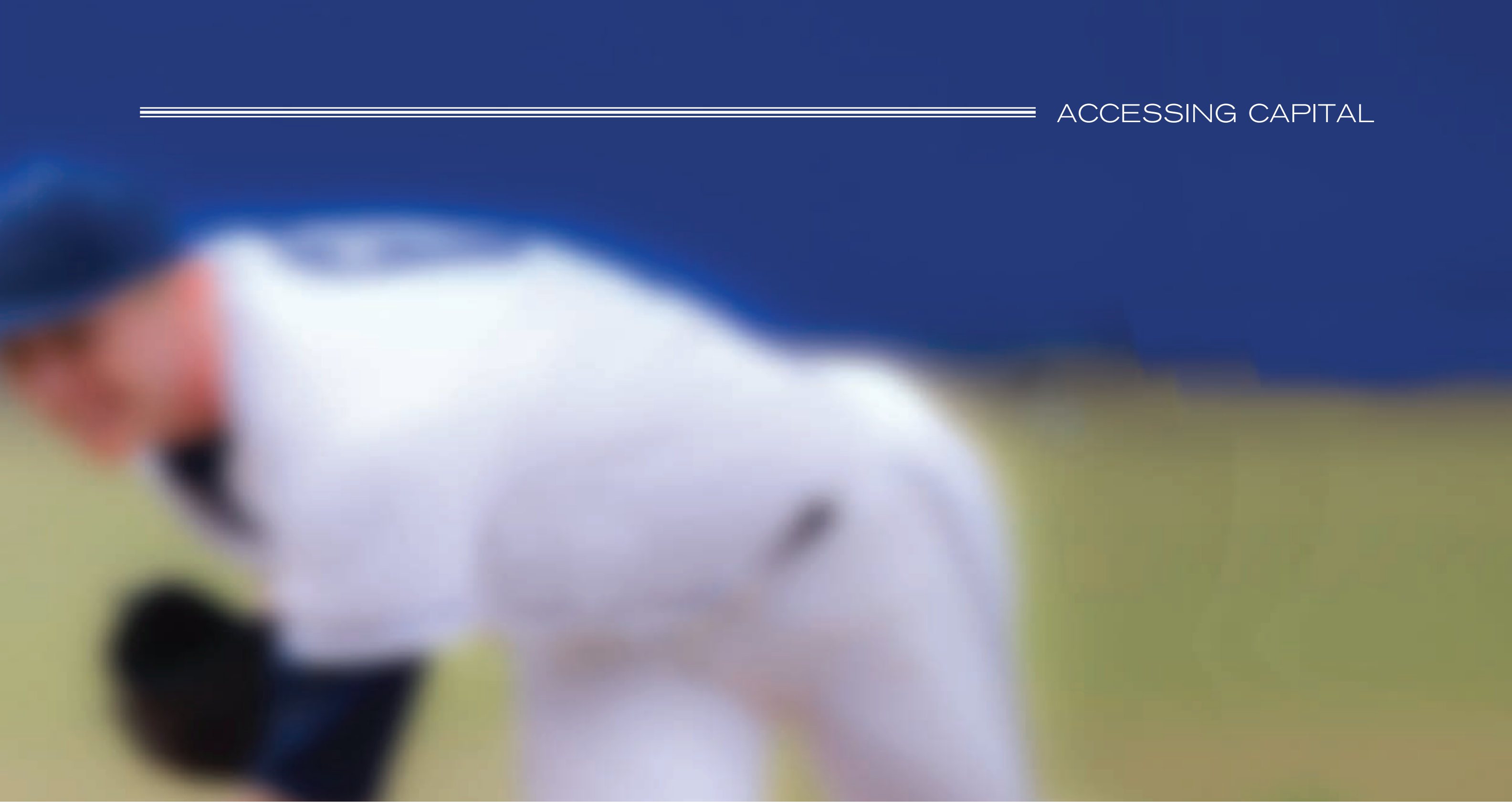
"Initially, make your pitch short and simple, and listen carefully to the capital provider."

Rob Lindermanis,
principal, Bay Capital Corp.

Investor What basics are you looking for in the pitch book?

Lindermanis The art to it is to provide some basic information. It depends on whether you're going for debt, equity or a drilling JV, but there is some basic info:

- What are the assets you have already or hope to acquire?
- What area (play) are you working?
- What is your strategy?
- How much are you looking for?
- What is the use of proceeds?
- What differentiates you from other companies?
- Management overview (bio of the principals on your team).



Investor Name some of the reasons that a provider would reject a funding pitch.

Lindermanis They may say no, but never tell you the reasons why—but hopefully, they will provide some insight that would help you better target their needs in the future. There are a number of possible reasons I've seen: One is whether they're looking for unconventional opportunities or conventional ones. Two, your geographic area is not in favor with the provider. Three, your deal size may be too large or small for their strategy, based on your ask. Four, your asset mix does not have enough PDPs, production or revenue to fit their strategy. Finally, it could be about their portfolio exposure—they may already have a portfolio company (or companies) in your area of interest.

Investor What about confidentiality agreements or NDAs?

Lindermanis You shouldn't expect to get an NDA (non-disclosure agreement) right up front. They will decide on that later after they've seen the initial pitch and visited with you. You've got to show them something concrete at first, you've got to open up your war chest a little bit. After the first pitch, if they're interested they'll guide you on what they need to see next, and set up meetings to take a look at all the details. At this point an NDA will be discussed.

Investor Should the pitch be a bit different depending on whether you're going after debt or equity?

Lindermanis. Yes. It depends on whether you own an asset or there is an asset you'd like to own.

If you're seeking debt, you probably own the assets, so you can be more specific about the use of proceeds, reserves/economic cash flows, corporate overview and field summary.

If you're a new management team with no assets, but you have a pipeline of opportunities, you'd take a different approach.

There are three buckets: equity, debt and the DrillCo. In two of those you already own the asset and are looking to obtain capital to execute your plan. In the end, your presentation needs to be custom-designed based on your company's management, assets and business plan. Hopefully this will be helpful as you look to secure capital to go forward with your venture. ■

DO'S AND DON'TS

- Keep the initial pitch short and simple.
- Reveal enough detail that a decision can be made quickly to go further.
- Don't expect an NDA right up front.
- Be prepared to come back with details if asked.
- Be able to articulate what differentiates you, the team or the strategy from others.
- Listen carefully.

TECTONIC SHIFT IN LENDING AHEAD

In 2016 bank regulators drew a line in the sand, and 86% of public companies surveyed may not meet new standards. Luckily, alternative debt financing is available.

By Scott W. Johnson

The regulatory agencies' response to the 2008 financial crisis, coupled with the sudden decline in oil prices in 2014, has hastened significant regulatory changes in the oil and gas lending space. These will result in the need to refinance billions of dollars of existing bank loans and there will be a sharp reduction in future bank credit availability.

Many energy executives are well aware of this, but they may not be aware of the magnitude of the problem, or familiar with all the new options available to replace bank debt. Our survey of data from 150 public E&P companies shows that fully 86% of them do not pass the new regulatory standards on debt.

We fear some executives may underestimate the shifts that must occur in both the financial services and energy industries when a large number of companies are simultaneously trying to find new lenders and refinance their debt.

The OCC sea change

Bank regulators spent years reviewing and revising lending standards for E&P companies after the commodity price downturn in 2008. In late 2015, an annual review by regulatory examiners found that a high number of loans were incorrectly rated by the banks. They concluded that their analysis and rating should be based on whether a given company is able to repay all of its debt, not just its bank debt.

This was a sea change, for banks historically based their analysis and resultant credit ratings on whether a given company was able to repay only the bank's debt. Given the fact that many borrowers were highly leveraged and had significant debt in addition to bank debt, there were large discrepancies in rating classifications between the examiners and the banks.

In March 2016, the Office of the Comptroller of the Currency (OCC), which regulates the largest national banks, revised its quantitative standards, based on a perceived increase in credit risk in the E&P industry and concerns that energy loans were being incorrectly rated by banks. As stated in the

OCC's 2016 Year in Review, "In June 2016, the Federal Deposit Insurance Corp. (FDIC) issued guidelines that are less specific but reinforce the OCC guidelines. The OCC regulations have become the de facto guiding principal for the entire industry."

The revised OCC guidelines were dramatically more stringent than in the past. While there are many facets, there was one key result: All E&P loans must be classified into one of five categories ranging from pass to loss, and a huge amount of existing bank debt does not pass, as seen in Figure 3.

What's more, the OCC changed the standards as to what qualifies for each category, effectively reducing the amount of bank credit available to E&P companies. Each category other than pass results in increasing the amount of equity capital banks must hold in comparison to their loans outstanding. The weaker a loan's credit rating, the more reserves a bank must set aside, making it more expensive, and less economic, to keep the loan on the books.

From the bank's point of view, holding large percentages of equity capital against non-pass loans often makes it unprofitable to continue to hold these loans. It will become increasingly less attractive to hold non-conforming loans as compared to loans that pass the standard and require less equity capital on hold.

In addition to the tightening of numerical targets, three major changes in the OCC regulations affect how E&P loans are assessed and categorized:

- All debt, not just bank debt, is included in the calculations.
- Total committed amounts of reserve-based loans (RBLs) are tested, not just the outstanding amount.
- Future net revenue (FNR) is calculated using strip pricing and unrisked reserves, so that bank-determined metrics have been removed, allowing banks much less discretion and increasing pressure.

The specific metrics for each regulatory classification are defined in Figure 2.

FIGURE 1: NEW OCC CATEGORIES

- Pass
- Special Mention
- Substandard
- Doubtful
- Loss

Over time, it is logical to conclude that banks will hold pass loans and eliminate non-pass loans from their portfolios.

And while most banks have been relatively lenient through the worst part of the downturn, the March 2016 release of revised standards drew a line in the sand and forced banks to begin to act. Research shows the current bank holdings of non-pass loans are not sustainable, and it predicts a sharp reduction in bank credit availability.

