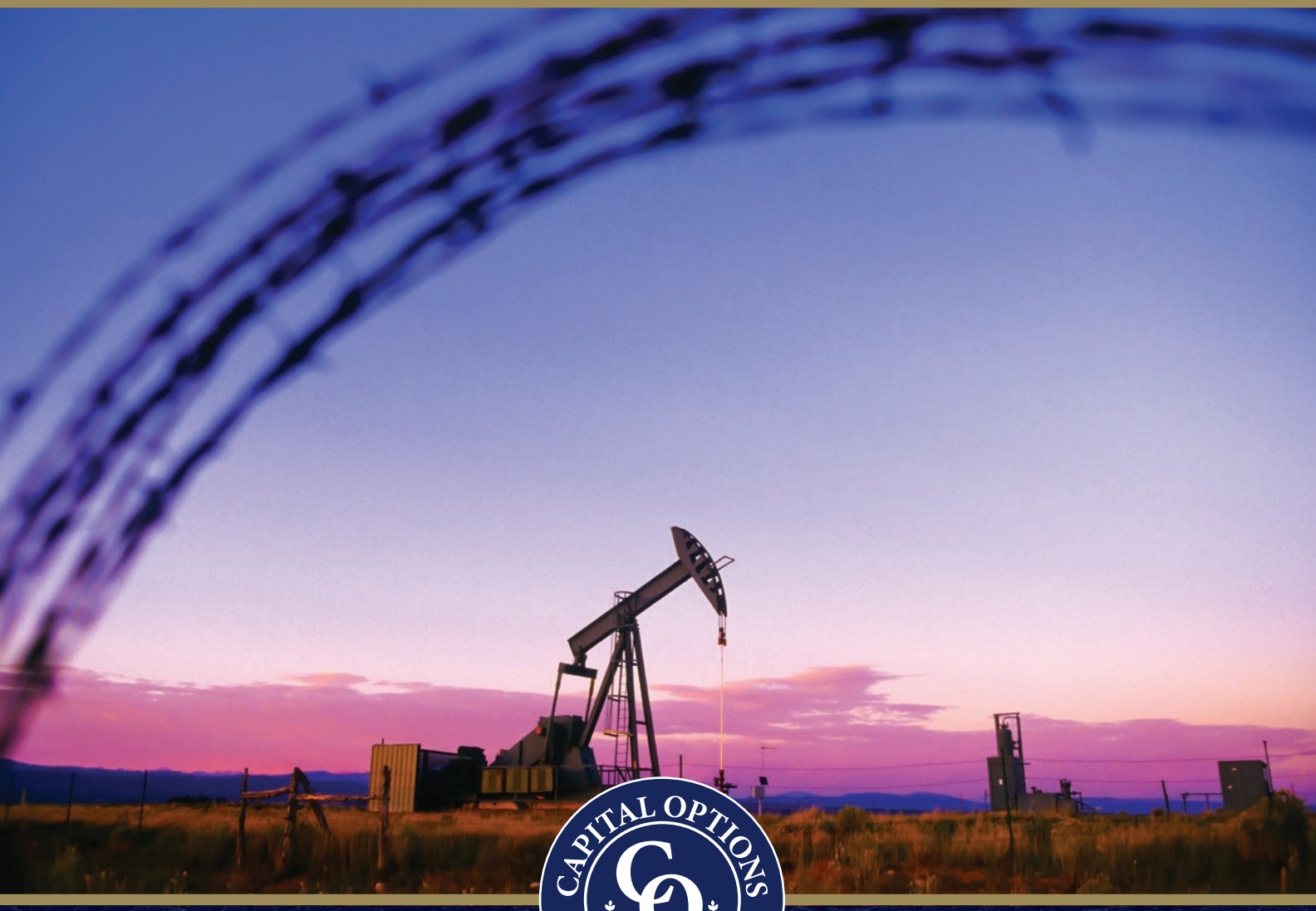
CAPITAL OPTIONS

Opportunities in a Challenged Landscape



CAPITAL OPTIONS 2020

A supplement to

Oil and Gas Investor

BUILDING BLOCKS OF A STRONGER OIL & GAS INDUSTRY

UNDISCLOSED	$950 MILLION	$66 MILLION	UNDISCLOSED	$750 MILLION
AETHON	EARTHSTONE Energy Inc.	KIMBELL ROYALTY PARTNERS	ROSEWOOD RESOURCES	Matador RESOURCES COMPANY
ASSET DIVESTITURE	HAS AGREED TO ACQUIRE SABALO	FOLLOW-ON OFFERING	JOINT VENTURE TRANSACTION	SENIOR UNSECURED NOTES
Financial Advisor	Fairness Opinion	Co-Manager	Financial Advisor	Co-Manager
$28 MILLION	$100 MILLION	UNDISCLOSED	UNDISCLOSED	$350 MILLION
VIKING MINERALS	LILIS ENERGY	PEARL ENERGY INVESTMENTS	HAYNESVILLE MINERALS PLATFORM	VIPER Energy Partners
ASSET DIVESTITURE	CONVERTIBLE PREFERRED STOCK	BUSINESS COMBINATION OF PORTFOLIO COMPANIES	PRIVATE PLACEMENT OF EQUITY	FOLLOW-ON OFFERING
Financial Advisor	Placement Agent	Valuation Analysis	Placement Agent	Co-Manager
$22 MILLION	UNDISCLOSED	UNDISCLOSED	UNDISCLOSED	UNDISCLOSED
Thunder Basin Resources	PETROFLOW ENERGY	BEELINE COLORADO, LLC	ELM RIDGE EXPLORATION	EAGLE FORD MINERALS PLATFORM
PRIVATE PLACEMENT OF EQUITY	ASSET DIVESTITURE	HAS DIVESTED ITS COLORADO MIDSTREAM ASSETS	HAS DIVESTED ITS COLORADO UPSTREAM ASSETS	PRIVATE PLACEMENT OF EQUITY
Placement Agent	Financial Advisor	Financial Advisor	Financial Advisor	Placement Agent

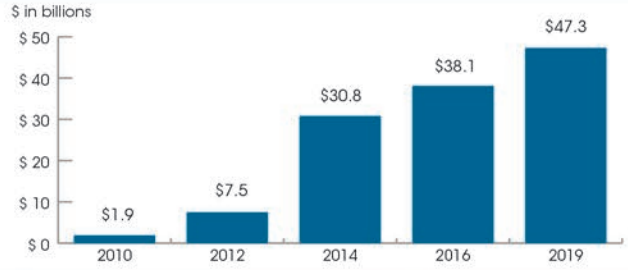
ENERGY GROUP KEY STATISTICS

$47.3 Billion
Aggregate Transaction Volume since 2009

$300 Million
Average Transaction Size

161
Transactions Closed since 2009

ENERGY GROUP AGGREGATE TRANSACTION VOLUME



As an active participant in the energy industry with a principal mentality for over 50 years, we understand that capital and ideas are indispensable to a thriving oil and gas industry. Our advisory assignments demonstrate how an independent investment bank, backed by extensive industry knowledge and innovative ideas, can build stronger, more prosperous energy companies.

