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Startups Target Growth Opportunities

By Danny Boyd
Special Correspondent

The past five years have seen new faces cropping up in every nook and cranny of the industry–from the upstream to the downstream, and all points in between. In many cases, these new entities have spun out of merger and acquisition activity. Although declining commodity prices have put a temporary chill on the M&A market, veteran oil and gas investors and operators continue to embark on startups and expand new exploration and production companies through organic growth while contemplating the possibility of acquisitions somewhere down the line in 2009.

“By closing on financing, we will have the opportunity to get after current asset development, which has such low finding costs that the return on the capital deployed is realized very quickly.”

MARK HARRINGTON
Vice Chairman
Rock Energy Resources

A case in point is Houston-based Rock Energy Resources, which is anticipating first-time profitability in early 2009 as it secures financing and creates a public currency with its stock while spending $15 million developing gas reserves in the Wilcox trend of South Texas, according to Vice Chairman Mark Harrington.

Founded in 2004 as a master limited partnership, the company raised capital by going public in January 2008 through a reverse merger involving Hanover Gold Co., a shell company that had been inactive for several years, explains Harrington.

Given the prospects for industry consolidation and lingering price uncertainty, Harrington says his company is certainly not ruling out potential acquisitions in the future as lower commodity prices reduce the value of in-ground reserves. But he adds that Rock Energy is focusing chiefly on developing properties that offer two very attractive advantages in a volatile market: consistently low finding and development costs, and near certain success in exploiting proven reserves.

“I think the real key for identifying good prospects is knowing true finding and development costs,” he opines. “In the Wilcox trend in Colorado and Starr counties in Texas, our F&D cost is about $0.80 cents an Mcf, which means we can make good money down to a wellhead price of $3.50-$4.00 an Mcf.”

In May 2008, Rock Energy assumed operatorship of the Garwood properties in Colorado County after acquiring additional working interests in the field, Harrington says. At the time, the company announced that it was conducting an in-depth technical evaluation of possible well recompletions. In August, Rock Energy announced it had successfully recompleted the Pintail No. 1 well in the field, with an initial flow rate of 300 Mcf/d (payout was achieved in slightly more than 21 days). Proven, probable and possible natural gas reserves in pay horizons extending between 5,000 and 16,000 feet in the Garwood Field are estimated to exceed 40 billion cubic feet, Harrington reports.

In Starr County, Rock Energy has a 100-percent working interest in the Bob West prospect, an 1,110-acre leasehold on the Mexico border, Harrington goes on. “There are 22 potential pay horizons in this area, beginning at 5,000-6,000 feet in the shallow section and extending to 21,000 feet, with 250 Bcf of Wilcox discovery potential,” he states.

A Starr County well drilled by El Paso Corp. on nearby acreage has proven very successful, essentially moving Rock Energy’s acreage from the category of a wildcat prospect to a development with proven/probable reserves, Harrington says.

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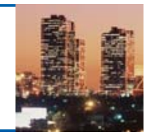

deployed is realized very quickly," he comments, noting that at a typical Colorado County Wilcox well can pay out in only 15 months at a price of $6/Mcf. "Gas production should accelerate quickly as Wilcox reserves are accessed from new wells completed in the coming months."

California Oil Projects

Following the completion of the reverse merger, the company announced its acquisition of a 2.5 percent working interest in two notable oil development projects in central California (the Orcutt and Casmalia fields), and applying for listing on the American Stock Exchange.

Three wells have since been completed and pilot steamed on the Orcutt prospect. Rock Energy and its partners, which include the operator, Santa Maria Pacific, realized oil production from cyclical steam recovery projects in the Diatomite and Monterey formations in the Orcutt Field and from the Northwest Casmalia diatomite field–both located in Santa Barbara County, where Harrington says there is a known resource base of more than 2.5 billion barrels of oil in place.

But with F&D costs of at least $10 a barrel, Harrington reports that softening oil prices have temporarily idled its plans to invest in additional cyclic steam recovery. "However, investment in the basin will pick up when prices rebound consistently to the $60-$70/bbl range, perhaps in 2010-2011, and cyclic steam production becomes economic again," he says.

Rock Energy and its partners have about $12 million invested in the fields, Harrington adds, with the company now holding 7 percent working interest and receiving 14 barrels a day net in production from previously existing Monterrey production. To date, none of the diatomite production has been brought on line. "I do not see any reason to put more capital into that side of it now, but it is a huge resource base," he avers.

Because of the success of cyclic steam recovery projects in the shallow Opal A Diatomite in Kern County, Harrington says production from the play now accounts for 20 percent of California's total oil output, with 80-90 percent of that production and total acreage in the basin locked up by the majors.

"You develop a project on anywhere from 0.75- to 0.5-acre spacing, steam it for four or five days, let it sit for a couple days, flow it back for a month or so, and then go back in and do it again," he explains. "The recovery factor can be 20 percent, with at least one operator reporting recovery up to 35 percent."