Size of the problem

The exact size of non-pass loans for all public, privately held, family-owned and private equity-owned businesses is unknown. However, information is available on public companies upon which assumptions can be made for this segment of loans.

It is important to note that the following research includes only 150 public E&P companies for which information was readily available. The research studied cash flows and debt for the last 12 months through September 2016; oil and gas reserves at December 2015; and $204 billion in total debt in public companies, excluding the majors.

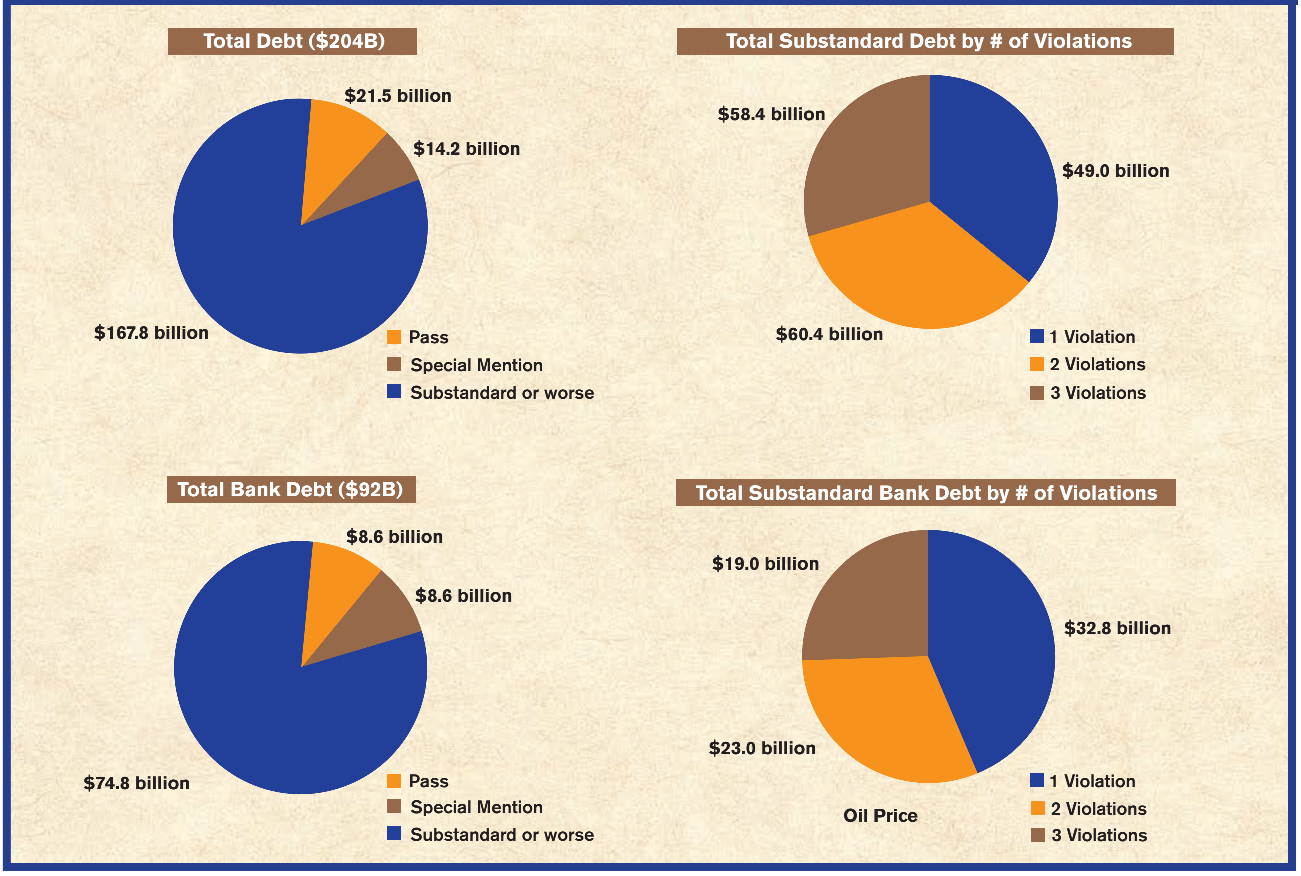
Of this amount, $92 billion is first-lien debt, meaning that the non-bank debt total is more than 120% of the bank debt amount.

Our results showed at least 129 companies, or 86% of the 150 total, do not pass the new regulatory standards. Total debt outstanding for these companies is $168 billion, and approximately $75 billion of bank debt is rated substandard or worse, as shown in Figure 3.

FIGURE 2: OCC METRICS

OCC Metric	Pass	Special Mention	Substandard or worse
Total Funded Debt to EBITDA	<3.5:1	3.5-4.0:1	4.0:1 or >
Total Funded Debt/Capital	<50%	50%-60%	>60%
Total Committed Debt to FNR	<65%	65%-75%	>75%
Total Proved Reserves Eco Life after Repayment	>25%	25%-10%	<10%

FIGURE 3: TOTAL DEBT



It is important to note that these numbers are estimates. Companies that have filed bankruptcy or are no longer operating were removed, and private companies are not counted. The repayment test was omitted due to lack of necessary information. Had this information been available, the repayment test would likely have resulted in more non-pass debt. On the other hand, rising commodity prices and additional debt restructuring will likely reduce the non-pass total over time.

Options and alternatives

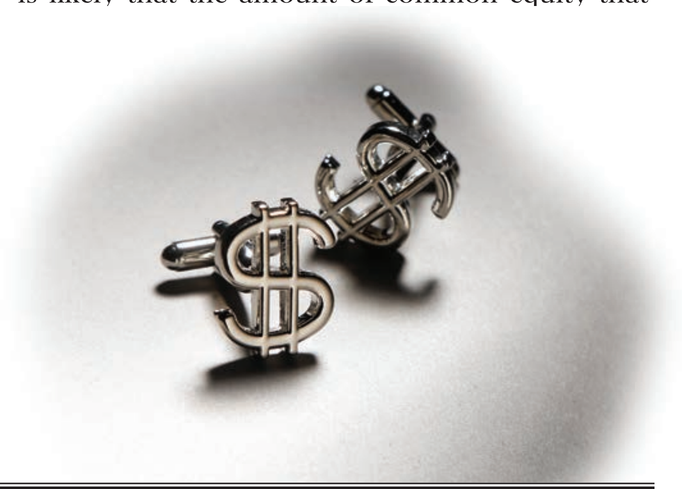
Timing for the new regulatory guidelines was not ideal. Debt capacity took a double hit from the commodity price cycle and the new regulatory guidelines at the same time. So far, banks have in many cases moved relatively slowly in forcing refinancing or debt restructuring, which can be labeled either as patience or as "kicking the can down the road" to avoid or defer write-downs.

It is likely that the adjustments in bank credits will take a year or two longer to complete.

Many banks now say they will have to take more aggressive action in response to regulatory pressure and a need to clean up their own balance sheets. It may take a year or two for all of this to occur, but it is starting to happen now.

Although bank debt will not continue to play the sizeable role the E&P industry has relied on, operators do have alternatives. Some companies may choose to sell some assets, especially noncore assets, to reduce debt, but often that option is either not economically attractive or will not make a large enough positive impact on the balance sheet.

Other companies will raise common equity capital sufficient to retain some bank financing, sometimes in connection with acquisitions, but with the amount of outstanding non-bank debt in public companies totaling more than their bank debt, it is likely that the amount of common equity that



would be required is large enough and would be dilutive enough that this course alone will not be enough for a good many companies.

Some E&Ps may continue to restrain capital expenditures, even as commodity prices strengthen, in order to pay down debt.

For larger investment-grade companies, refinancing in the public debt markets will continue to be attractive. Public debt offerings are likely to be a sizeable part of the response to a reduced role for the banks. Of the $75 billion in bank debt that is substandard under the OCC guidelines, $27 billion is issued by investment grade public companies. Much of this bank credit may be replaced with publicly traded debt.

Some, but probably a smaller portion of the other $48 billion in non-complying debt, with debt ratings below investment grade (BBB), may also be refinanced in public high-yield debt, though a large portion of this amount will look to the private market.

The responses will be as numerous as the number of companies pursuing them, but it is likely that non-bank alternative debt will need to fill a large portion of the gap. Many companies that do not pass the standards will need to leave the banks, and time is running out. Companies are better off proactively seeking new debt sources before their banks and their regulators run out of patience, because short deadlines result in fewer and less attractive alternatives.

Alternative debt

The current bank regulatory environment has expanded opportunities for alternative capital sources. For many of the private E&P companies and quite possibly a significant number of public ones, alternative debt providers will be the main source of replacement capital.

Alternative debt sources provide capital that is significantly more expensive than the banks, but they are also more aggressive with their advance rates, more flexible with their loan structures and repayment terms, and more supportive of drilling programs that can give companies a way to grow again. These capital product choices will allow companies to recapitalize their balance sheets with an appropriate, sustainable capital structure for the future.

The alternative debt market is large and growing as increasing amounts of investor money are allocated to the space. As a sector, the coming demand will require that it gets even larger.

This capital is invested from funds sourced primarily from institutional investors such as public and private pension funds, endowments, foundations and sovereign wealth funds, but also from family offices and high net worth individuals. Some are pure debt funds (sometimes called credit funds) and some offer equity as well as debt capital. Recently, a number of established private-equity fund managers have added credit funds. Some of these funds are focused entirely or largely on oil and gas investments; others invest in multiple industries.

Chiron Financial has recently conducted a survey of 30 larger funds with an interest in E&P investments. Of these, 14 have provided specific investment guidelines. They span a wide range in size, risk tolerance, targeted rates of return and form of investment, but some highlights are:

- Total assets managed of approximately $520 billion;
- Total debt investment funds of approximately $345 billion;
- Targeted E&P company debt investment funds of approximately $26 billion;
- Targeted individual company investment size ranges from $10 million to $1 billion or more, across a very broad risk spectrum;
- Interest coupon rates of 5% to 16%;
- Total cost of money, including fees and return "kickers," if any, range from 5% to 25%;
- Type of investments: first-lien debt, second-lien debt, unsecured debt, preferred stock and working interests (i.e. joint ventures with reversions); and
- Advance metrics range from near to bank terms to straight drilling deals with no proved developed producing (PDP) reserves.