Keith Behrens, Managing Director, Head of the Energy Group • 214-258-2762 • keith.behrens@stephens.com
Charlie Lapeyre, Managing Director • 214-258-2784 • charlie.lapeyre@stephens.com
Paul Moorman, Managing Director • 214-258-2773 • paul.moorman@stephens.com
Brad Nelson, Managing Director • 214-258-2763 • brad.nelson@stephens.com
Jim Wicklund, Managing Director • 214-258-2798 • jim.wicklund@stephens.com

300 Crescent Court | Suite 600 | Dallas, TX 75201

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Stephens
Investment Banking

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1616 S. Voss Rd., Suite 1000
Houston, TX 77057
1.713.260.6400 Fax: 1.713.840-8585
HartEnergy.com

Editor-in-Chief
Steve Toon, stoon@hartenergy.com

Executive Editor-at-Large
Leslie Haines, lhaines@hartenergy.com

Senior Editor
Darren Barbee, dbarbee@hartenergy.com

Associate Editor
Faiza Rizvi, frizvi@hartenergy.com

Senior Managing Editor, Print Media
Ariana Hurtado, ahurtado@hartenergy.com

Senior Managing Editor, Digital Media
Emily Patsy, epatsy@hartenergy.com

Assistant Managing Editor
Bill Walter, bwalter@hartenergy.com

Creative Director
Alexa Sanders, asanders@hartenergy.com

Art Director
Melissa Ritchie, mritchie@hartenergy.com

For additional copies of this publication, contact customer service at **713.260.6442,** or go to **store.hartenergy.com**.

Publisher
Kevin C. Holmes
kholmes@hartenergy.com • 713.260.4639

Vice President, Sales
Darrin West
dwest@hartenergy.com • 713.260.6449

Director, Business Development
Chantal Hagen
chagen@hartenergy.com • 713.260.5204

Ad Materials Coordinator
Neresa Williamson
iosubmission@hartenergy.com

HARTENERGY

Editorial Director
Len Vermillion

Chief Financial Officer
Chris Arndt

Chief Executive Officer
Richard A. Eichler

Redesigning the Playing Field

The oil and gas sector hasn't seen the flight of capital from the space like what has occurred this year in 30 years. Public-equity investors have taken their proverbial balls and gone to other playing fields until E&Ps can show capital discipline and—more importantly—consistent returns on and of capital for an extended period. Private-equity limited partners are feeling the singe of investments gone bad over the past few years and either have capital trapped in portfolio companies with no exit or just don't feel the love for putting new capital back into an industry with an obscure upside. And energy-supporting banks are either running away from the sector entirely or at least playing with a lot more caution.

Blame COVID-19, OPEC, Russia and the like, but the capital exodus began well before the global lockdowns tanked oil prices. The landscape for energy money is looking a lot like the financial desert that was the late 1980s.

But that doesn't mean all is without hope. Wall Street's cold shoulder will force public E&Ps to refocus plans, tighten up efficiencies and (hopefully) consolidate, ultimately resulting in stronger companies that can build value and not just barrels.

New private-equity dollars are already beginning to flow into the space, seizing a generational opportunity to buy at valuations likewise not seen in 30 years. Reserve-based lenders, exposed in bankruptcies for the first time in memory, are forcing borrowers to up their game to get access to credit lines, which will strengthen them all.

Yes, capital options are limited in the near term. And yes, capital will return to the oil field. But the playing field might look different, and the rules are definitely changing. Oil and Gas Investor presents some of those challenges and options in the pages that follow. ■

—Steve Toon, Editor-in-Chief, Oil and Gas Investor

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Energy companies will continue to use preferred stock as an alternative financing source to fund their existing operations and future capex.

(Cover photo courtesy of Marc Morrison/marcmorrison.com)

SOURCE: PLA2NA/SHUTTERSTOCK.COM

NEW FUNDRAISING

What the Downturn Means for Capital Providers

While some private-equity investors have closed new funds, others are looking for ways to navigate market volatility.

By Faiza Rizvi, Associate Editor

Amid depressed valuations and declining exits, deal activity in the energy sector was already experiencing a slowdown over the past few years. But the current downturn—one of the worst in the history of oil and gas—has left capital providers grappling. However, despite significant slowdown in deal activity, several private-equity investors have managed to close new funds while others are looking at new ways to take advantage of potential investment opportunities.

Beating the odds

Houston-based Andros Capital Partners LLC closed its inaugural $250 million fund in August to target investments across the energy sector. The firm is considering "private-equity investments, credit opportunities and direct asset-level investments" for the Andros Energy Capital LP fund, which is primarily focused on middle-market transactions requiring between $25 million and $200 million of equity.

"This has historically been an underserved portion of the market and really below the radar of what makes sense for many of the larger, more established fund complexes out there, particularly on the credit side," said Phillip A. Gayle Jr., founder and managing partner of Andros Capital Partners, which he established earlier this year.

"One of the unique features of our fund is the ability to pursue private-equity investments, credit opportunities and direct, asset-level investments. Having the ability to invest across the capital structure allows us to be creative and focus on the specific needs of both public and private energy companies as we structure and scale investments," he said.

Having completed the fund recently, the firm hasn't closed on any investments yet but is currently eyeing multiple prospects across multiple domestic basins.

"We have the ability to be opportunistic," Gayle said. "Upstream and midstream assets or companies are our primary focus. Our firm comprises investment professionals and energy entrepreneurs who have spent their entire careers as energy investors, asset managers and operators. So we fundamentally understand the business. We feel that creates a differentiated perspective as an investor and as a capital partner."

"Currently, there is an extreme lack of capital flowing into the energy sector at a time when balance sheets are stressed and the A&D market is really slow."

—**Phillip A. Gayle Jr.,** *Andros Capital Partners*

Gayle noted that fundraising has become more difficult in the current environment, especially since the onset of the global pandemic.

"I think most people would prefer to meet with a potential capital partner in person and that is much tougher if not impossible given the current situation," he said.

Capital isn't flowing either, as company balance sheets remain stressed and the A&D market is hobbled by a wide bid-ask spread. "Currently, there is an extreme lack of capital flowing into the energy sector at a time when balance sheets are stressed and the A&D market is really slow," Gayle continued. "Some companies, which you would think would be motivated sellers, are unwilling to sell assets at a valuation that makes sense to buyers in the current commodity price environment. So the bid-ask spread has prevented transactions that probably should get done from happening. That being said, we believe oil and gas prices will remain relatively depressed in the near-to-medium term, which should lead to more consensus on asset valuations and drive additional deal flow."

"The current environment presents additional avenues to capture opportunities with both our existing portfolio company partners as well as companies that we are not currently affiliated with."

—**Matt Kelly,** *Carnelian Energy Capital*

Recapitalization opportunities

Carnelian Energy Capital is a Houston-based investment firm focused on equity investments in the North American energy space. The company has raised approximately $1.8 billion since 2015, including its third fund, which closed in 2019 at its hard cap of $786.25 million.

Matt Kelly, vice president with Carnelian Energy, said the firm is spending significant time reviewing recapitalization opportunities for companies going through the bankruptcy process as well as evaluating asset sales from reemerged companies.