The anticipated success of Rock Energy Resources is contingent on the synergies created from officers and directors with strong investment banking and operations backgrounds, relates Harrington, who has 30 years of experience in investment banking, exploration and production, and oil field services. The company's other two principals are Rocky Emery, who founded the company after a 10-year career in financial services to pursue promising new domestic exploration and production projects, and President and Chief Operating Officer Tom Elliot, who has more than 300 successful Wilcox wells to his credit in a career that spans roles in engineering, exploitation, acquisition, divestiture and corporate development.

Given the potential for low oil and gas prices, Harrington says conditions could ripen for acquisitions over the course of the year. He describes 2009 as a potentially "difficult time for exploration and production companies because of their shrinking borrowing bases as a result of the devaluation of reserves."

He surmises that reserves devaluation will hit some companies harder than others. "Vulnerable companies will face reductions in reserve values and corresponding demands from banks to shore up collateral while struggling to fund operations, pay interest on debt and meet general and administrative operating expenses as cash flow dwindles," Harrington says. "Those conditions could add to value for companies or funds looking for attractive acquisitions."

Adding to the attractiveness are potential discounts on subdebt and moves by hedge funds to reduce their exposure by relinquishing upstream oil and gas holdings, he adds. "If you have good fundamental assets, but they have been banged down in value and the company has been banged down further in value because it has too much general and administrative cost and financing, and the holder of the paper needs to get out, you have the best vulture fund environment you could hope for," Harrington comments. "It is not just going to be a question of the value of a property, but how you pick it up. There could be excellent opportunities in buying distressed pieces of debt from hedge funds that have to liquidate."

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CAMERON O. SMITH
Head of The Rodman Energy Group
& Senior Managing Director
Rodman & Renshaw LLC

Focusing On Acquisitions

With more operating companies being pressured to maximize asset values amid price declines and corresponding reserve devaluations, M&A activity will pick up as those companies look for opportunities to sell or trade assets to trim debt, says Cameron O. Smith, head of The Rodman Energy Group. But it could be the end of the second quarter or early in the third quarter of 2009 before deals accelerate as asset availability outpaces investor demand, he adds.

"There is a lot of private capital that lined up behind drill bit startups over the past year or two that this year will be looking instead to focus on acquisitions, as well as on new teams that can demonstrate an ability to capture and maximize asset values quickly," Smith observes.

However, organic growth will be a hard sell to some investors, because it could mean putting less capital to work quickly as returns are realized over the longer term, he says. Market conditions could be especially tough for some startups, Smith warns.

"For startups between early 2007 and mid-2008, many are under water or have assets lower than cost because a lot of them were buying very expensive leaseholds and drilling wells under higher-price expectations," Smith says. "Clear winners will be the startups that can turn around and start buying assets now, no matter what their initial business plans may have been."

Jason Reimbold, director of capital markets for PLS Inc. in Houston, says in the current climate of lower commodity prices, operating companies should be on the lookout for value-priced acquisition opportunities.

"If we manage to maintain relative price stability, I expect M&A activity to increase as we move through 2009," says Reimbold. "The major obstacles include high volatility in commodity prices and access to capital. However, companies with dry powder should be able to capture acquisition targets in the near term."

The best positioned companies are those that avoided paying premium prices to buy high-valued properties during the run of record prices in 2007-08, Reimbold suggests. Having done so, they should have ample capital to pursue acquisition opportunities in 2009, he adds.

High commodity prices throughout much of 2008 made it difficult for many players to identify accretive acquisition opportunities, and as prices influenced higher acreage costs for areas with unconventional potential, it was difficult for some startups to enter certain plays, Reimbold notes.

"However, some of the companies that paid top-dollar for assets in 2008 are now in need of cash," he explains. "This, combined with lower commodity prices, could provide an opportunity-rich environment in 2009. The companies that did not get carried away with acquisitions at last year's record price levels should be able to take advantage of good acquisition opportunities this year."

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JASON REIMBOLD
Director of Capital Markets
PLS Inc.

Bullish Outlook

Duncan, Ok.-based Mt. Dora Energy is one new startup that is ready and willing to do acquisition deals, according to President Kelly Kirkland.

Founded in June 2008, Mt. Dora has already secured $35 million in private equity funding from Scotia Waterous to develop acreage in what Kirkland describes as the "fairway of Oklahoma" through the central part of the state. About one-third of that equity is being put to work acquiring acreage in proven basins, and the remainder is funding low-risk development, infill and step-out drilling to achieve targeted returns over the next four or five years, says Kirkland, who founded the company along with CEO Gary Mayfield.

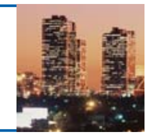
Acreage under development includes holdings in Pawnee and Noble counties in northern Oklahoma and Stephens and Carter counties in the south, he says. "We are looking for opportunities in those areas and everywhere in between," avows Kirkland, whose industry experience includes past positions as an engineer/economist at Amoco, as well as a stint at Noble Corp. Mayfield's background includes engineering work at Phillips Petroleum and at the privately held Mayfield & Payne logging company.