Although each provider has its own specific preferences, they may be roughly categorized in groups by total cost of capital as follows, with some funds providing terms that span more than one of the categories. (Figure 4.)

FIGURE 4

Capital type	Bank-like	Stretch	Mezzanine/hybrid
Total cost	5%-8%	9%-13%	14%-22%
Use of proceeds	Purchase; modest development	Acquire & develop	Aggressive development
Advance vs. PDP PV10	50%-100% of PDP PV10	70% to more than 100% of PDP	100% + of PDP to no PDP
Participating kickers	No	Not usually	Sometimes

Not surprisingly, the lowest-cost capital shares some of the attributes of bank debt, generally including lower advance rates, a first lien and borrowing base reviews. Most of the providers seeking total returns below the mid-teens are not seeking any form of equity participation such as warrants or overriding royalties, while at least some of those seeking higher returns do seek some form of participation.

Cost of funds is lower when the advance is based predominantly on producing reserves (PDP), though for most of these providers the advance rate versus PDP and even vs. total proved reserves is substantially greater than in a bank credit.

Many providers are quite supportive of economic drilling programs, and will periodically expand credit advances as new production is brought on line. These increases will typically occur much more rapidly in response to additional production than is the case with a bank.

Conclusions

Even with continued oil and gas price recovery, there will be dramatically less bank credit available a year or two in the future as compared with today. As a result of regulatory guidelines, oil and gas producers will find it harder to obtain new bank financing, and current borrowers will find it harder to obtain amendments or extensions from their existing banks.

Given the size and duration of the crisis, banks have been remarkably patient so far, but regulators are engaged, and the numbers show a tectonic shift on the near horizon. Most banks appear to be beginning to respond more firmly under the regulatory pressure.

This piece is not written to cause alarm. Fortunately, public and private capital is plentiful and will fill any reduction in bank credit availability. The point is that E&P companies will be well served to recognize that a shift is occurring.

They need to take steps to adapt on their own initiative and timetable before being forced to react to the timetable of their banks and the bank regulators. Each E&P company should recognize the range of alternatives available and know where to look for the most attractive capital for its particular assets and opportunities. In many cases, an experienced investment bank can help identify and capture the best solution.

For the industry, the bad news is that capital will be more expensive, but much of the new capital will also support a wider range of activity and faster growth. Fortunately, these alternative capital providers are willing to assume more risk in return for the possibility of higher reward. ■

Scott W. Johnson is a managing director for Chiron Financial LLC in Houston.

SPACS SPRING FORWARD

Following the recent success of Centennial, blank-check vehicles are more popular than ever.

By Leslie Haines

The special purpose acquisition company (SPAC) is a rarely used vehicle for E&P companies. It is a shell company created to raise public equity through an IPO, the proceeds of which are used for an acquisition of a company or assets, typically made within 24 months or the money must be returned to the investors. The SPAC is usually formed, managed and brought to market by a well-known investor or firm.

SPACs generally have a broad investment mandate and are confined by few restrictions, such as the sponsor cannot pre-identify the acquisition target prior to the IPO, nor can it have commercial operations until the initial acquisition is made, and the fair market value of the initial acquisition must be at least 80% of the SPAC's net assets, according to a brief explaining SPACs that was published by Parkman Whaling LLC in its E&P Dashboard in March.

The limited time frame for an acquisition—and the ability for investors to walk from the deal with their money back—provides investors significant downside protection. For that control, investors compensate sponsors with a lucrative promote structure, typically 20% of the post-acquisition equity.

"SPACs strike a unique balance between investors and sponsors: on the one hand, investors maintain more control and liquidity than in a typical private equity structure; and on the other, sponsors earn promoted interests immediately upon the initial acquisition," said Michael Hanson, a partner at Parkman Whaling.

Although SPACs have been used on occasion to acquire energy companies (Hicks Acquisition's merger with Resolute Energy Corp. in 2009 is an example), the renewed interest in SPACs is built upon more recent success in 2016, that of Mark Papa's Silver Run Acquisition Corp., sponsored by Riverstone Holdings.

Silver Run IPO'd in February 2016 at $10 per share, acquired Permian-focused Centennial Resources at a value of $1.7 billion in October 2016, then acquired Silverback Exploration in December 2016 for $855 million.

The entire entity now trades on Nasdaq as

Centennial Resource Development Inc. (CDEV), for about $17 per share as of the end of April.

Riverstone has since followed up with another SPAC, Silver Run Acquisition Corp. II, led by Jim Hackett (former CEO of Anadarko Petroleum Corp.), which raised more than $1 billion through its IPO in late March. At press time it had not made an acquisition yet.

In addition, over the course of four weeks from March to the end of April, three other SPACs went public.

- Matlin & Partners Acquisition Corp., raised $325 million in its IPO. David Matlin, CEO, is a successful distressed situations investor based in New York City.
- Kayne Anderson Acquisition Corp. priced SPAC shares at $10 for an IPO of $350 million. Its likely target will be a midstream asset.
- Vantage Energy Acquisition Corp., a blank-check company led by the former CEO of Vantage Energy and EnCana US, Roger Biemans, and backed by NGP, raised $480 million. It now trades on Nasdaq.

Unlike other SPACs, Matlin is without an energy-specific management team, which it views as a strong selling point to potential acquisition targets.

"We want to partner with the best management team, not buy them. The best use of our capital is helping a team go on offense at this point of the cycle," said Matlin. The SPAC's mandate is also flexible enough to effectively buy a minority interest in a larger business. "So long as the opportunity is right, we are as comfortable ending up with only 25% of a business as we are 90%," added Matlin.

Other SPACs are rumored to be in the process of public filings as well. Former Occidental Petroleum Corp. CEO Steve Chazen is heading up a SPAC formed by TPG Pace Energy Holdings Corp. It is preparing for an IPO that could raise up to $690 million, to pursue unconventional gas targets.

Gary Evans, CEO of recently formed Energy Hunter Resources, has said he intends to consider going public via the SPAC format. Meanwhile, he is building the new company by seeking acquisitions in resource plays such as the Eagle Ford Shale.

In April, KLR Energy Acquisition Corp., a SPAC led by Gary Hanna (former CEO of offshore company EPL Oil & Gas), completed its $445 million merger with Tema Oil & Gas Co., renaming the enterprise Rosehill Resources Inc. (Nasdaq: ROSE). The assets are in Loving County, Texas, in the heart of the Delaware Basin, where Tema's predecessor companies have been operating since the 1940s.

"The ultimate success of the SPAC structure in energy will depend heavily on the track record created by Kayne Anderson, Vantage, Matlin and Silver Run II," Hanson added. "With these SPACs searching for an acquisition and the rumors of more SPACs on the horizon, it will be a very competitive environment for sponsors. The acquisition targets may likely be the ultimate beneficiaries through higher valuations or better merger terms." ■

BENEFITS OF A SPAC

To SPAC Sponsors

- Immediate vesting of promote upon acquisition
- Pre-funded acquisition vehicle
- Greater flexibility than private equity in acquisition targets and structures
- Liquidity and capital for future development through the public market

To Investors

- Ability to invest in PE-style investments
- Access to experienced investment teams
- More control then PE (liquidity and exit options)
- Downside protection if acquisitions not consummated
- Tradeable stock and warrants

To Target Companies

- Quicker and cheaper than reverse merger or traditional IPO (No IPO window timing, no minimum size for IPO, money is pre-raised)
- Retain control and upside (SPAC doesn't have to buy a controlling interest; majority or all of consideration could be in stock)
- Clean shell company with no residual or legacy liabilities

Some Key Considerations

- Loss of initial investment in 2 years if no acquisition is made
- Risk of mediocre acquisition
- Risk of failed deal if redeeming investors are not replaced by closing
- Potential for promote to be shared with target to compel a deal

Source: Parkman Whaling LLC

CATCH AND RELEASE

Private equity firms are spotting deals and purchasing large, legacy assets that E&Ps are jettisoning as they look for efficiencies and innovation to turn profits.

By Darren Barbee

Private equity (PE) was largely the engine that made the Delaware Basin run, and for the most part it got extremely good mileage.

The time for a tune-up is coming, though.

In the pre-Permian land rush, PE-backed teams bought acreage for $4,000 an acre and flipped it later for up to 10 times that amount as larger E&Ps hunted for acreage. Many of the Delaware acquisitions in 2016 and early 2017 have featured public companies purchasing PE-backed management teams.

With their billion-dollar bankrolls, PE executives are akin to talent scouts. The deals they've generated in the Delaware and Scoop/Stack have come from an ability to ferret out bargain acreage while managing a bullpen of ace oil and gas operators.

Spotting a good deal is increasingly important as the industry begins a gradual A&D shift from the hottest plays. One opportunity: large companies are beginning to dispose of legacy assets once thought untouchable. And pockets of popular basins may yet have secrets to yield.

E. Murphy Markham IV, a managing partner at EnCap Investments LP, said traditionally, PE firms have had two strategies: lease and drill or acquire production and exploit.

"Prior to this downturn, I'd say 90% of our capital has really been focused more on the lease and drill," Markham said. Since the recent downturn,

"There's been a lot of legacy assets that have been for sale and even in these basins in the Permian and the Stack; private equity has really been active on both sides."

Murphy Markham,
EnCap Investments LP

however, EnCap's acquisition activity has stepped up, overshadowing the lease and drill model.

Markham spoke alongside Garry Tanner, a partner at Quantum Energy Partners, and Charles Cherington, co-founder of Argus Energy Managers, at Hart Energy's Energy Capital Conference in April.

"There's been a lot of legacy assets that have been for sale and even in these basins in the Permian and the Stack; private equity has really been active on both sides," Markham said.

Many of the sellers are large, financially strong companies selling not because of distress, but to develop their core assets "with half of the cash flow as a result of commodity prices dropping," he said.

