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Energy Funding Still Is Alive And Well

By Gregory DL Morris
Special Correspondent

Resource plays have fundamentally altered the nature of the domestic independent oil and gas industry, and as a result they also have altered the financial markets that back those plays. This shift is taking place against a backdrop of record high oil prices, but a faltering domestic economy and struggling credit markets.

Investors, lenders and deal makers say public debt markets are suffering and that public equity is late in a bull market. However, private debt and equity are bulging with cash seeking strong places to invest. And traditional bank loans remain a ready source of funding for operators who can prove themselves to be good risks.

There are plenty of those, affirms S. Wil VanLoh Jr., president and chief executive officer of Quantum Energy Partners in Houston. Domestically, he says he sees resource plays as the focus of development for the next 10 years. "We are in only the second or third inning of this game, but it is very different from previous investment cycles," he says.

S. Wil VanLoh Jr.
President and CEO
Quantum Energy Partners

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Quantum is an investment firm specializing in the energy industry that manages more than $3.2 billion in capital. Of that, $2.0 billion is in its family of private equity funds and $1.2 billion is in Quantum Resources, a direct property acquisition fund comanaged by Quantum and Aspect Energy LLC, according to VanLoh. He says Quantum primarily is focused on the oil and gas and midstream sectors with a secondary emphasis on the oil field service, coal, power, and alternative energy sectors.

"The operator management teams we back are very different these days," VanLoh explains. "It used to be that we would back a small team with maybe two key individuals such as a land guy and an engineer. Now the teams need to represent five or six disciplines–engineering, geology, geophysics, drilling, completions, and so forth–as well as have a chief executive who is skilled in capital allocation and is capable of integrating all these disciplines."

He adds, "The game today is much more about costs, because in a resource play it may take 200, 400 or 600 wells to complete a field. We have gone from custom production to mass production. This is a very big paradigm shift. That said, we still think there will be interesting conventional plays."

VanLoh uses the analogy of a six-digit combination lock to explain resource plays. "One digit is geology, one is seismic, one is mud, one is drilling technique, and the other two are fracturing and stimulation techniques. Even if you know all the

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digits, you need to figure out the exact order to unlock the formation," he expounds. "Even within the Barnett Shale there can be different ways to drill and complete wells that are only a few miles apart. You learn something from each well and begin to put the digits in order. Once you get through 20 or 30 wells, you get the combination and you can put the hammer down."

Public And Private Divide

Cameron Smith is senior managing director of COSCO Capital Management LLC, an intermediary for financing oil and gas startups and middle-capitalization operations. He suggests that the major divide in funding the independent upstream sector is between public and private money. COSCO is a source of venture and growth capital through private placements.

"The distress in credit markets hits mostly retail investors in the public markets," Smith says. "Within the private market there are closed-end funds, which have dedicated capital for 10-12 years. Then there are open-end funds, such as hedge funds, which are subject to at least annual redemption. They are more like retail capital."

There is near-term optimism in both open- and closed-funds, and even a positive long-term outlook in the retail sector, Smith says. Among open funds, however, he says there is some liquidity pressure and a shorter time frame.

Closed-end funds, he continues, are trying to find management teams with the business acumen and technical expertise. "They have massive capital and a mandate to invest. They see the retail distress as an opportunity for investment. That class of investor has experienced growth beyond anything except the foreign sovereign wealth funds. Ten years ago there were five of those closed-end funds. Five years ago there were 20. Now there are 40 of them," Smith says.

According to Smith, the smallest investment being made by the closed-end funds is $50 million. These investors typically exercise control through a board of directors, which they appoint. "Most of these investors are capable of debating the ideal number of perforations per foot with anyone in the field. Some are more hands off, but most are very involved," he stresses.

"The usual structure is a line of equity," Smith continues. "So long as the operator performs according to the business plan, that capital is available on call."

He acknowledges that sometimes management teams are scared by active fund managers. "They feel that being checked on means the money could be shut off," he says. "But these investors are under a mandate to invest, and they are responsible to their backers. They want management to execute the business plan–not using too much money, but also not using too little. One measure backers have when investing in funds is how much of the commitments have been drawn. If it is not much, questions arise about the selection of the operator."