Since June, Mt. Dora Energy has drilled 20 wells and is planning an aggressive drilling program in 2009, according to Kirkland. The company's drilling program will benefit from the growing availability of rigs, he says, and the resulting decline in drilling costs, as well as from increasing availability of casing and other equipment and services.

"We are looking for properties with upside potential," he explains. "We believe the only way we will see the value we want is through the drill bit. In general, we would like to invest two to three times the acquisition price into development drilling with little downside risk. We are willing to pay a premium for proven, developed and producing reserves for the right get in and realize the upside from further development."

After acquiring and developing properties and benefitting from expected rebounds in oil and gas prices over the next few years, Kirkland says the company hopes to achieve anticipated rates of returns for its investors when the production and acreage are sold. In the meantime, when prices turn around and begin increasing again–which Kirkland says should happen sooner rather than later–they will further bolster the value of the company's reserves and potential returns, he holds.

"We have a bullish outlook for prices," he says. "Frankly, $150/bbl was far too



high for oil, but $40 is far too low. We feel that prices in the $70-$75/bbl range are reasonable to expect over the next 12 months, and probably within the next six months."

Growing Through The Bit

Houston-based Southern Star Energy has not counted out growth through selective acquisitions down the road, but the company expects a more stable price outlook as it plans to spend 2009 developing its properties in the gas-rich Cotton Valley and Haynesville Shale plays in northern Louisiana, says President and CEO David Gibbs.

"We are more interested in the near term in growing through the drill bit," Gibbs explains. "Having said that, in the current marketplace, there are some bargains to be had, perhaps even better than what you can find through the drill bit in some cases."

Southern Star was formed in 2006 to take advantage of available acreage in the Sentell Field of the Cotton Valley trend, which was originally developed in the 1950s, says Gibbs, who has 33 years of experience with ExxonMobil, The Superior Oil Co., Union Texas and TDC Energy.

Other top company executives include Vice President of Exploration and Development Bruce L. Ganer, who has 35 years of experience with Schlumberger, Home Petroleum, Union Texas Petroleum and Pennzoil; CFO Christopher H. Taylor, who joined Southern Star after serving as an assistant treasurer at Noble Drilling Inc. and working at major accounting firms; and Operations Manager Douglas M. Harwell, who has 10 years of experience with Cannon Services Ltd. and ExxonMobil.

The company holds a 40 percent interest in 5,400 acres, Gibbs notes. "A big piece of our growth going forward will be to continue to develop this acreage position. We have drilled eight wells on it so far, and we are drilling our ninth well now," he said in December. "There is room for at least another 50-60 wells."

Haynesville Shale

But the considerable potential extends beyond the Cotton Valley sands, Gibbs points out. Southern Star drilled two of its latest wells in a second development project targeting the underlying Haynesville Shale, he adds, which ranges in depth from 10,500-11,000 feet across the company's leasehold.

"We encountered significant productive intervals in the Haynesville in both of those wells, and we are evaluating completion techniques while we finish expanding our pipeline system," he says. "Assuming this continues to pan out as I think it will, we could be looking at 30-50 Haynesville Shale wells on our property."

The company also is looking at farm-in opportunities from larger operators that need to hold large blocks of Haynesville acreage under lease, Gibbs says, noting that his company sees business opportunities emerging as larger operators scale back aggressive drilling programs amid the market downturn. "They have to get wells drilled on their acreage or risk losing it as their lease terms begin to expire," he explains.

Southern Star completed a pilot program in May 2008 that resulted in the first five successful Cotton Valley completions with gross daily production of 2,500 Mcf equivalent (760 Mcfe/d net), proved reserves of 3,585 MMcfe/d as of May 31, and 2008 proved, probable and possible (3P) reserves of 13.465 Bcfe, according to the company.

Revenue from the first five wells covers all overhead and office operating expenses, leaving the company a net positive cash flow of $50,00-$100,000 a month, Gibbs reports. "We expect those numbers to turn up rapidly as we begin to put some of these new wells on production and continue with our development program," he estimates, adding that the company has secured ample financing to fund growth, including a $25 million revolving line of credit from Macquarie Bank Ltd.

Southern Star plans to develop locations on 160-acre spacing, and technical analysis has unveiled opportunities to substantially increase drillable locations within that acreage, according to Gibbs. "We can typically drill Cotton Valley wells in 15-20 days," he says. "Our net proved reserves have now grown to a little over 10 Bcf, and 2P (proved and probable) and 3P reserves could take that number as high as 150 Bcf. Our overall finding and development cost in the Cotton Valley is $1.44/Mcfe, so wells can be very economic even at lower gas prices." ❒

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President & CEO
Southern Star Energy