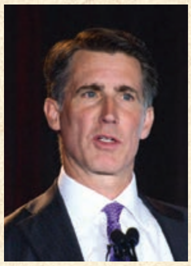
That's provided an opportunity for private companies to step in and buy legacy "assets that probably wouldn't have been on the market had it not been for the downturn in commodity prices," he said.

EnCap has made deals with Pioneer Natural Resources Co., Newfield Exploration Co., Energen Corp. and Anadarko Petroleum Corp. for key positions. Tanner said that with the amount of opportunities for companies, "everyone from ExxonMobil on down is going through portfolio adjustments. That's popping out a lot of assets that you would have thought would never have been sold."

At the end of 2015, for instance, Quantum backed a deal to purchase a 130,000-acre position from ConocoPhillips in East Texas.

But after the successful run in the Delaware, the challenge is where to go next.

"The tough part now is we were getting into these plays when these prices were pretty cheap," Tanner said. "We were buying at $2,000 to $4,000 an acre, and selling at $40,000 is a nice thing, but now it's a little more difficult to afford to live in the neighborhoods you're selling out of."



"That's the kind of thing we're looking for—reinventing plays that may be off the radar."

Garry Tanner,
Quantum Energy Partners

But recognition is all part of the strategy that PE firms rely on.

In one case, Tanner said, Quantum went into an area of the Delaware where roughly 20 wells had been drilled by a handful of operators that had resulted in mediocre results.

"They were marginal producers, uneconomic, and the industry had pretty much written off that part of the Delaware," he said. "This is right along the river in Reeves County, Texas."

Tanner's team look it over, did extensive geological and petrophysical work and decided the rock looked "every bit as good as the stuff people are drilling on the other side of the river."

Conclusion: "We think it's the operator, not the rock," he said.

Quantum paired with a Midland, Texas, company and began an acquisition program, making small deals and swaps, which built up an acreage position of roughly 25,000 contiguous acres.

"We have four rigs running right now. And we're drilling wells that look every bit as good as the stuff on the east side of the river," he said. "All of a sudden that acreage is now moving toward the $40,000 an acre value where we were picking it up for $2,000 to $4,000."

ENCAP ACQUISITION ACTIVITY

Date	Seller	Focus area	Acquisition size ($MM)	Seller rationale
Sept. 16	Pioneer Natural Resources Co.	Midland Basin	$270	Capital reallocation
Sept. 16	Newfield Exploration Co.	Eagle Ford Shale	$310	Capital reallocation
Aug. 16	Finley Resources Inc.	Midland Basin	$100	Deleveraging
Jun. 16	Energen Corp.	Delaware Basin	$220	Capital reallocation
Jun. 16/ March 15	Anadarko Petroleum Corp./ Energen Corp.	Rockies	$985	Capital reallocation

Source: EnCap Investments LP

The majority of EnCap's acquisition activity has centered on capital reallocation.

NOTABLE MONETIZATIONS FROM 1Q 2017-2Q 2017

Company	Play focus	Transaction status	Commentary	Enterprise Value
Vantage Energy Inc.	Marcellus	Closed (Oct. 2016)	$2.7 billion sale (cash and stock) to Rice Energy Inc.	$2.6 billion
Vitruvian Exploration II LLC	Scoop	Closed (Feb. 2017)	$1.85 billion sale (cash and stock) to Gulfport Energy Co.	$1.88 billion
Jagged Peak Energy LLC	Southern Delaware	IPO completed (Jan. 2017)	Completed IPO in Jan. 2017	$2.9 billion
Crump Energy Partners LLC (Delaware assets only)	Northern Delaware	Closed (May 2017)	$1.1 billion cash sale to Marathon Oil Corp.	$1.1 billion
Total				~$8.5 billion

Source: EnCap Investments LP

Notable monetizations from the first two quarters hit a robust amount of roughly $8.5 billion.

Tanner said the difference was simply execution. "That was just a different operator coming in and bringing that better execution capability," he said.

The key to success, Markham agreed, is simple—successful management teams.

"It's partnering with quality management teams, providing them with growth capital and then sitting on boards and assisting on the strategic advice and risk management," he said.

In 2016, Markham said, EnCap sold more than $11 billion of properties and assets while investing $4.6 billion—"probably about twice what we've done in the past."

Quantum, which exclusively invests in energy, has its own technical teams that emphasize building up companies rather than buying and flipping assets.

"When you think about execution, we like to drill wells," Tanner said. "Two-thirds of my experience has been on the industry side. I've spent 20 years at ExxonMobil and other places and 10 years in private equity. It really makes it easier to partner with folks when you've kind of been there and done that and lived in their shoes."

The next round of investments may well target old plays that are being reinvigorated, especially since entry prices to other plays are so expensive. The Haynesville, for instance, has seen a rebirth after years of being virtually forgotten.

"For a number of years, nobody was really drilling in the Haynesville, and recently people [started] drilling there and seeing incredibly better wells," Tanner said. "That's the kind of thing we're looking for—reinventing plays that may be off the radar."

EnCap is also looking at minerals businesses and has acquired more than $750 million in rights through various portfolio companies.

"We're in the process of buying quite a bit of minerals again and are very focused on activity in some of these key areas," Markham said.

Its portfolio companies are taking advantage of legacy fields that haven't competed well for capital in larger companies. EnCap's $310-million deal for Newfield Exploration's Eagle Ford assets was born from Newfield wanting to invest more capital in the Stack instead.

"As a result, we were [able to] get in and do the acquisition," Markham said, noting that the Eagle Ford acreage is about 96% HBP, produces 7,000 barrels per day and is 80% operated.

But the opportunity now is to upgrade what Newfield was already doing.

"Newfield hadn't really gotten into the later-generation completion techniques," he said.

"We were able to buy it … with the strategy of developing generation four and five," Markham said. "Plus, we saw additional zones that were prospective. We didn't have to pay for it but there's significant upside." ■

FINDING CAPITAL
A DIRECTORY

I = Investment banking;
C = Commercial banking;
M = Mezzanine;
P = Private equity/debt;
A = Advisor

To submit information, photos or corrections, contact Len Vermillion at lvermillion@hartenergy.com

A

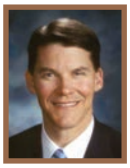
ABN AMRO Bank USA (I)
Darrell Holley
Managing Director -
Global Head of Oil & Gas
972-543-6404
darrell.holley@abnamro.com
5800 Granite Parkway, Suite 265
Plano, TX 75024

ACON Investments (P)
Mo Bawa
Partner
202-454-1109
1133 Connecticut Ave. NW
Suite 700
Washington, DC 20036

Aegis Energy Advisors Corp. (I)
James Smith
Vice President
212-245-2552
jsmith@aegisenergy.com
708 Third Avenue, 6th Floor
New York, NY 10017

Alerian Capital Management LLC (P)
Kenny Feng
President/CEO
972-957-7700
kf@alerian.com
2100 McKinney Avenue, 18th Floor
Houston, TX 75201

AltaCorp Capital (A, I)
Leslie Kende
Managing Director, A&D
403-539-8622
lkende@altacorpcapital.com
410, 585 – 8 Avenue SW
Calgary, AB T2P 1G1

Amegy Bank of Texas (C, I, M)

Steve Kennedy
Executive Vice
President & Head of
Energy Banking
713-235-8870
steve.kennedy@amegybank.com
4400 Post Oak Pkwy.
Houston, TX 77027
Preferred deal size: $10-$50MM, up to $300MM via syndication

Apollo Global Management LP (M, P)

Greg Beard
Head of Natural Resources,
Senior Partner
212-822-0750
gbeard@apollolp.com
9 West 57th St., 43rd Floor
New York, NY 10019
Preferred deal size: $25MM mezz; up to $1B PE

Apollo Natural Resources (M, P)
Jeff Bartlett
Credit and Joint Ventures
713-936-2420
jbartlett@apollolp.com
700 Louisiana St., Suite 2710
Houston, TX 77002
Preferred deal size: $25MM mezz; up to $1B PE

ARC Financial Corp. (P)
Brian Boulanger
President/Director
403-292-0790
bboulanger@arcfinancial.com
4300 Avenue SW
Calgary, AL T2P 4H2
Preferred deal size: $50-$200MM

ArcLight Capital Partners (P)
Daniel Revers
Managing Partner and Founder
617-531-6300
drevers@arclightcapital.com
200 Clarendon St., 55th Floor
Boston, MA 02116

Associated Bank (C)

Tim Brendel
Senior Vice President-
Oil and Gas
Segment Leader
713-588-8205
timothy.brendel@associatedbank.com
333 Clay St., Suite 2823
Houston, TX 77002

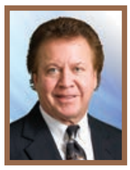
B

Bank of America Merrill Lynch (A, I)

Mark DeVito
Managing Director,
Global Energy & Power
646-855-2988
mark.devito@baml.com
One Bryant Park, 22nd floor
New York, NY 10036

Barclays Investment Bank (A, C, I, M, P)

Steve Almrud
Managing Director
713-236-2417
salmrud@barcap.com
1301 McKinney St.,
Suite 400
Houston, TX 77010

Bay Capital Corp. (M)

Rob Lindermanis
Owner
832-980-8074
robl@baycapcorp.net
4400 Post Oak Pkwy.,
Suite 2100
Houston, TX 77027

Bayou City Energy Management LLC (P)

William McMullen
Founder &
Managing Partner
713-400-8200
will@bayoucityenergy.com
1201 Louisiana St., Suite 3308
Houston, TX 77002
Preferred deal size: $5-$50MM

BB&T Capital Markets (C, I)

Jeff Forbis
Senior Vice President,
Corporate Banking
Team Leader
713-797-2141
jforbis@bbandt.com
330 Clay St., Suite 3800
Houston, TX 77002
Preferred deal size: $10MM+

BBVA Compass (C, I, M)
Kathleen J. Bowen
Senior Vice President
713-968-8273
kathy.bowen@compassbank.com
15 20th St. South
Birmingham, AL 35233