In essence, Smith says, "We find a good jockey, feed the horse enough hay, and have no hard deadline to exit. With that strategy you have to have very bad luck not to make money in this market. And we have been hitting it out of the park in the past five years."

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Senior Managing Director
COSCO Capital Management LLC

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Compensation Inflation

One speed bump on that racetrack is the accelerating growth of management compensation. "Ten years ago it was about 10 percent," says Smith. "Five years ago, 20 percent was standard. These days we are seeing 30, 40 or 50 percent. There are criteria–hurdles the team must clear–but the growth of compensation is becoming an issue. Some funds indulge the teams and some don't."

Smith indicates that in response to compensation inflation, some funds are starting to look at other parts of the energy sector in North

America, and also are starting to look abroad. "People are looking at the service sector, midstream, renewables, and also worldwide where the politics are manageable," he says. "Domestic onshore, conventional oil and gas are still the most popular, but they are also the most competitive, so investors have opened their vision."

So how does an operator find investors and how do investors find good management teams? "Call COSCO," laughs Smith, quickly acknowledging that there are at least a few other top-level intermediary firms.

"Things have gotten so competitive that most funds go on the road to find investment opportunities," he mentions. "They are meeting management teams early in the process, going to conferences, and even advertising. The trouble is that most of the A+ teams already are known. One solution is to refinance the same team. There are some teams and investors who have been at this for 20 years, building and selling companies with five- to six-year turnovers."

Business Is Booming

For continuing operations, traditional bank loans are still an important part of financing in the independent sector, and will remain so, says Stephen Kennedy, senior vice president and manager of the energy group at Amegy Bank, based in Houston. The bank has $2.3 billion in loan commitments, half of which are funded. Loans outstanding increased 65 percent in 2007, he reports, while income increased 44 percent.

Stephen Kennedy
Senior Vice President
Amegy Bank

"We really are in a terrific situation in the industry. The Federal Reserve is reducing interest rates to stimulate the economy while prices for oil remain high and access to capital is great."

"Last year was fantastic," Kennedy enthuses, "the best in our 11-year history. We saw broad activity in all areas: upstream, midstream, and services. The big reason is the use of completion technology in resource plays. That has provided a steady flow of business to oil field services.

"With oil prices being sustained, there is less likelihood that development will be stopped because of volatility in the commodity. The futures market is another type of technology to manage price risk," he adds.

According to Kennedy, it was common with conventional exploration to see a 30 percent range of economic feasibility, then about a 90 percent range of success in development for a blended rate of 60 percent. But in resource plays, investors are seeing a blended success rate of 90 percent or better, he says.

The two characteristics of resource plays sustain each other, Kennedy holds. He says the high success rate and the relatively steady production reduce volatility, and that encourages investors to commit the large sums necessary to develop those plays. "With less volatility, you can commit to leases, rigs and personnel," he attests.

The oil and gas industry has made a fundamental shift away from high-permeability, high-porosity, high-productivity fields, points out Tom Petrie, vice chairman of Merrill Lynch & Co. "Those have been drilled out," he says. "We have shifted into unconventional resource plays that yield hydrocarbons grudgingly.

"The nice thing about those, however, is once you are in, there is good running room," Petrie observes. "These are known formations, so there is low geologic risk, as long as there is enough pay thickness and you are confident you can unlock the rock. The problem is that they take a lot more capital to jump-start than do conventional wells."

Contrary to popular belief, Petrie insists that debt markets are still open. He cites a major player that went looking for $400 million, and got such a response that it increased its financing to $600 million–and got a good interest rate. At least one other producer is in the market for a similar deal, he says.

For most types of financing, producers are being expected to perform within "a prudent band" of cap-

ital consumption, Petrie says. "With the blended cost of capital, the optimal results fall within a prudent band. Too high and you run off the cliff; too low and you get lesser returns to investors. The ideal debt to capital ratio varies for different operations, but the low end is 20-25 percent and the high range is into the 40s," he says.