"Bankruptcy processes take time and typically include various stakeholders and viewpoints, so picking your spots is important," he said. "We are also spending time providing capital solutions to healthy companies who find themselves with limited access to capital in today's environment but who have accretive opportunities such as bolt-on acquisitions, core locations to drill or who simply want to delever balance sheets. And finally, we continue to spend time on traditional A&D. Even as the volume and pace of deal flow has slowed in 2020, we have been able to execute on several bolt-on acquisitions at attractive valuations that further enhance our existing assets."

To date, Carnelian Energy has made 18 platform investments and most are wholly owned and controlled by Carnelian and management, but the investment firm is open to other capital solutions, including structured equity and debt.

"Our overarching strategy centers on partnering with entrepreneurial management teams to pursue attractive risk-reward investment opportunities, and that core tenet remains unchanged. Having said that, the current environment presents additional avenues to capture opportunities with both our existing portfolio company partners as well as companies that we are not currently affiliated with," Kelly explained.

Reflecting on some recent trends of the oil and gas industry, he said the reserve-based lending market is definitely evolving.

"While several historically active lenders have left the space or meaningfully reduced exposure, the remaining participants have high-graded capital availability to a select few companies with top-tier teams and capital providers," he said. "We think this will actually create more stability in our industry over the long run and provide exciting opportunities for equity to flow to well-run companies who are focused on creating sustainable returns through operations and drilling and not through leverage."

Discussing the company's future projects, Kelly said, "We've recently re-partnered with the management teams of two of our previously exited companies, Bison Oil and Gas and Percussion Petroleum, and we are honored to have the opportunity to be in business with those teams again. We also recently partnered with John Oberg and Marc Shatzer to form Hawthorne Energy. We have known the Hawthorne principals for years and watched their success at Three Rivers Operating II and III closely and are excited about our partnership with them. More generally, we have more than $1 billion of unfunded capital and are looking to play offense in what we believe is a reemerging and growing opportunity set within the upstream space."

"The upstream exit market is drier than the midstream market, which is leading equity investors like us to think about how to hold on to investments longer until the exit markets open back up again."

—**Ben Davis**, *Energy Spectrum Capital*

Navigating the downturn

In April 2020, Energy Spectrum Capital, a Dallas-based venture capital firm focused on energy infrastructure, closed its eighth midstream venture capital fund (ESP VIII), amounting to $969 million, which the firm is currently investing.

Ben Davis, partner at Energy Spectrum, said ESP VIII has committed to five portfolio companies to date including funding for a crude gathering project.

"We have backed teams including Frontier Energy Services, Taproot Energy Partners, Pinnacle Midstream and our newest investment, Tivoli Midstream, which is looking at opportunities in the terminal space."

He added that the firm is eyeing more renewable deals as well.

Despite the current low-price environment, the firm intends to "profitably navigate the market volatility and build another strong portfolio." The investment firm sees potential for acquisitions that could ripen in the midstream space as companies struggling with high debt are under increasing pressure to sell off assets to pay down debt.

Davis noted that the firm's investment strategy has not changed materially in the past few months.

"We continue to back highly experienced teams and focus on the basins with the lowest development and production costs," he said. "In Energy Spectrum's 25 years, we have learned that those teams and reserves are best positioned to weather price downturns."

Davis continued, "I think there has been a lack of divestiture activity, which is leading equity investors like us to think about how to hold on to investments longer until the exit markets open back up again. And the upstream exit market is even slower than midstream. One thing that we have observed in the current downturn that is quite different than the financial crisis of 2008 is that there continues to be attractive debt available for energy infrastructure. I wouldn't say capital is cheap but reasonably priced, and providers are partner-minded."

Challenging times

"LP [limited partnership] capital formation for energy-specific investment funds has rarely been more challenged," said Jeff Bartlett, managing partner with Pontem Energy Capital, which he co-founded earlier this year with partners Cameron Brown and Skye Callantine. Pontem is dedicated to providing alternative capital and operations solutions to public and private energy companies, investing across the capital structure while providing value-added operational expertise.

"The capital markets, including high yield, remain wary of all but the most creditworthy upstream companies and, due to stress within existing portfolios, only a few energy-dedicated investors remain open for new business."

—**Cameron Brown**, *Pontem Energy Capital*

Bartlett said energy underperformance relative to non-energy sectors over the past several years has led to an "outright revolt from LPs against blind pool capital raise" for energy funds.

"Only a select few GPs [general partnerships] have been able to raise dedicated energy funds over the past few years," he said. "The recent pandemic caused a demand side shock that led to lower commodity prices, a historic reduction in domestic rig activity and ultimately a large number of upstream companies seeking Chapter 11 protection. Pontem seeks to provide

capital and operations improvement options for many of these distressed energy companies that have attractive, low breakeven assets."

Reflecting on the recent trends in the capital markets, Bartlett noted, "Due to the challenging outlook for LP fundraising, most remaining private-equity capital is reserved for existing portfolio companies' balance sheets in order to extend the liquidity runway and increase the odds of exposure to a more constructive exit environment."

Highlighting current public market sentiment toward energy, Pontem co-founder Brown said, "Public investors no longer reward growth but instead allocate capital toward the most efficient companies that show a clear ability to generate returns above their cost of capital in a mid-cycle oil price environment. Given less rig activity and growth, investors are seeking GPs that place significant emphasis on right sizing both the financial and operational sides of the ledger to achieve an investment profile that competes in absolute returns rather than just within oil and gas."

He added, "The capital markets, including high yield, remain wary of all but the most creditworthy upstream companies and, due to stress within existing portfolios, only a few energy-dedicated investors remain open for new business."

Discussing the firm's future plans, co-founder Callantine said Pontem has lined up a large capital commitment from a leading institutional investor that provides for a broad, flexible mandate that is intended to enable Pontem to capitalize on the dynamism of the current energy investment landscape. Pontem expects to provide either targeted or holistic capital solutions and to work with existing management teams to optimize its capital structure from top to bottom, including through new money common equity.

He further noted that as upstream companies focus more on cash flow generation with minimal development, Pontem will look to invest opportunistically, focusing on the technical team's capabilities to identify assets and businesses in need of cost structure, capital structure or balance sheet improvements.

"We plan to identify investments in larger upstream companies seeking liquidity enhancement solutions in an otherwise difficult capital markets environment," Callantine said. "Pontem will continue to develop relationships with our LPs to enhance access to capital that can be allocated to the most attractive energy investments through a very flexible mandate including equity and debt, gas and oil, and whether actively operated or through passive investments aligned with existing management teams." ■

CAPITAL OPTIONS 2020

CAPITAL MARKETS OUTLOOK

Where's the Money?

Burned by a sector gone bad, energy capital providers are hyper risk averse or just absent. Capital will flow back into the space when certain conditions are met, and those that are prepared will prosper.

Darren Barbee, Senior Editor

Cash-strapped? Bad credit? Out of marketable assets to sell? Welcome to much of the oil and gas industry, with a dash of pandemic.