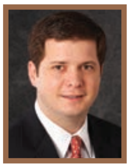
Benefit Street Partners (P)

Tim Murray
Managing Director &
Head of Energy Origination
713-345-4610
*tmurray@
benefitstreetpartners.com*
1401 McKinney St., Suite 1825
Houston, TX 77010

Blackstone Energy Partners (P)
Angelo Acconcia
Sr. Managing Director
212-538-5211
acconcia@blackstone.com
345 Park Ave., Ste. 1100
New York, NY 10154

BlueRock Energy Capital (M, P)

Stuart Rexrode
Managing Partner
281-376-0111 ext. 305
srexrode@bluerockep.com
20445 State Highway 249
Houston, TX 77070
Preferred deal size: $1-$10MM

BMO Capital Markets (I)

Jon Marinelli
Group Head, Investment
& Corporate Banking–
U.S. Energy
713-223-4400
jon.marinelli@bmo.com
700 Louisiana St.,
Suite 2100
Houston, TX 77002
Preferred deal size in US: $50 million+

BOK Financial (C)

Mickey Coats
Executive Vice President
918-588-6409
mcoats@bokf.com
One Williams Center
Tulsa, OK 74172

Brycap Investments Inc. (C)
Bryant H. Patton
Founder and Principal
469-248-3081
bpatton@brycap.com
2602 McKinney Ave., Suite 200
Dallas, TX 75205

Canaccord Genuity (I)
Steve Harris
Managing Director
713-331-9452
sharris@canaccord.com
1000 Louisiana St.
Houston, TX 77002

Capital One Securities (I, C)
Bob Mertensotto
Senior Managing Director
713-435-7200
1000 Louisiana St., Suite 2950
Houston, TX 77002

Capital One Southcoast Inc. (A)
Pierre E. Conner, III, P.E.
Head of Research Sales & Trading
504-593-6108
pierre.conner@capitalone.com
201 St. Charles Ave.
New Orleans, LA 70130

Carlyle Group LP (P, M)

Rahul Culas
Managing Director and Co-Head of Energy Mezzanine Opportunities
212-813-4564
rahul.culas@carlyle.com
520 Madison Ave.
New York, NY 10022

Carnelian Energy Capital (I)
Tomas Ackerman
Partner
713-322-7310
info@carnelian.com
2229 San Felipe St., Suite 1450
Houston, TX 77019

Castlelake (P)
Luke Beltnick
Partner
612-851-3000
4600 Wells Fargo Center
90 South Seventh St.
Minneapolis, MN 55402

CCMP Capital Advisors LLC (P)
Christopher Behrens
Managing Director-Energy
212-600-9640
christopher.behrens@ccmpcapital.com
277 Park Ave., 27th Floor
New York, NY 10172
Preferred deal size: $25MM+

Chambers Energy Capital (I)

Phillip Pace
Partner
713-554-6773
info@chambersenergy.com
600 Travis St., Suite 4700
Houston, TX 77002

Chiron Financial LLC (I)
Scott Johnson
Co-Owner
713-929-9081
sjohnson@chironfinance.com
1301 McKinney St., Suite 2800
Houston, TX 77010

CIBC (A, I)
Jordan Horoschak
Executive Director – Energy Investment Banking
713-452-1593
jordan.horoschak@cibc.com
1001 Fannin St., Suite 4450
Houston, TX 77002

CIT Energy Finance (C, I)
Mike Lorusso
Managing Director & Group Head
212-771-6002
mike.lorusso@cit.com
11 West 42nd St., Floor 11
New York, NY 10036

Citi (A, I, C)

Steve Trauber
Vice Chairman & Global Head of Energy
713-821-4800
stephen.trauber@citi.com
811 Main St., Ste. 3900
Houston, TX 77002

Comerica Inc. (C)

Mark Fuqua
Senior Vice President and Manager, Energy Banking
214-462-4424
mfuqua@comerica.com
Comerica Bank Tower
1717 Main St.
Dallas, TX 75201

Coquest Structured Products (P)
Dave McAdams
Business Development
214-219-7555
dave@coquest.com
12222 Merit Dr., Suite 1130
Dallas, TX 75251

Coral Reef Capital (P)
Jared Powell
Partner
(646) 599-9676
45 Rockefeller Plaza, Ste. 2300
New York, NY 10111

Credit Suisse Securities (USA) (I)

Tim Perry
Global Co-Head of Oil & Gas
713-890-1400
timothy.perry@credit-suisse.com
700 Louisiana St.
Houston, TX 77002

Crestmark Bank (C)
Steve Hansen
Regional First Vice President, West Division Sales Manager
713-628-0101
shansen@crestmark.com
5480 Corporate Dr., Suite 350
Troy, MI 48098

CSG Investments Inc. (P)
Hans Hubbard
Managing Director
713-353-4642
hhubbard@csginvestments.com
6000 Legacy Dr.
Plano, TX 75025
Preferred deal size: $50-$550MM

CSL Capital Management (P)
Charlie Leykum
Managing Partner
203-987-6010
charlie@cslenergy.com
811 Main St., Suite 4275
Houston, TX 77002
Preferred deal size: $10-$50MM

D

Denham Capital Management (P)

Jordan Marye
Managing Partner
713-217-2700
jordan.marye@denhamcapital.com
700 Louisiana St., Suite 3700
Houston, TX 77002

Deutsche Bank (I)
Lackland Bloom
Managing Director, Natural Resources Group
60 Wall St.
New York, NY 10005

Development Capital Resources (P)
Ronnie Scott
CEO/President
432-631-8266
rscott@dcrlp.com
712 Main St., Suite 920
Houston, TX 77002

Donovan Ventures LLC (A, P)
John W. Donovan Jr.
Founder
713-812-9887
jwd@dv-llc.com
2121 Sage Rd., Suite 225
Houston, TX 77056
Preferred deal size: $25-$50MM

E

East West Bank (C)

Christina Kitchens
Group Managing Director, Energy Finance
469-801-7368
christina.kitchens@eastwestbank.com
5001 Spring Valley Rd., Suite 825W
Dallas, TX 75244
Preferred deal size: $5-$500MM

EIG Global Energy Partners (M, P)
Rob Chuchla
Associate-Oil and Gas
713-615-7400
rob.chuchla@eigpartners.com
333 Clay St., Suite 3500
Houston, TX 77002

EnCap Flatrock Midstream (P)
Bill Waldrip
Managing Partner and Founder
210-494-6777
bw@efmidstream.com
1826 North Loop 1604 W, Suite 200
San Antonio, TX 78248

EnCap Investments LP (P)

Murphy Markham
Managing Partner
214-599-0800
mmarkham@encapinvestments.com
3811 Turtle Creek Blvd., Suite 2100
Dallas, TX 75219
Preferred deal size: $10-$100MM

Energy Capital Solutions LP (A, I)
Russell Weinberg
Managing Director
214-219-8201
rweinberg@nrgcap.com
2651 N. Harwood St., Suite 410
Dallas, TX 75201
Preferred deal size: $20MM+

Energy Special Situations Funds (P)
Jonathan S. Linker
Founder
713-869-0077
jlinker@essfunds.com
1801 Patterson St.
Houston, TX 77007

Energy Spectrum Capital (P)
Jim P. Benson
Managing Partner
241-987-6103
jim.benson@energyspectrum.com
5956 Sherry Lane, Suite 900
Dallas, TX 75225
Preferred deal size: $5-$50MM

Energy Trust Partners (P)
Leland White
Founding Partner
214-987-6104
leland.white@energyspectrum.com
5956 Sherry Lane, Suite 900
Dallas, TX 75225

Enstream Capital (A, I, M, P)
Daniel Mooney, CPA, CFA
Managing Director
214-468-0900
dmooney@enstreamcapital.com
5646 Milton St., Suite 318
Dallas, TX 75206
Preferred deal size: $20-$200MM

Entoro Capital (A, I)

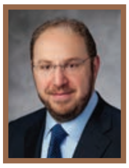
James Row
Managing Partner
713-823-2900
jrow@entorocapital.com
710 N. Post Oak Rd., Suite 150
Houston, TX 77024

Evercore (I, P)
Dan Ward
Senior Managing Director
713-403-2440
2 Houston Center
909 Fannin, Suite 1750
Houston, TX 77010

F

FBR Capital Markets Group (I)
Brian Anderson
Senior Managing Director
703-312-9500
1300 North 17th St., Suite 1400
Arlington, VA 22209

First Reserve Corp. (P)
Neil A. Wizel
Managing Director
713-227-7890
nwizel@firstreserve.com
600 Travis St.,
Suite 6000
Houston, TX 77002



First Tennessee Bank (C)
John Lane
Executive Vice President
832-839-5556
jblane@ftb.com
3009 Post Oak Blvd.,
Ste. 1210
Houston, TX 77056

Five States Energy Co. LLC (M, P)
Thomas Edwards
Business Development Associate
972-860-1124
tedwards@fivestates.com
4925 Greenville Ave., Suite 1220
Dallas, TX 75206
Preferred deal size: $1-$25MM

Fortis Capital Corp. (C, I, M)
Richard Herrick
Director
214-754-0009
richard.herrick@us.fortis.com
15455 Dallas Pkwy., Suite 1400
Addison, TX 75201

Frontier Capital Management Co. Inc. (A)
William Teichner
Executive Vice President-Oil and Gas
617-261-0777
99 Summer St., 20th Floor
Boston, MA 2110

Galway Capital LP (I, A)
Hal Miller
Chairman
713-952-0186
hmiller@galwaygroup.com
3009 Post Oak Blvd., Suite 950
Houston, TX 77056

Glendale Energy Capital (P)
Brent Grundberg
Partner
832-982-1100
bgrundberg@glendalecap.com
440 Louisiana St., Ste. 900
Houston, TX 77002

GMP Securities (I)
Harris Fricker
Chief Executive Officer
416-367-8600
harrisf@gmpsecurities.com
145 King St. West, Suite 300
Toronto, ON M5H 1J8

Goldman Sachs & Co (I, P)
Scott Grandt
Vice President
713-654-8400
scott.grandt@gs.com
1000 Louisiana St., Suite 550
Houston, TX 77002