Cautions And Caveats

There is one source of capital on which Petrie is not sanguine: equity. "Typically only a few companies can make an argument for bringing equity to market," he contends. "That is especially true for mundane plays with tight margins. It is very hard to access equity markets for those."

He says companies with exciting growth potential may be able to make a case for equity financing, but even for them, he says, the economic cycle is well advanced and there is a great deal of uncertainty whether the nation is facing a slowdown or a recession.

Marshall Lynn Bass, principal of GasRock Capital LLC in Houston, emphasizes the importance for capital providers to have a strong knowledge of the business. "A lot of energy funds have had industry skill on staff, and now there is more financial savvy on the producer side," he comments.

He says that is being demonstrated with hedging, master limited partnerships, and other specialized financial techniques.

GasRock makes $5 million to $100 million mezzanine project debt and project equity investments in selected exploration, production, and midstream projects. Bass says the firm also finances acquisitions and development projects.

Tom Petrie
Vice Chairman
Merrill Lynch & Co.

"If oil stays in a range of $80-$120 a barrel and we still have at least very slow economic growth in North America, then there will be a decent operating environment. The focus will be on development rather than exploration."

Reflecting further on MLPs, Bass notes that after the first few followed by a larger second wave, MLPs "seem like they are at a pausing point. The first movers definitely benefited, so if we are at the end of the trend, that means less competition for them. Also, several of them have access to assets that can be dropped into the MLPs, even if they cannot acquire assets on the market."

Petrie at Merrill Lynch agrees that the high tide for master limited partnerships seems to have abated. "A year ago there was still some real arbitrage between the publicly traded MLPs and the conventional public corporations. Big firms were looking for appropriate assets to take out of C-corps and move into MLPs because of the much higher capitalization rate," he reflects. "That spread has narrowed between MLPs and C-corps. The market now seems satisfied with the MLPs having a slight advantage."

"The MLP wave got overheated," Quantum's VanLoh confirms. "Everyone who could sell into one did because they were paying top dollar."

Big Or Small?

One of the ironies of the huge volumes of capital seeking oil patch investments is that money managers are under pressure to make big investments. This leaves some smaller operators trying to sip from a fire hose. "A growing problem today is that you can get $50 million, but you can't get $5 million," suggests Smith at COSCO.

One answer, he offers, is to follow the advice of legendary architect Daniel Burnham: make no little plans; they have no magic to stir men's blood. Smith says that when operators come to him for modest investments, he asks, "What if capital was no object? What are your best ideas for the next 24-36 months?

"That is when the light bulbs go on," he says.

Smith adds that his questions are as much a caution as they are an exhortation. Given the likelihood of an administration in Washington less beholden to the energy sector a year from now, he also suggests that this could be the time to cash out for some operators, or a time for them to re-evaluate their leaseholdings.

"You have to be very careful if you

are producing federal units," Smith cautions. "Those factors, combined with the large investments looking for horses to back, mean it could be up or out for more than a few producers. Go big or go home."

Petrie also says there is less opportunity to attract financing at the smaller end of the market, but he notes that there are still several regional banks and some private equity funds that "like to play at the lower end of the scale. That end of the market is not as efficiently served or priced, but there are still a few options."

Bass at GasRock agrees that there are some, but says there are not enough options at the smaller end. "This is a real issue, and when we first raised our fund we tried to address that," he says. "Our range of financing is $5 million to $100 million. I don't know many others with that range. There are some nice small deals, but only a few people who will make them.

"The problem with most of the players who will make small deals is that they tend to be small themselves. So a producer may get stuck with small backers, and to grow beyond that (the producer) may have to start over," he says.

Quantum's VanLoh offers a different view. "It is true that with all the variability in resource plays, the capital requirements are much greater. And it is true that the traditional sources of capital are raising larger pools of money. But there are still plenty of people to provide funding in the $5 million, $10 million or $15 million range," he insists. "They are just different people than were at that level before."