The industry's bone-crushing fall from grace since 2014 has already led to deep mistrust from lenders and investors. Some companies may choose to wait out what has essentially been a half-decade of downcycles in the upstream sector. Some may have just enough wiggle room on their balance sheets and just enough oil to squeeze out of the rocks to survive.

Alternatives are narrowing even more.

At the recent Summer NAPE "Where's the Money Going to Come From" discussion on the future of oil and gas capital markets, panelists said even the usual confidence afforded companies with proved developed producing (PDP) assets has eroded.

Jim Wicklund, managing director with Stephens Inc., set the stage for the panel and the oil and gas industry 2020 version of Macbeth.

"Most of the production that we brought on over the last several years was not economic," Wicklund said. "If you look at the 21 E&P companies that have been public over the last 10 years, they outspent cash flow for seven of those years in order to build value. Over that 10 years, these 21 companies lost $96 billion in market cap value and $36 billion in net income."

"You can be creative, but you're not going to be able to do some of the fast and loose stuff that we've seen in this sector for a while."

—**Dan Pickering,** *Pickering Energy Partners*

Lending

Now that energy investments make up just 2.5% of the S&P 500, the industry is trying to meet the demand of positive new income. As the industry has struggled, they have spread the pain among energy-focused banks, private-equity providers, and public and private investors.

What emerges will be an energy banking sector far more risk averse. Mari Salazar, senior vice president and manager for BOK Financial, said when she started in energy banking, banks felt secured if operators had PDP assets. That confidence has plummeted as losses have soared in bankruptcy.

If "you were a senior secured lender and you really didn't have much of a risk for loss, that has really changed these days," she said. "You've seen articles where banks have taken $0.31 on the dollar or $0.50 on the dollar. And that's really what I think has changed the market."

The pandemic "allowed us to rethink how we're approaching our customers and really needing to prepare ourselves for the fall and what that would look like," she added.

Banks, now aware of their vulnerabilities, will place stricter controls on lending.

"You're going to see tighter structures. We're starting to see that now [with] cash flow sweeps, tighter RP [restricted payment] baskets," she said.

Banks may shift to terming out debt rather than holding, essentially, "perpetual debt" that remains on the books until a transaction or more favorable yields.

With capital availability such a crucial part of the industry's future, Salazar said the banks with a long history of energy lending will still be there. However, she also said some banks will exit the space by selling portfolios or paring down their overall energy exposure.

"What we are looking for more these days is really getting back to energy lending 101," she said.

Redetermination season looks to be more challenging than ever now that even once-secure PDP assets have let down banks.

Dan Pickering, CIO for Pickering Energy Partners, said the industry may see the most highly levered companies emerging from bankruptcy because creditors want to hold onto as much money as possible. Some of those companies that have already been through bankruptcy are still overleveraged.

"They put a number of companies out there with frankly too much debt, and we're seeing some of them go back" into bankruptcy, Pickering said.

Pickering expects a number of "zombie" companies with mediocre assets and mediocre balance sheets to "limp along for a long time in sort of purgatory." Some of the companies will liquidate their assets, and some will face obsolescence as acreage goes undrilled.

"A lot of it's in the hands of these have nots, and some are going to limp along and sort of survive but not thrive. And others are going to have to get restructured," he said.

Relationship banking will play a more important role in energy lending post-pandemic, with banks knowing their clients, their business model and understanding businesses' collateral.

"We really lead with our technical team, and I think it becomes super important," Salazar said.

Pickering said the industry is fighting headwinds, such as concerns over ESG, the industries inability to make money or peak demand concerns.

"We're six years into a downturn here," he said.

The industry has had to pivot from a focus on growth that was supported by commodity prices and OPEC. With both legs kicked out from under it, energy is now the worst-performing sector in the S&P on a one-, three-, five- and 10-year basis.

But the reality is that energy is relevant for the foreseeable future, Pickering said. Investors can be lured back by returning money to them. A move is already underway in the industry to send free cash flow to investors and sink less back into the ground.

During the next three to five years, Pickering sees the industry resetting from the current cyclical trough, which has starved operators of capital and caused drilling activity to come down and production with it.

"Assuming we don't have a global recession coming off of this kind of a pandemic, then we're going to find equilibrium and prices will improve," Pickering said. "So sometime in the next three to five years … prices are going to be back to the point where investing in the business generates good money. So that will turn people's heads."

"Most of the production that we brought on over the last several years was not economic."

—**Jim Wicklund,** *Stephens Inc.*

"You're going to see tighter structures. We're starting to see that now [with] cash flow sweeps, tighter RP [restricted payment] baskets."

—**Mari Salazar,** *BOK Financial*

The industry also appears to understand that it has passed the tipping point on ESG and climate, and it will need to better manage carbon emissions.

Pickering noted that bp Plc recently announced it would reallocate spending toward green energy over the next five years. The company said in August it would increase its low-carbon investments tenfold by 2030.

"The simple answer is the numbers have to get better," he said. "There's some skepticism now in the investor community that energies can't make money or [that] it's time has passed because peak demand is coming or [because of] ESG concerns."

For renewed investment, Pickering said oil prices likely need to be in the $50 range, with cash given to investors regularly.

"It will start to bring people back," he said. "Greed will bring people back."

M&A

If there's one silver lining from the pandemic, it's made clear "who are the haves and who are the have nots," said Steven Cobb, vice president with private-equity firm Pearl Energy Investments.

"The ability to select what assets, what companies are truly investable—you had a pretty clear picture of it for a short while," he said. "Obviously, there's still distressed [companies] out there today, but you know, I think what happens is the haves have a great opportunity to continue to raise some form of capital and start growing through and picking up some of these zombie companies."

Consolidation of such companies, depending on the quality of their assets, will represent opportunities for private-equity firms and financially healthy companies to engage in mergers and consolidation. For the rest, "if you're a private-equity firm, if you're an operating company [or] if you're not growing today and generating real scale, it's going to be hard to create value."

Cobb said Pearl will be extremely conservative about the acquisitions that involve leveraged returns.

"Today it's just not going to be something that we're going to bet on," he said.

Operating companies that aren't growing and aren't building out to scale will find it difficult to create value.

"Otherwise, you're a zombie company. You're treading water and you won't be able to withstand the next wave of cyclicality that we know is coming in the industry," he said.

The financially healthy companies will have a unique opportunity—to access capital and start picking up assets at a low price.

"You might actually see a little bit of tailwinds to the commodity. If you think of who is actually going to be able to develop assets and put supply online, it's only going to be the healthiest companies" with tier one acreage and assets.

"As the shale industry or shale boom has progressed over the last decade, it's shown you that those sweet spots only get smaller and smaller over time," he said.

Pickering said he expects a more disciplined approach to M&A.

"There's going to be more deals and less money for those deals," he said.

Mergers of equals have been a safe way to combine assets without setting off investor shockwaves. Other deals are taking different routes. In August, for instance, Antero Resources signed a volumetric production payment agreement with an affiliate of JPMorgan. The agreement pays Antero $220 million upfront in exchange for seven years of natural gas revenues.

"As the shale industry or shale boom has progressed over the last decade, it's shown you that those sweet spots only get smaller and smaller over time."