Grey Rock Energy Partners (I)
Lauren Maleri
Managing Director
214-309-1486
lauren@greyrockep.com
2911 Turtle Creek Blvd.
Dallas, TX 75219

GSO Capital Partners (M, P)
Larry Tharp
Managing Director and
Chief Engineer
713-358-1367
larry.tharp@gsocap.com
1111 Bagby St., Suite 2050
Houston, TX 77002

Guggenheim Partners (M, P)
Mike Beman
Director
713-300-1333
Mike.Beman@guggenheimpartners.com
1301 McKinney St.
Houston, TX 77002

H

Houlihan Lokey (A, I)
J.P. Hanson
Managing Director &
Head of E&P Group
212-497-4262
245 Park Ave., 20th floor
New York, NY 10167

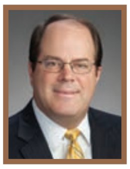
HSH Nordbank (C, I, M, P)
Michael Carter
Head of New York Office
212-407-6006
michael.carter@hsh-nordbank.com
230 Park Ave., 34th floor,
Suite 3200
New York, NY 10169

Huntington Bank (I)
Stephen Hoffman
Managing Director-Energy Banking
617-316-8910
stephen.hoffman@huntington.com
2 Oliver St.
Boston, MA 2110

I

Imperial Capital (I)
Darin Ackerman
Managing Director,
Co-Head of Energy Investment Banking
713-892-5602
dackerman@imperialcapital.com
1330 Post Oak Blvd., Ste. 2160
Houston, TX 77056

IBERIABANK (C)



Bryan Chapman
Market President -
Energy Lending
713-624-7731
bryan.chapman@
iberiabank.com
11 Greenway Plaza, Suite 2900
Houston, TX 77046
Preferred deal size: $10-$35 MM

ING Capital LLC (C, I)
Charles Hall
Managing Director
713-403-2424
charles.hall@ing.com
1325 Avenue of the Americas
New York, NY 10019

Intrepid Financial Partners (A)
Neil Chen
Vice President
646-979.3452
chen@intrepidfp.com
540 Madison Ave., 21st floor
New York, NY 10022

IOG Capital LP (P)
Michael T. Arnold
Vice President
214-272-2702
marnold@iogcapital.com
2911 Turtle Creek Blvd., Suite 900
Dallas, TX 75219
Preferred deal size: $50MM+

J

Jefferies (A)
Steve Straty
Head of Energy Corporate Finance
281-774-2145
sstraty@jefferies.com
3 Allen Center
333 Clay St., Suite 1000
Houston, TX 77002

Johnson, Rice & Co. (C)
Joshua Cummings
Head Energy Investment Banking
504-584-1247
cummings@jrco.com
639 Loyola Ave., Suite 2775
New Orleans, LA 70113

JPMorgan Chase Bank (I)

Mike Lister
Managing Director
214-965-2891
mike.lister@jpmorgan.com
2200 Ross Ave., Floor 5
Dallas, TX 75201

Juniper Capital (P)
Richard K. Gordon
Partner
713-335-4715
rgordon@juncap.com
2323 S Shepherd Dr., Suite 1150
Houston, TX 77019
Preferred deal size: $25-$75MM

K

Kayne Anderson
Energy Funds (P)

Chuck Yates
Managing Partner-
Energy Private
Equity Activities
713-493-2000
cyates@kaynecapital.com
811 Main St., 14th Floor
Houston, TX 77002

Kessey Capital Partners LLC (A)
Scott Kessey
Managing Partner
713-385-8245
tpk@kesseycap.com
3016 Ella Lee Lane
Houston, TX 77019
Preferred deal size: $25-50MM

KeyBanc Capital Markets (A, C, I)
Keith Buchanan
Managing Director and Head of Oil & Gas Investment Banking
713-221-3970
keith.buchanan@key.com
600 Travis St., Suite 3100
Houston, TX 77002

Kimmeridge Energy (P)
Ben Dell
Managing Partner
646-517-7250
ben.dell@kimmeridgeenergy.com
400 Madison Ave., Suite 14C
New York, NY10017

KKR (P)
David Rockecharlie
Head, Energy Real Assets
713-343-5142
david.rockecharlie@kkr.com
5051 Westheimer Rd., Suite 300
Houston, TX 77056

KLR Group LLC (I)
Edward Kovalik
CEO
713-321-2555
ek@klrgroup.com
BG Group Place Building
811 Main St., 18th Floor
Houston, TX 77002

L

Ladenburg Thalman & Co. (I)
Barry Steiner
Managing Director
212-409-2000
bsteiner@ladenburg.com
277 Park Ave., 26th floor
New York, NY 10172

Lazard Ltd. (A, I)
Harry Pinson
Managing Director
713-236-4600
harry.pinson@lazard.com
JPMorgan Chase Tower
600 Travis St., Suite 2300
Houston, TX 77002

Legacy Texas Bank (C)
Chris Parada
Managing Director,
Energy Finance Manager
214-217-7084
2101 Custer Rd.
Plano, TX 75075
Preferred deal size: $5-$40MM

Lime Rock Partners (P)
James Wallis
Managing Director
713-292-9500
jwallis@lrpartners.com
1111 Bagby St., Suite 4600
Houston, TX 77002

M

M.M. Dillon & Co. (C, I, M)
Michiel McCarty
Managing Director and Head of Investment Banking
203-569-6800
mmccarty@mmdillon.com
1 Sound Shore Dr.
Greenwich, CT 6830

M1 Energy Capital (A, I, M)
Rich Bernardy
Managing Partner
713-300-1422
rbernardy@mecapital.com
3701 Kirby Ave., Suite 1086
Houston, TX 77098
Preferred deal size: $10-$500MM

Macquarie Bank Ltd. (A, C, I)
F. Brady Parish Jr.
Head of U.S. Oil & Gas
713-275-6810
brady.parish@macquarie.com
One Allen Center
500 Dallas Street, Suite 3300
Houston, TX 77002

Mason Capital Partners (A)
Albert D. Mason
Managing Partner
617-228-5190
50 Congress St., Suite 843
Boston, MA 02109

Morgan Stanley (I)

Geoff Davis
Managing Director
713-512-4480
geoffrey.davis@ morganstanley.com
600 Travis St., Ste. 3700
Houston, TX 77002

Morgan Stanley Energy Partners (P)

John Moon
Head of MSEP
212-761-0591
john.moon@ morganstanley.com
JP Morgan Chase Tower
600 Travis St., Suite 3700
Houston, TX 77002

Mountain Capital

Sam Oh
713-357-9600
sam@mountainlp.com
811 Louisiana St.,
Ste. 2550
Houston, TX 77002

MUFG Union Bank (C, I)
Jamie Conn
Managing Director - Head of Oil & Gas
713-655-3814
jamie.conn@uboc.com
1100 Louisiana St., Suite 4850
Houston, TX 77002

Mutual of Omaha Bank (C)
Mike Turner
Market President Mutual of Omaha Bank Houston
713-405-1570
mike.turner@mutualofomahabank.com
520 Post Oak Blvd., Suite 700
Houston, TX 77027

N

NBH Bank (A)

David Nelson
Reserve Evaluation Consultant
720-529-3379
dnelson@nbhbank.com
7800 E. Orchard, Suite 300
Greenwood Village, CO 80111
Preferred deal size: $5-$30MM

NGP Energy Capital Management (P)

Tony Weber
Managing Director
972-432-1440
5221 N. O'Connor Blvd., 11th Floor
Irving, TX 75039

O

Old Ironsides Energy
Sean O'Neill
Managing Partner
617-366-2033
soneill@oldironsidesenergy.com
10 St. James Ave., 19th Floor
Boston, MA 02116

Origami Capital Partners (P)
Darren O'Brien
Partner
312-263-7800
darren@origamicapital.com
191 N. Wacker Dr., Suite 2350
Chicago, IL 60606
Preferred deal size: $20-$50MM

ORIX USA Capital (M,P)

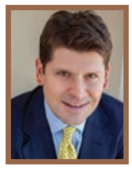
Jay Mitchell
Managing Director
214-237-2266
jay.mitchell@orix.com
1717 Main St., Suite 1100
Dallas, TX 75201

Outfitter Energy Capital (P)
George McCormick
Managing Partner
281-402-8185
gmccormick@outfitterenergy.com
711 Louisiana St, Suite 2160
Houston, TX 77025

P

Parallel Resource Partners (P)
John Howie
Managing Director
713-238-9500
919 Milam St., Suite 550
Houston, TX 77002

Parkman Whaling LLC (A)
James E. Parkman
Co-Founder
713-333-8400
info@parkmanwhaling.com
600 Travis St., Suite 600
Houston, TX 77002

Pearl Energy Investments (I)

Billy Quinn
Managing Partner
214-308-5275
bquinn@pearl-energy.com
2100 McKinney Ave.,
Suite 1675
Dallas, TX 75201
Preferred deal size: $25-$75 MM

Petrie Partners (A, I)
Andrew Rapp

Co-Founder
303-953-6768
andy@petrie.com
1700 Lincoln St.
Denver, CO 80203

Petro Capital Group (P)
Garrett Mayer
Business Development
214-661-7765
3710 Rawlins St., Suite 1000
Dallas, TX 75219

Petro Capital Securities (I)
Marvin Webb
Managing Director
214-572-0771
marvin@petro-capital.com
3710 Rawlins St., Suite 1000
Dallas, TX 75219

PetroCap Inc. (P)
David Hopson
Managing Director
214-871-7967
dhopson@petrocap.com
2602 McKinney Ave., Suite 400
Dallas, TX 75204

Pine Brook Road Partners (P)
Jim Aube
Co-President
832-924-9950
jaube@pinebrookpartners.com
1301 McKinney St., Suite 3550
Houston, TX 77010

PNC Bank (C)
Tom Byargeon
Managing Director
713-658-3940
tom.byargeon@pnc.com
1200 Smith St., Suite 830
Houston, TX 77002
Preferred deal size: $75MM-$2.5B

