

Looking Past M&A Market

Drillbit-focused business plans may be increasing in popularity.

By Bertie Taylor, Associate Editor, *Oil and Gas Investor This Week*

With commodity prices still going strong and investor interest as piqued as ever, private capital providers aren't having much trouble drumming up business these days in the oilpatch. Though the M&A market is still active, more investors are looking to the drill-bit for growth or rolling the dice with new start-ups—and coming out on top.



Cameron Smith

“We have not backed an M&A-focused business plan in more than three years,” says Cameron Smith, senior managing director of New York-based COSCO Capital Management. The firm's 25 engagements for the past three years have been drill-bit focused, with the majority being start-ups.

“This means that for the first six to 12 months, most of the equity raised by our clients has gone to cover overhead and pay for leases. A few examples from 2005 are Coronado Resources, Genesis Gas and Oil, Onefour Energy, Energy 51, Potoco and Bunker Energy, for which in aggregate we raised equity commitments of more than \$250 million,” Smith says.

Last year, COSCO's largest financing at \$80.8 million was for Tulsa, Okla.-based Coronado Resources. “The management team, although a start-up, had such strong backgrounds that we were able to attract more than 10 of the best known and most successful capital sources in the U.S., each vying for the opportunity to invest at or above the terms set out in our original offering,” Smith says.

The Coronado transaction was the first time COSCO

Investments, COSCO's investment arm, exercised its right to participate for up to 10% of the total targeted amount. The deal closed in October and already has more than 100,000 acres under lease or in advanced negotiation.

By the end of last year, COSCO had 16 investments in its portfolio, having also monetized two, both with noteworthy returns. The bigger—in terms of scale—was the company's participation in the sale of Montana-focused Sleeping Giant LLC for a little more than \$90 million.

Smith says Sleeping Giant is a good example of the transactions that will remain popular this year. The deal involved the sale of a partially developed resource-oriented unconventional play, where the buyer was willing to pay even for non-proved reserves. The deal also spotlights growing interest by Canadian Royalty Trusts to acquire long-lived, low-risk reserves and development opportunities in the U.S. The trusts can often pay more than their U.S. competitors because of their lower cost of capital, Smith adds.

COSCO's latest semi-annual survey of its index of 20 private capital sources in the U.S. and Canada reveals that most either raised new capital in 2004/2005 for energy investments or made energy one of their core focus areas.

“The bottom line is that there is extraordinary capital available now for energy investments, but many of its sources, and a vast proportion of its gross amount, are new to the sector, don't have the knowledge or discipline of the ‘All Time’ investors and are more likely to pursue business plans indicative of an overheated market, unaware of their exposure to the margin,” Smith says.

There is a general sentiment among the private capital community that energy prices are likely to remain high, but the “borrower's market” may have diminished slightly as short-term interest rates climbed, cutting into cash flows of leveraged properties, he adds.

“Since long-term rates are still relatively low, however, a borrower's market continues to exist for those producers willing to issue longer term, fixed-rate debt, instead of commercial bank borrowing base lines of credit. A significant drop in commodity prices would end the borrower's market...”

All kinds of investors are being drawn to the energy market these days, Smith says. “Institutional investors have recognized that private capital has materially outperformed the public markets and other investment categories during the past five years, and that energy within that subclass has blown away the other subclasses.”

This heightened interest is putting pressure on established funds to expand new offerings and create new investment products, Smith says. That pressure is acting as a lure for new entrants, some backed by new energy-focused managers, others by general equity funds, and finally, more supported by the mother of all momentum players—hedge funds, he adds.

“We're also seeing the retail investor clamoring for access to energy, which is why we are deluged with public initial and follow-on financings, both for corporations and for funds, all offering the public an opportunity to pile onto the Black Gravy Train,” Smith says. “It all adds up to a bundle of dough, and everyone will have to maintain strict discipline, if we are all, like last time, not to get burned.” ●