—**Steven Cobb,** *Pearl Energy Investments*

However, for now capital is still difficult to find given the challenging times, the political atmosphere and low prices. With potential upheaval, dealmakers don't want to get cute, Pickering said.

"I think that you can be creative, but you're not going to be able to do some of the fast and loose stuff that we've seen in this sector for a while," he said.

But Pickering offered some sunlight on the industry's many challenges.

"The reality is there is a great opportunity," he said. "This is sort of our generation's 1986 and what came after '86, which was a terrible year in the oil patch, was some really good returns and great returns for investments.

"We're going to make money, putting money to work down here over the next two, three, four years. And it may take a while for people to realize that's coming," he said. ■

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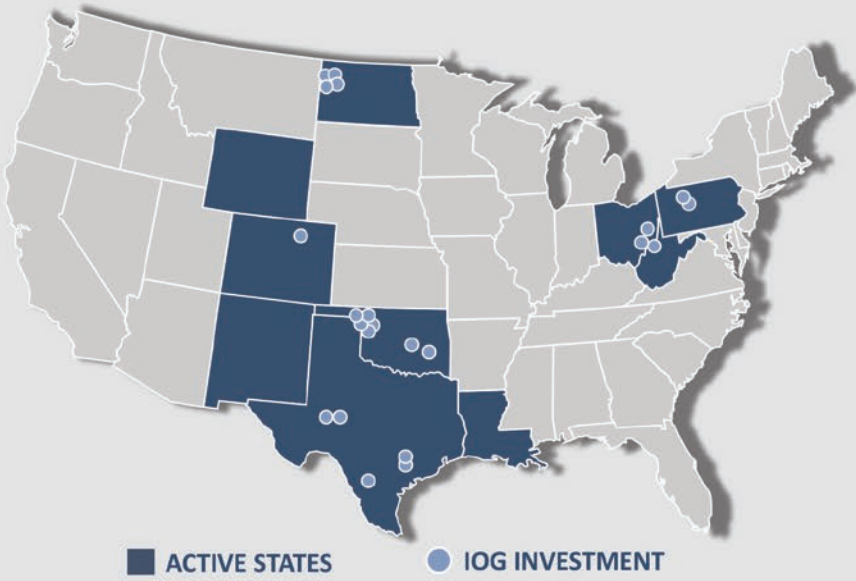

IOG is the preferred capital provider for upstream U.S. onshore assets. IOG invests directly as a working interest partner, offering flexible solutions designed to help partners achieve their goals throughout the commodity cycles. Since inception we have closed all types of asset-level transactions, including most recently a new development JV in September 2020 with an investment grade large cap public E&P.

Development JV's | **Non-op AFE acquisitions** | **PDP Acquisitions**

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WORKING INTEREST IN 500+ WELLS

$900 MM+ CAPITAL DEPLOYED

13 OIL & GAS PROFESSIONALS

CLOSED 50+ DEALS

$25 MM - $150 MM TARGET SIZE DEAL

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The Current Market Requires a Creative and Constructive Capital Partner

"Our team is focused on helping entrepreneurs build and maintain quality assets, with an emphasis on reliable and safe operations, to meet customer needs. This recipe for success requires an open-minded partner who can see the opportunity and support our partners as they focus on execution."

—**Patti Melcher,** *Co-founder and Managing Director, EIV Capital, LLC*

Headquartered in Houston, EIV Capital, LLC (EIV) is an energy private-equity firm focused on providing growth equity to small and mid-cap North American energy companies. Founded in 2009, the firm has $1.6 billion in assets under management across four funds and co-investment, including approximately $1 billion of available capital to invest in new opportunities.

EIV primarily invests in midstream businesses, such as transportation, logistics and processing. EIV also pursues opportunities throughout the entire energy value chain, including oilfield service and equipment, renewable/sustainable, upstream and downstream sectors.

Experienced, entrepreneurial team sets itself apart

The firm's investment team includes a diverse set of energy-focused backgrounds, including commercial, construction, entrepreneurial, financial and operational experience.

"Based upon our team's deep assortment of energy expertise, EIV seeks to quickly understand the business, capital and leadership requirements necessary for a potential investment to achieve long-term growth and profitability," said Patti Melcher, co-founder and managing partner of EIV.

EIV's partners have started their own businesses and understand the passion and determination required to drive success in a growing enterprise. The entrepreneurial backgrounds of EIV's senior members provide the breadth of experience needed to act as a sounding board to help EIV's portfolio companies work through the typical growth challenges.

Building customer-focused, operationally sound businesses

By concentrating its investment focus, limiting the number of investments per fund and fostering an environment of open communication, EIV believes its operationally focused team can help each portfolio company achieve success.

The firm typically commits between $20 million and $100 million per investment, teaming up with entrepreneurs in existing businesses or initiating new platforms. EIV has the flexibility to provide commitments of more than $200 million and has done so when its portfolio company partners identified larger opportunities with appropriate risk-adjusted returns.

"EIV is focused on supporting teams to build and operate good businesses as opposed to emphasizing capital deployment. This allows us to pursue niche opportunities and support our partners as their businesses grow into stable, profitable enterprises with steady cash flows, which are attractive to a diverse buyer universe," said Jenny Gottschalk, partner with EIV Capital.

Diverse portfolio across the energy value chain

EIV seeks to partner with talented management and field-level operators to acquire quality businesses with assets that have potential to achieve strong returns throughout industry cycles. The cornerstone of EIV's investment philosophy is to identify opportunities where EIV's investment professionals' expertise in operations, asset management and price risk management can be utilized to create or optimize economic value.

This nimble investment strategy allowed EIV to partner with a wide range of energy companies including a midstream engineering firm, an oilfield water infrastructure company, a renewable natural gas business and multiple traditional midstream gathering and processing businesses.

"This environment presents opportunities for both first-time and serial entrepreneurs to identify inefficient or underutilized assets and work with capital providers, such as EIV, to enhance operations, improve customer service and drive returns."

—**David Finan,** *Partner, EIV Capital, LLC*

AMP Americas

Led by CEO Grant Zimmerman, AMP Americas I (AMP I) was a renewable company focused on producing renewable natural gas (RNG) from dairy waste and owning/operating CNG fueling stations. EIV partnered with AMP I in mid-2017, and in mid-2019, AMP I sold its assets concluding a successful relationship with EIV, management and the company's minority owners.

EIV subsequently partnered with the same management team to form AMP Americas II (AMP II) to develop similar RNG projects and a full-service operating, maintenance and RNG fuel marketing business for third-party projects.

"With its history of leadership and innovation, experienced management team and strong relationships within the RNG space, AMP II is in an excellent position to flourish in this exciting and evolving market," Gottschalk said. (www.ampamericas.com)

Bayou Midstream

EIV partnered with Bayou, led by CEO Travis Roby, to develop, acquire and operate crude oil, natural gas and oilfield water midstream infrastructure focused in the Rockies.