Post Oak Energy Capital (P)
Clint Wetmore
Managing Director,
Founding Partner
713-554-9404
wetmore@postoakenergy.com
5200 San Felipe St.
Houston, TX 77056

PPHB (I)
Len Paton
Co-founder &
Managing Partner
713-580-2710
lpaton@pphb.com
1900 Saint James Place #125,
Suite 125
Houston, TX 77056

Premier Capital Ltd. (A)
J.W. Brown
General Partner
214-808-3540
jbrown@precap.com
3604 Potomac Ave.
Dallas, TX 75205
Preferred deal size: $10-$100MM

Prudential Capital Group (P)
Brian Thomas

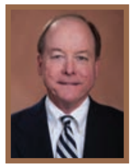
Managing Director
214-720-6216
brian.thomas@prudential.com
JP Morgan Chase Tower
2200 Ross Ave., Suite 4300
Dallas, TX 75201
Preferred deal size:
Senior debt $10-$250MM,
Mezz/Equity $10-$50MM

Q

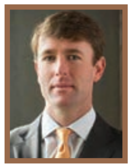
Quantum Energy Partners (P)
Eric Nielsen
Managing Director –
Business Development
713-452-2050
enielsen@quantumep.com
1401 Mckinney St., Suite 2700
Houston, TX 77010

Quintana Energy Partners (P)
Rogers Herndon
President & Chief
Executive Officer
832-518-4094
herndon@qeplp.com
1415 Louisiana St., Suite 2900
Houston, TX 77002
Preferred deal size:
$10-$125MM equity

R

Raymond James (I)
Michael P. Ames

Managing Director,
Head of Energy
Investment Banking
713-278-5268
mike.ames@raymondjames.com
5847 San Felipe St., Suite 1800
Houston, TX 77057

RBC Capital Markets (C, I)
Brian Atkins
Managing Director, Head,
U.S. Exploration & Production
713-403-5663
brian.atkins@rbccm.com
Williams Tower
2800 Post Oak Blvd.,
Suites 3900 and 4325
Houston, TX 77056

Red Bird Capital (P)
Hunter Carpenter

Partner
214-238-4000
info@redbirdcap.com
667 Madison Ave.,
16th floor
New York, NY 10065

Regions Bank (C)
Brian Tate

Executive Managing
Director, Head of Energy
& Natural Resources Group
704-335-9618
brian.tate@regions.com
1045 Providence Rd.,
Suite 200
Charlotte, NC 28207

Ridgemont Equity Partners (P)
John Shimp
Partner
704-944-0914
150 North College St.,
Ste. 2500
Charlotte, NC 28202

Riverstone Holdings LLC (P)
John Lancaster Jr.
Managing Director - Energy Industry
212-993-0076
john@riverstonellc.com
712 5th Ave., Suite 36
New York, NY 10019

Rivington Capital Partners (A, I)
Scott Logan
Co-Founder
713-750-0900
slogan@rivingtoncap.com
1021 Main St., Suite 1500
Houston, TX 77002

Roth Capital Partners (I)
Alexander Montano
Managing Director
949-720-5770
amontano@roth.com
888 San Clemente Dr.
Newport Beach, CA 92660

R.W. Baird (I, M)
Frank Murphy
Managing Director & Co-head
of Energy Group
314-445-6532
fmurphy@rwbaird.com
777 East Wisconsin Ave.
Milwaukee, WI 53201

Sage Road Capital (P)
Josh L. Batchelor
Managing Partner & Co-Founder
713-364-1400
info@sagerc.com
2121 Sage Rd., Suite 325
Houston, TX 77056

Sand River Capital Advisors LLC (A)
Jason Whitt
Managing Partner
432-848-3020
jason.whitt@sandriver.com
3300 North A St., Bldg. 2, Suite 101
Midland, TX 70705

SCF Partners (I, P)
Andrew L. Waite
Co-President
713-227-7888
awaite@scfpartners.com
600 Travis St., Suite 6600
Houston, TX 77002

Scotiabank (A, I, C)

Doug Reynolds
Managing Director &
Head Corporate
Banking Energy
713-752-0900
711 Louisiana St., Suite 1400
Houston, TX 77002

Seaport Global Securities (I)
Edward Lainfiesta
Partner, Executive Managing Director
of Equity Sales & Trading
949-274-8044
elainfiesta@seaportglobal.com
600 Anton Blvd., Ste. 1700
Costa Mesa, CA 92626

SFC Energy Partners (M, P)
Michael T. Stolze
Vice President of Origination
303-893-5007
mstolze@sfcepartners.com
1225 17th St., Suite 2575
Denver, CO 80202

Siemens Financial Services, Inc. (C, M, P)
Kirk H. Edelman
President/CEO
800-327-4443
kirk.edelman@siemens.com
170 Wood Ave. South
Iselin, NJ 08830

Simmons & Co. International (I)
Damon Box
Managing Director, Investment Banking
713-546-7224
damon.f.box@simmonspjc.com
700 Louisiana St., Suite 1900
Houston, TX 77002

Skyway Capital Markets (C)
D. Michael Faraone
Managing Director
813-210-952
100 N. Tampa St., Suite 3550
Tampa, FL 33602

Societe Generale (C)
Elizabeth Hunter
Managing Director and Senior Banker
713-759-6300
elizabeth.hunter@sgcib.com
111 Bagby St., Suite 2020
Houston, TX 77002

Sprott Global Resources Investment Ltd. (P)
Rick Rule
Founder, Global Companies
800-477-7853
rrule@sprottglobal.com
1910 Palomar Point Way
Carlsbad, CA 92009
Preferred deal size: $10-$100MM

Stephens Group LLC (I, P)
Eric D. Summerhill
Principal - Public Markets
501-377-3401
esummerhill@stephensgroup.com
100 Morgan Keegan Dr., Suite 500
Little Rock, AR 72202

Stephens Inc. (I)
Keith Behrens
Managing Director & Group Head,
Energy Investment Banking Group
214-258-2762
keith.behrens@stephens.com
300 Crescent Ct., Suite 600
Dallas, TX 75201

Stifel Nicolaus & Co. (A, I, P)
Christian Gibson
Managing Director
713-237-4515
chris.gibson@stifel.com
700 Louisiana St., Ste. 2350
Houston, TX 77002

Sumitomo Mitsui Bank (C, I, M)
James Weinstein
Deputy General Manager,
Head of Energy/Natural Resources
212-224-4120
jweinstein@smbclf.com
277 Park Ave.
New York, NY 10172

SunTrust Robinson Humphrey (A,I)
Sterling Bomar
Managing Director-Oil & Gas Investment Banking
404-439-5000
sterling.bomar@suntrust.com
3333 Peachtree Rd. NE
Atlanta, GA 30326

Tailwater Capital (P)

Edward Herring
Managing Partner
214-269-1183
eherring@tailwatercapital.com
20121 McKinney Ave., Suite 1250
Dallas, TX 75201

Talara Capital Management (P)

David Zusman
Managing Member
646-396-6040
privatedeals@talaracapital.com
1001 Fannin St.
Houston, TX 77002
Preferred deal size: $50-$150MM

Tenaska Capital Management (P)
Grant H. Davis
Managing Director
402-691-9700
gdavis@tenaskacapital.com
14302 FNB Pkwy.
Omaha, NE 68154
Preferred deal size: $50MM+

Texas Capital Bank (C)
Lester Keliher
Executive Vice President
214-932-6739
lester.keliher@texascapitalbank.com
2000 McKinney Ave., Suite 700
Dallas, TX 75201

The Mitchell Group (A)
Bradley Mitchell
President
713-759-2070
bmitchell@tmgenergy.com
712 Main St., Suite 3100
Houston, TX 77002

Tortoise Capital Resources (P)
Robert Thummel
Managing Director and Portfolio Manager
913-981-1020
rthummel@tortoiseadvisors.com
11550 Ash St., Suite 2300
Leawood, KS 66211

Trilantic Capital Management LP (P)

Glenn Jacobson
Partner
212-607-8450
gjacobson@trilantic.com
301 Congress Ave., Suite 2050
Austin, TX 78701

Trive Capital (P)
Jeff Leatherman
Business Development
303-507-0262
jeffleatherman@trivecapital.com
2021 McKinney Ave., Suite 1200
Dallas, TX 75201

Tudor, Pickering, Holt & Co. (I)
Bobby Tudor
Chairman
713-333-7100
btudor@tphco.com
1111 Bagby St., 49th Floor
Houston, TX 77002

U

U.S. Bank (C)
Mark Thompson
Account Manager
303-585-4213
mark.thompson@usbank.com
950 17th St.
Denver, CO 80202

UBS Investment Bank (I)
Miles Redfield
Managing Director
713-331-4685
miles.redfield@ubs.com
Five Post Oak Park
16th and 17th Floors
4400 Post Oak Pkwy.
Houston, TX 77027

V

Vortus Investment Advisors (P)
Brian Crumley
Managing Partner
817-945-2400
407 Throckmorton St., Suite 560
Fort Worth, TX 76102
Preferred deal size: $50-$75MM

W

Warburg Pincus LLC (P)
Peter Kagan
Managing Director
212-878-0600
450 Lexington Ave.
New York, NY 10017

Weidner Advisors (A)
Bill Weidner
Owner
207-761-2600
bill@weidneradvisors.com
45 Exchange St.,
Suite 300E
Portland, ME 4101

Wells Fargo Energy Group (C)
Bart Schouest
Executive Vice President
and Group Head
713-391-1850
bart.schouest@
wellsfargo.com
1000 Louisiana St.
Houston, TX 77002

Wells Fargo Securities
LLC (C, I, M)
James M. Kipp
Managing Director
and Group Head,
Wells Fargo Securities
713-346-2701
james.kipp@wellsfargo.com
1000 Louisiana St., 12th Floor
Houston, TX 77002

White Deer Energy (P)
Thomas Edelman
Managing Partner
713-581-6900
tedelman@
whitedeerenergy.com
700 Louisiana St., Suite 204
Houston, TX 77002
Preferred deal size: $50-$150MM

Wilcox Swartzwelder & Co. (I)
Jason Wilcox
Founder and
Managing Director
972-831-1300
jason@ws-ibank.com
102 Decker Ct., Suite 204
Irving, TX 75062

William Blair and Co. (I)
Brent Gledhill
Managing Director,
Global Head of Investment Banking,
Executive Committee
312-364-5475
bgledhill@williamblair.com
222 West Adams St.
Chicago, IL 60606

Wunderlich Securities (A, I)
Kevin R. Andrews
Managing Director of
Investment Banking
713-403-3979
kandrews@wundernet.com
4400 Post Oak Pkwy., Suite 1400
Houston, TX 77027

Wynnchurch Capital Ltd. (I)
Michael Teplitsky
Managing Director
847-604-6120
mteplitsky@wynnchurch.com
6250 North River Rd., Suite 10-100
Rosemont, IL 60018

Y

Yorktown Partners LLC (P)
Peter Leidel
Partner
212-515-2113
pleidel@yorktownenergy.com
410 Park Ave., Suite 1900
New York, NY 10022
Preferred deal size: $10-$70MM

Energy Lending is a highly specialized field and requires experienced professionals that understand the dynamics of the oil and gas industry. IBERIABANK has a strong capital base and the lending capacity to support the financial goals of energy companies of various sizes.