Positive Outlook

For at least the rest of this year, Kennedy at Amegy says he anticipates current trends continuing. "Spreads may be a little higher between the cost of funds and the cost to produce, but the news is still very good," he assesses. "The net cost of capital has decreased. We really are in a terrific situation in the industry. The Federal Reserve is reducing interest rates to stimulate the economy while prices for oil remain high and access to capital is great."

Kennedy notes that not as much funding is coming from the public bond market as before, but maintains those disruptions are temporary. The strain on liquidity is the result of the subprime credit crunch, he says, adding that he is confident "those markets will open again in time."

Also, the nature of deals is not changing much, says Kennedy, but the timing is being accelerated. "There are equity providers willing to get in earlier in the cycle, making commitments to new management teams even before they have acquired any properties," he observes. "Four or five years ago, backers would have to see performance, a track record, and a base of assets at least sufficient to cover overhead. That is not necessarily the case anymore."

Kennedy says he does not expect much change in the nature of financing for at least the next few years. "Financial markets are well developed," he says. "I am not sure much more development needs to take place. Public and institutional markets will open again. The credit crisis may be resolved as early as the middle of the year. Those markets are still well disposed toward the oil industry, they just are not liquid."

Merrill Lynch's Petrie says that what happens the next two or three years depends on the price of the commodity, and that will be driven by how deep the downdraft in the economy is. "If oil stays in a range of $80-$120 a barrel and we still have at least very slow economic growth in North America, then there will be a decent operating environment," he allows. "The focus will be on development rather than exploration.

"It took the Barnett Shale 17 years to be an overnight success. Now we are using what we learned in the Barnett in the Fayetteville

Marshall Lynn Bass
Principal
GasRock Capital LLC

"There are more oil transactions than we thought we would be doing three years ago. With the price of oil and the levels of technology, you can make a lot of things work."

Shale. We can compress the timeline somewhat, but we are still learning," he says.

Price Volatility

Bass at GasRock questions whether oil will remain steady. He says he expects the price of hydrocarbons will fluctuate more widely in the near term and have more effect on future financing in the sector than some may think. "Volatility will be stronger in the commodity, and deals will start or stop making sense," he poses. "Some people paid more for their acres than others did, and the costs of services will change. This will be a challenge for resource plays.

"It is not only the price you paid for the assets, but the availability of parts and people. If oil prices go up, then tightness in service costs will hamper the availability of drilling rigs and frac trucks," he says.

While much attention is being focused on new assets and new technology, Bass says there is still a steady stream of renewing old deals. "One transaction of ours was a refinance of a shale, coalbed methane and conventional operator in the Rocky Mountain region," he says. "It was a 3-year-old startup, and the original equity backers wanted out. We purchased the common shares and made another infusion of capital."

Bass also notes, "There are more oil transactions than we thought we would be doing three years ago. With the price of oil and the levels of technology, you can make a lot of things work. We financed senior level debt for an enhanced oil recovery play in Wyoming that is (utilizing) a carbon-dioxide flood."

Quantum's VanLoh says he believes the market is witnessing a long-term secular upswing for energy worldwide. "This is being driven by demand in China and India," he says.

Even natural gas, he comments, which used to be a regional commodity, is becoming a global industry. At the same time, the U.S. oil and gas sector has matured. Consequently, VanLoh says capital providers still will invest in the domestic sector, including Canada, but they also will look worldwide where the resource is sufficient and there is the rule of law.

"With that greater variability you need much more money," VanLoh concludes.

But he warns that maybe too much capital is coming in. "I mean fast, hot money, like in the Internet boom. We could be setting ourselves up for some capital destruction like we have not seen in decades," he cautions.

VanLoh also sounds the tocsin on some management teams. "It is not a popular thing to say, but there are too many investors getting in who do not understand the industry, and there are too many management teams getting money who should not," he intones. "That has a negative impact in the short term by bidding up the price for land, people, and services. That is making it tough on the good teams with sound backers."

But in the long run, for good teams with patience and deep pockets, VanLoh says he sees a lot of opportunities. "In a few years they will be able to buy assets for pennies on the dollar," he posits. "Maybe the good companies will not grow so fast in the next few years, but after that they will be in great shape to acquire misplayed assets." ❒