"Bayou constructed its first asset, a crude oil gathering system in the Bakken, in mid-2019 and is currently undergoing a system expansion, under long-term contracts, to accommodate the continued activity of our anchor producer," said Greg Davis, partner with EIV Capital. "Management has done an outstanding job positioning Bayou to grow organically around its initial asset and through acquisitions where we see a wide range of attractive investment opportunities." (www.bayoumidstream.com)

CAM Integrated Solutions

EIV partnered with CAM, led by CEO Craig Pierrotti, to provide lean design engineering services to midstream and upstream customers for the "first mile" midstream from wellhead, including facilities, to the main long haul pipelines. CAM successfully expanded its business to offer additional services, including fabrication, procurement and construction management. CAM's full-suite of engineering, procurement and ancillary services, provides its customers a valuable cost-effective integrated product offering, including providing an exclusive EPC midstream solution for a supermajor's Permian Basin buildout.

"CAM's integrated product offering provides resilience during market downturns and cost-effective solutions to customers," said David Finan, partner with EIV Capital. "CAM continues expanding its services outside

of the 'first mile' midstream market, capitalizing on an evolving energy landscape." (www.camintegrated.com)

Canes Midstream

EIV partnered with CEO Scott Brown and CCO Chad Choate to form a midstream company focused on developing, acquiring and operating crude oil, natural gas, NGL, and/or oilfield water midstream infrastructure in the Lower 48.

"With the changing dynamics of the energy industry, the Canes team brings a robust background that spans numerous basins and commodities, positioning the team well to partner with producers looking for midstream solutions," Davis said. (www.canesmidstream.com)

EcoVapor Recovery Systems

EIV partnered with EcoVapor, led by CEO Mike McMahon, to provide technology and engineering solutions to eliminate flaring and significantly reduce producers' wellsite emission footprint. EcoVapor developed the patented $ZerO_2$ unit helping producers recover, deoxygenate and sell valuable flash gas from storage tanks while eliminating flaring. $ZerO_2$ units are installed throughout the most active oil and gas producing basins in the U.S. The company also provides turnkey H_2S treating solutions for produced gas streams as well as site assessments to review producers' vapor management systems.

"We were thrilled that a supermajor acknowledged EcoVapor as a main contributor to helping reduce flaring in its Permian Basin operations by 80%," Melcher said. "We appreciate the continued opportunity to help producers achieve their corporate ESG mandates and targets." (www.ecovaporrs.com)

Fullstream Energy

EIV partnered with Fullstream, led by CEO Larry Murphy, to develop, acquire and operate midstream infrastructure in the Marcellus and Utica. In November 2017, Fullstream secured an anchor producer and moved forward with the construction of the Goff Connector System, which comprises a 21-mile, high-pressure pipeline and a 500,000-Mcf/d compressor station.

When Fullstream identified its anchor project, EIV increased its commitment to $180 million in support of the company.

"EIV worked alongside management as the commercial and capital scope of the project evolved, ultimately providing flexible equity support to assure the success of the project and provide incremental capital to expand the project's scope," Finan said. (www.fullstreameh.com)

H_2O Midstream

EIV identified the oilfield water sector as primed for growth, professionalization and cost savings and partnered with H_2O Midstream, led by CEO Jim Summers. In 2017, H_2O acquired Ovintiv's produced water infrastructure in Howard County, Texas. H_2O also acquired Sabalo Energy's adjacent water infrastructure in 2019, expanding its overall footprint to include an integrated gathering system across 300 sq miles of contiguous acreage, including access to 540,000 bbl/d of permitted disposal capacity.

"Since closing the Ovintiv transaction, H_2O expanded its gathering, disposal and recycling infrastructure to diversify its contracted customer base and provide multiple services to seven different customers" Finan said.

Outside of Howard County, H_2O is a partner in UL Water Midstream, the preferred water service provider for University Land's ~170,000 surface acre position in the Southern Delaware Basin. (www.h2omidstream.com)

Woodland Midstream

EIV partnered with Woodland Midstream I (Woodland I), led by CEO Richard Wright, to build a business providing gathering and processing services primarily for horizontal drilling activity in East Texas. Woodland I sold its existing businesses in late 2018, and EIV subsequently partnered with Wright to form Woodland Midstream II (Woodland II).

In October 2019, Woodland II acquired the West Texas located James Lake System, a fully integrated sour gas gathering, treating and processing system consisting of ~230 miles of pipeline, 110 MMcf/d of gas processing capacity and ~210,000 dedicated acres from multiple producers.

"Since acquiring James Lake, Woodland II has done an excellent job maximizing operational efficiencies and uptime, including emission reduction focused projects, and developing commercial opportunities to expand the system throughout the Central Basin Platform and Northern Delaware Basin" Melcher said. (www.woodlandmidstream.com)

High-quality opportunities exist due to current market dynamics

The contraction in public and private markets improved the quality and risk profile of opportunities in the market, creating prospects for well-funded private capital to invest in core areas and underwrite achievable, near-term drilling plans. The risk-adjusted returns for new capital investments are improving as midstream companies implement more downside contractual protections.

"Opportunities exist and can be profitable regardless of size, market cycle or geography. The key is to focus on the likelihood of value creation for the customer and company and less on the size of the project," Davis said. ■

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CAPITAL OPTIONS 2020

PREFERRED PRIVATE PLACEMENTS

How to Raise Capital in Tough Times

Energy companies will continue to use preferred stock as an alternative financing source to fund their existing operations and future capex.

By Hillary H. Holmes and Louis Matthews

HOLMES

MATTHEWS

The energy industry is particularly capital intensive, meaning that access to the equity and debt markets is critical to the survival and growth of companies in this sector. While the current economic climate has only exacerbated the need for access to liquidity—as reduced revenue resulting from historically low energy prices have required energy companies to seek additional capital—energy companies are looking beyond traditional offerings of straight debt or common equity.

Considering their present stock prices, energy companies are reticent to issue common equity securities because low trading prices mean equity issuances would be significantly dilutive. Further, energy companies have found it difficult to obtain debt financing on commercial terms when their balance sheets are already stressed due to market conditions.

Therefore, energy companies have looked to preferred stock as an alternative financing source for their existing

operations and future capex. Preferred stock can provide maximum flexibility for both the company and the investor.

To assist energy companies in their capital raising strategies, in this article, Gibson Dunn & Crutcher summarizes the key terms of preferred securities, highlights potential benefits and pitfalls for companies and investors to consider when negotiating these terms, and provides market data regarding key terms of preferred stock. This article also shares the firm's expectations, based on experience and discussions with investment bankers in the space, for future developments with respect to the preferred private placement market in the energy industry.

What is preferred equity?

Preferred equity is a separate class of equity securities that entitles holders thereof to certain rights and preferences over common equity. The terms of the preferred stock can be tailored to the needs of the company and the investment goals of the purchasers. Common features include dividends, liquidation preferences, redemption rights, conversion rights, voting powers and, occasionally, preemptive rights. These preferences are heavily negotiated between companies and investors and result in bespoke terms from issuance to issuance.

What are the benefits of preferred equity?

The tailored nature of preferred stock offers companies with the flexibility to determine the scope of the rights and preferences to be offered to the investors. Depending on the circumstances and funding needs of the company, the rights of preferred stockholders may be narrow or broad. These preferences vary on a case-by-case basis as parties make accommodations to meet their ultimate investment goals.