Our energy team has:

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- Construction and Acquisition of Pipeline, Processing and Compression Assets
- Working Capital

IBERIABANK

Bryan Chapman
Market President
bryan.chapman@iberiabank.com
713-624-7731

Moni Collins
Relationship Manager
moni.collins@iberiabank.com
713-624-7764

Stacy Goldstein
Relationship Manager
stacy.goldstein@iberiabank.com
713-624-7726

Tyler S. Thoem
Relationship Manager
tyler.thoem@iberiabank.com
713-624-7767

Member FDIC

EQUAL HOUSING LENDER

Who's Who By Contact Person

Acconcia, Angelo	Blackstone Energy Partners
Ackerman, Thomas	Carnelian Energy Capital
Ackerman, Darin	Imperial Capital
Almrud, Steve	Barclays Investment Bank
Ames, Michael P.	Raymond James
Anderson, Brian	FBR Capital Markets Group
Andrews, Kevin R.	Wunderlich Securities
Arnold, Michael T.	IOG Capital
Atkins, Brian	RBC Capital Markets
Aube, Jim	Pine Brook Road Partners
Bartlett, Jeff	Apollo Natural Resources
Batchelor, Josh L.	Sage Road Capital
Bawa, Mo	ACON Investments
Beard, Greg	Apollo Global Management
Behrens, Christopher	CCMP Capital Advisors
Behrens, Keith	Stephens Inc.
Beltnick, Luke	Castlelake
Beman, Mike	Guggenheim Partners
Benson, Jim P.	Energy Spectrum Capital
Bernardy, Rich	M1 Energy Capital
Bloom, Lackland	Deutsche Bank
Bomar, Sterling	SunTrust Robinson Humphrey
Boulanger, Brian	ARC Financial Corp.
Bowen, Kathleen J.	BBVA Compass
Box, Damon	Simmons & Co. International
Brendel, Tim	Associated Bank
Brown, J.W.	Premier Capital Ltd.
Buchanan, Keith	KeyBanc Capital Markets
Byargeon, Tom	PNC Bank
Carpenter, Hunter	Red Bird Capital
Carter, Michael	HSH Nordbank
Chapman, Bryan	IBERIABANK
Chen, Neil	Intrepid Financial Partners
Chuchla, Rob	EIG Global Energy Partners
Coats, Mickey	BOK Financial
Conn, Jamie	MUFG Union Bank
Conner, Pierre E.	Capital One Southcoast
Crumley, Brian	Vortus Investment Advisors
Culas, Rahul	Carlyle Group
Cummings, Joshua	Johnson, Rice & Co.
Davis, Geoff	Morgan Stanley
Davis, Grant H.	Tenaska Capital Management
Dell, Ben	Kimmeridge Energy
DeVito, Mark	Bank of America Merrill Lynch
Donovan, John W.	Donovan Ventures
Edelman, Kirk	Siemens Financial Services
Edelman, Thomas	White Deer Energy
Edwards, Thomas	Five States Energy Co.
Feng, Kenny	Alerian Capital Management
Forbis, Jeff	BB&T Capital Markets
Fricker, Harris	GMP Securities
Fuqua, Mark	Comerica Inc.
Gibson, Christian	Stifel Nicolaus & Co.
Gledhill, Brent	William Blair and Co.
Gordon, Richard K.	Juniper Capital
Grandt, Scott	Goldman Sachs & Co.
Grundberg, Brent	Glendale Energy Capital
Hall, Charles	ING Capital LLC
Hansen, Steve	Crestmark Bank
Hanson, J.P.	Houlihan Lokey

Harris, Steve	Canaccord Genuity
Herndon, Rogers	Quintana Energy Partners
Herrick, Richard	Fortis Capital Corp.
Herring, Edward	Tailwater Capital
Hoffman, Stephen	Huntington Bank
Holley, Darrell	ABN AMRO Bank USA
Hopson, David	PetroCap Inc.
Horoschak, Jordan	CIBC
Howie, John	Parallel Resource Partners
Hubbard, Hans	CSG Investments Inc.
Hunter, Elizabeth	Societe Generale
Jacobson, Glenn	Trilantic Capital Management
Johnson, Scott	Chiron Financial
Kagan, Peter	Warburg Pincus
Keliher, Lester	Texas Capital Bank
Kende, Leslie	AltaCorp Capital
Kennedy, Steve	Amegy Bank of Texas
Kessey, Scott	Kessey Capital Partners
Kipp, James M.	Wells Fargo Securities
Kitchens, Christina	East West Bank
Kovalik, Edward	KLR Group
Lancaster Jr., John	Riverstone Holdings
Lane, John	First Tennessee Bank
Leatherman, Jeff	Trive Capital
Leidel, Peter	Yorktown Partners
Leykum, Charlie	CSL Capital Management
Lindermanis, Rob	Bay Capital Corp.
Linker, Jonathan S.	Energy Special Situations Funds
Lister, Mike	JPMorgan Chase Bank
Logan, Scott	Rivington Capital Partners
Lorusso, Mike	CIT Energy Finance
Maleri, Lauren	Grey Rock Energy Partners
Marinelli, Jon	BMO Capital Markets
Markham, Murphy	EnCap Investments LP
Mason, Albert D.	Mason Capital Partners
Marye, Jordan.	Denham Capital Management
Mayer, Garrett	Petro Capital Group
McAdams, Dave	Coquest Structured Products
McCarty, Michiel	M.M. Dillon & Co.
McCormick, George	Outfitter Energy Capital
McMullen, William	Bayou City Energy Management
Mertensotto, Bob	Capital One Securities
Michael, Michael D.	Skyway Capital Markets
Miller, Hal	Galway Capital
Mitchell, Jay	ORIX USA Capital
Mitchell, Bradley	The Mitchell Group
Montano, Alexander	Roth Capital Partners
Moon, John	Morgan Stanley Energy Partners
Mooney, Daniel	Enstream Capital
Murphy, Frank	R.W. Baird
Murray, Tim	Benefit Street Partners
Nelson, David	NBH Bank
Nielsen, Eric	Quantum Energy Partners
O'Brien, Darren	Origami Capital Partners
Pace, Phillip	Chambers Energy Capital
Parada, Chris	Legacy Texas Bank
Parish Jr., F. Brady	Macquarie Bank Ltd.
Parkman, James E.	Parkman Whaling
Paton, Len	PPHB
Patton, Bryant H.	Brycap Investments Inc.
Perry, Tim	Credit Suisse Securities (USA)
Pinson, Harry	Lazard Ltd.
Powell, Jared	Coral Reef Capital
Quinn, Billy	Pearl Energy Investments
Rapp, Andrew	Petrie Partners
Redfield, Miles	UBS Investment Bank
Revers, Daniel	ArcLight Capital Partners
Rexrode, Stuart	BlueRock Energy Capital
Reynolds, Doug	Scotiabank
Rockecharlie, David	KKR
Row, James	Entoro Capital
Rule, Rick	Sprott Global Resources Investment Ltd.
Schouest, Bart	Wells Fargo Energy Group
Scott, Ronnie	Development Capital Resources
Sheils, Kay	Seaport Global Securities
Shimp, John	Ridgemont Equity Partners
Smith, James	Aegis Energy Advisors Corp.
Steiner, Barry	Ladenburg Thalman & Co.
Stolze, Michael T.	SFC Energy Partners
Straty, Steve	Jefferies
Summerhill, Eric D.	Stephens Group
Tate, Brian	Regions Bank
Teichner, William	Frontier Capital Management
Teplitsky, Michael	Wynnchurch Capital Ltd.
Tharp, Larry	GSO Capital Partners
Thomas, Brian	Prudential Capital Group
Thompson, Mark	U.S. Bank
Thummel, Robert	Tortoise Capital Resources
Trauber, Steve	Citi
Tudor, Bobby	Tudor, Pickering, Holt & Co.
Turner, Mike	Mutual of Omaha Bank
Waite, Andrew L.	SCF Partners
Waldrip, Bill	EnCap Flatrock Midstream
Wallis, James	Lime Rock Partners
Ward, Dan	Evercore
Webb, Marvin	Petro Capital Securities
Weber, Tony	NGP Energy Capital Management
Weidner, Bill	Weidner Advisors
Weinberg, Russell	Energy Capital Solutions
Weinstein, James	Sumitomo Mitsui Bank
Wetmore, Clint	Post Oak Energy Capital
White, Leland	Energy Trust Partners
Whitt, Jason	Sand River Capital Advisors
Wilcox, Jason	Wilcox Swartzwelder & Co.
Wizel, Neil A.	First Reserve Corp.
Yates, Chuck	Kayne Anderson Energy Funds
Zusman, David	Talara Capital Management

QUANTUM
ENERGY PARTNERS