In the current climate, many companies believe their common stock is temporarily undervalued and the issuance of additional common stock would be significantly dilutive. These companies can raise capital by issuing preferred stock and avoiding immediate dilution. The extent to which the company minimizes the risk of dilution depends on whether, when and under what circumstances the company or the holder can convert the preferred stock to common stock.

Also in the current climate, companies are concerned about leverage or the impact of issuing debt on their credit ratings. These companies can carefully tailor the terms of the preferred stock to attract fixed income investors but still receive partial or full equity treatment under their credit agreement or from the rating agencies.

From the investor's perspective, preferred stock can be an attractive investment as it can provide both debt-like returns and equity upside. The convertible nature of many preferred stock allows the investor to share in the upside returns alongside common stockholders, including in a change of control. If cash dividends are required to be paid on the preferred stock, then the investor will receive a debt-like instrument with interest payments. Further, while preferred stock is generally subordinate to debt claims, preferred stock may provide superior downside protection for equity investors due to being senior in priority in the capital structure in the event of bankruptcy or liquidation.

Another benefit to bespoke preferred stock is the private nature of the transaction. First, the negotiation process between the company and the investors as to the terms of the preferred security is more efficient. Rather than negotiating with a representative of potential investors, the company can negotiate directly with the investor to tailor the terms of the preferred security to provide the suite of economic and governance rights desired by the investor while being satisfactory to the company. Second, the deal timeline can be more condensed than in a public offering. The growth and maturity of the private placement market has resulted in increased standardization of documentation and terms, which has expedited the length of negotiations between companies and investors. Further, placing preferred stock with a previous or current sponsor eliminates any time delay resulting from the investor needing to complete certain due diligence prior to making the investment.

What are the key provisions of preferred stock?

As previously mentioned, one of the primary benefits of preferred stock, particularly when issued in a private placement, is the ability of the parties to customize the terms of the

5 Things to Know About Preferred Stock

1. The tailored nature of preferred stock offers companies and investors with the flexibility to design bespoke rights and preferences. The process will be most efficient if parties clearly agree on the goals of the issuer and the investor from the start.
2. Investors will definitely want economic protections (e.g., redemption on change of control, seniority to the common and limitation on other preferred equity, redemption after period of time, conversion rights if equity undervalued) and issuers will want liquidity protection (e.g., PIK option).
3. Investors may want governance protections (e.g., board seat, veto rights), and issuers should plan for the long-term impact on other strategic initiatives (e.g., M&A, restructuring).
4. Watch out for issues with the terms of the preferred stock under the credit agreement (e.g., restricted payments, mandatory redemption, debt treatment).
5. Structure the preferred stock for equity treatment from the rating agencies and to avoid shareholder approval under stock exchange rules.

security. The most common customized terms relate to dividends, liquidation preferences, conversion rights, redemption rights, voting powers and board representation rights.

Dividends: Although dividend payments on preferred stock are conceptually similar to interest payments on debt securities, preferred stock generally provides for a higher return to compensate the investors for their junior position in the capital structure as compared to the debtholders. Further, dividends generally must be paid to holders of preferred stock prior to payment of a dividend to holders of common stock, eliminating some of the risk of payment. Other points of negotiation relating to dividends include (a) whether the dividend rate is fixed or floating, (b) the frequency and form of payment, (c) whether the dividends are cumulative or noncumulative and (d) any restrictions on payment.

The dividend rate on preferred stock may be fixed or floating. A fixed rate dividend is generally a percentage of the initial purchase price, but it can also be based on the liquidation preference or another predetermined metric. This rate may increase or be adjusted after a certain period of time. A floating rate is adjustable and is typically tied to a predetermined formula that fluctuates with interest rates.

Dividends on preferred stock are commonly paid on a quarterly basis, although the parties may instead negotiate for semiannual or annual payments. Dividends may be paid in cash, payment-in-kind (PIK) of company securities or a combination. A PIK option is attractive to a company that is prohibited from issuing cash dividends by debt covenants in its outstanding debt or that has limited liquidity.

Dividends may be cumulative or noncumulative. A cumulative dividend will accrue over time until paid, rather than being lost. Companies are restricted from paying dividends on junior stock so long as accumulated dividends remain unpaid. Noncumulative dividends are lost if not paid by the company and will not be made up at a later time.

The majority of the recent preferred private placements in the energy industry were fixed rate securities that paid quarterly dividends with a combined cash/PIK payment option. However, the precise terms of payment varied widely. For example, one company's preferred stock provided that no dividends would be payable in the first year, but dividends would be payable thereafter at a fixed rate of 10% of the purchase price. Another company's preferred stock provided for an initial fixed dividend rate, but a

SOURCE: WILLIAM POTTER/SHUTTERSTOCK.COM

representative of a majority of holders of the preferred security could elect to convert the fixed rate into a variable rate after the five-year anniversary.

Liquidation: One of the hallmarks of preferred stock is that upon the occurrence of a liquidation event, the holders of preferred stock are entitled to receive a certain amount (called the liquidation preference) prior to any liquidation distribution to holders of junior securities (e.g., common stock).

A key issue for the parties is determining what qualifies as a liquidation event. Typically, liquidation events include an IPO, mergers or consolidations, or a sale of all or substantially all of the company's assets. There are variations on this depending on the forecast for the company. If a merger is likely in the near term, then the preferred stock might provide that a "merger, consolidation or other business combination transaction" in which the company retains less than 50% ownership would trigger a redemption event, rather than a liquidation, requiring the company to redeem all of the preferred security for cash at a premium.

Alternatively, if the preferred stock is perpetual in a company without a near-term fundamental change, then the preferred stock might provide that anything less than a winding up of the entirety of the company's affairs, including a merger or consolidation, would not constitute a liquidation event.

The liquidation preference generally equals the greater of (a) an amount equal to the invested capital, plus all accrued accumulated dividends (if applicable) and (b) the amount the holder would have received had its shares of preferred security been converted into common stock immediately prior to the liquidation.

After the liquidation preference is paid, depending on whether the preferred security is participating or nonparticipating, the holders of the preferred security may be entitled to additional distributions of the company's assets in connection with a liquidation. Nonparticipating preferred stock is not entitled to any of the remaining assets distributed to holders of junior preferred stock and common stock following the payment of the liquidation preference. Participating preferred stock may receive additional distributions of the company's remaining assets by participating alongside the holders of common stock on an as-converted basis. This preference may also be referred to as a double dip.

Most preferred stock issued in the energy industry recently provided that the holders of the preferred stock would not participate in any additional distribution of assets alongside the holders of common stock. These securities generally applied the formula presented above in determining the liquidation preference amount. A minority of preferred stock issued recently allowed the holders thereof to participate in additional distributions on an as-converted basis pari passu with the common stock.

Conversion: Another important feature of preferred stock is whether it is convertible into the company's common stock (or other securities). Conversion can be an attractive feature to investors because it allows them to share in any appreciation in the price of the company's common stock, particularly if trading prices are at low levels.

Conversion may be based on a fixed rate or floating rate, and it will often include anti-dilution adjustments to the rate upon certain corporate events occur (e.g., dilutive stock issuances and stock splits). Another important term related to conversion is whether the holders have the option to convert the preferred stock (i.e., mandatory conversion) and whether the company has the option to convert the preferred stock (i.e., optional conversion). With respect to mandatory conversion, holders are typically only permitted to convert the security after a specific date. With respect to optional conversion, the company is typically permitted to convert the security only after a specific date or upon the occurrence of certain circumstances, like a merger.

Energy companies have found it difficult to obtain debt financing on commercial terms when their balance sheets are already stressed due to market conditions.

Considering the ubiquitous nature of the conversion feature, it was unsurprising that, among the recent issuances in the energy industry, only one series of preferred stock did not include conversion rights. All of the preferred stock with a conversion feature provided for mandatory conversion upon certain circumstances. Most of the preferred stock's mandatory conversion feature was time-based, in which the holder could convert its securities following a period ranging from six months to two years. Most of the preferred stock with optional conversion features allowed the company to convert the preferred stock after a certain date (ranging from one to three years after the closing of the placement) or once a certain number of preferred shares remained outstanding. In addition, the most common conversion formula was the quotient of the (i) liquidation preference and (ii) the then-applicable conversion price (subject to anti-dilution adjustments and other equitable adjustments).

Redemption: Preferred stock may include redemption rights in which the company is required to redeem the preferred security for cash at various times or during a specific period.

When the holder of the preferred security has the right to cause the company to redeem the security, this is known as a mandatory redemption feature. This may be sought by investors if they require liquidity after a certain period or seek immediate liquidity upon a certain triggering event, such as a change of control of the company. Mandatory redemption is

typically set at a fixed or floating price per share or unit and is typically cumulative.

When the company has the right to redeem the preferred security, this is known as an optional redemption feature. An optional redemption is typically expressed as a percentage of the liquidation value of the preferred security, which may decrease over time. For example, the certificate of designation (or other agreement setting forth the terms of the security) may not allow optional redemption for a certain number of years, but the company may redeem the security for an agreed upon percentage (which percentage decreases over time).

Finally, some preferred stock does not provide for redemption rights, and these securities are known as perpetual preferred stock.

Approximately half of the recent issuances provided for optional redemption. A majority of these securities featuring optional redemption rights granted the company with the option to redeem all or a portion of the preferred security at any time, while two of the securities permitted the company to redeem only following a certain period of time. With respect to mandatory redemption, five of the securities mandated redemption upon a change of control, three of which also provided preferred stockholders with an optional redemption right after a certain period of time.

The tailored nature of preferred stock offers companies with the flexibility to determine the scope of the rights and preferences to be offered to the investors.

Voting powers: Investors will often seek certain voting rights to protect their investment, particularly when they do not have board representation. These voting rights are typically structured whereby the holders of the preferred security are entitled to vote as a single class with the holders of common securities on matters that the holders of common securities are entitled to vote. But the holders of the preferred security also have the right to vote as a separate class on issues that specially impact the preferred security. These special rights, often referred to as consent rights, require an affirmative vote of a certain portion of holders of the preferred security (often a majority or two-thirds of the class) before the company may take any of the covered actions.

The consent rights can either be limited to certain fundamental transactions, such as the sale of the company, or relate to operational matters. The most common actions requiring a vote by a majority of preferred stockholders include:

- any amendment, alteration or repeal of any provision of the organizational documents in a manner that adversely affects the rights, preferences or powers of the applicable preferred security (and this consent right may be even further limited solely to amendments that directly or indirectly affect dividend, liquidation or redemption preferences of the applicable preferred security);
- authorization, creation or increase of senior equity or parity equity, or the reclassification of any existing class of securities if such reclassification would render the other security senior to the applicable preferred security;
- repurchase or redemption of shares of junior securities while the applicable preferred security remain outstanding; and
- change of control transactions or material acquisitions resulting in a change to the preferences and seniority of the preferred stock.

With the exception of nonvoting convertible preferred stock issued to avoid the stock exchange's 20% shareholder approval rule, all of the preferred stock issued recently in the energy industry granted consent rights in one form or another, though the specific language of each varied. Preferred stockholders generally held the right to vote as a separate class from the common stock on fundamental issues (e.g., merger or bankruptcy) and some extended to operational matters (e.g., large expenditures).

Board representation: Board representation presents a unique issue with respect to preferred investments. Investors that make a substantial investment may pursue board representation in some capacity to protect their interests beyond mere consent rights (although investors will often seek both board representation and certain consent rights). In the absence of board representation, an investor may seek board observation rights.

However, obtaining board representation or observer rights has drawbacks. For example, a director appointed by a designated group of stockholders risks violating fiduciary duties owed by the director to all stockholders. Further, access to material nonpublic information by the director may limit the investor's ability to exit its investment without violating insider trading laws. Therefore, many investors elect not to seek such board representation or observer rights.

These concerns were reflected in the recent issuances. Only a minority of preferred stock recently issued in the energy industry granted board representation to the investors, and it required the investor to maintain a certain ownership threshold right to keep the board seat. Further, a small minority granted board observation rights to the preferred stockholder.

Other terms: There are other negotiated provisions of preferred equity issuances:

- Whether the preferred stock has preemptive rights;
- Whether the use of proceeds will be limited to certain corporate purposes;

- Whether the investors will be subject to a standstill;
- Whether the investors will be locked up from transferring the preferred equity for a period of time following the date of issuance;
- Whether the investors will receive registration rights;
- Whether the investment will include an equity kicker (e.g., warrants); and
- Whether the investor's expenses will be reimbursed.

What is the future of preferred stock?

Market conditions are conducive to private placements of preferred stock. Therefore, Gibson Dunn & Crutcher expects private placements of preferred stock to continue to serve as a tool for energy companies to manage their liquidity during the length of the existing crisis. In fact, the firm expects the size of these private placements to increase as companies use them to finance M&A and other consolidation efforts in the energy industry.

In particular, keep your eye out for more consistency among terms of new preferred stock:

- Use of proceeds is to enhance liquidity;
- Percentage of market cap at 10% to 20%;
- One to three private-equity or hedge fund investors;
- Not broadly marketed;
- More liquidity protection for the issuer (e.g., option to pay interest in-kind or cash);
- Investor receives board seats, subject to ownership requirements;
- Increased use of downside protection features;
- Mandatory redemption trigger upon change of control;
- Long-term investments (e.g., perpetual or matures 3 to 5 years; noncallable for at least 3 to 5 years); and
- More flexible mandatory conversion feature (i.e., provide investor with upside when equity markets strengthen).

Given preferred stock can provide maximum flexibility for both the company and the investor, and the equity and debt capital markets continue to present challenges, Gibson Dunn & Crutcher expects energy companies to continue to use preferred stock as an alternative financing source to fund their existing operations and future capex. ■

Hillary H. Holmes is partner with Gibson Dunn & Crutcher's Oil & Gas practice and co-chair of the firm's Capital Markets practice; she is based in Houston. Louis Matthews is an associate with the firm's Oil & Gas and Capital Markets practices based in Dallas.