CAPITAL CLOUT

Whether it's public equity, bonds, bank debt or private-sponsor funding, the doors of capital will be wide open to the energy sector in 2005.

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COSCO Capital Management's Cameron O. Smith looks to support operators with drillbit- or technology-driven business plans.

Oil and Gas Investor

Excerpted from December 2004

4545 Post Oak Place
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(713) 993-9320
Oil and Gas Investor is circulated internationally by subscription only at $259 per year

With world events and market speculators pushing oil prices to record levels, it's not surprising that 2004 was a relatively sleepy year for public capital-markets deal flow.

In such a heady and volatile commodity-price environment, merger and acquisition transactions—the driver of public-equity offerings and energy-lending activity—couldn't get too much traction.

Sellers were using stratospheric commodity-price assumptions; buyers, much more mundane price decks.

Meanwhile, independents more drillbit-driven didn't have a great deal of impetus to fund growth through Wall Street or bank debt—not when they had trouble figuring out how to deploy ballooning upstream cash flows.

If there was any real action in energy financing this year, it was in the private-equity market. Says one intermediary of such capital, "The 15 most active fund managers in this space, who committed some $15 billion to the energy sector in 2003, are already back in the market this year to raise more money for their next fund."

With an increasing number of institutional investors seeing the potential to realize annual rates of return north of 30%—and more seasoned E&P management teams looking around for capital to seed the growth of their private upstream start-ups—the private-sponsor market is likely to heat up further in 2005.

Choose partners wisely

Within the private-equity arena, this may be one of the best of times for upstream companies to raise capital, but operators need to be selective in choosing their financial partners. "We're seeing today a good number of quality E&P management teams, usually coming out of larger public companies, looking to replicate their earlier successes through private start-ups," says Jeffrey Harris, managing director at Warburg Pincus & Co. in New York.

Through its current $5.3-billion Warburg Pincus Private Equity VIII Fund, the firm has nearly $1 billion committed to the energy sector, including upstream investments in Bill Barrett Corp. and Antero Resources, two Denver-based producers.

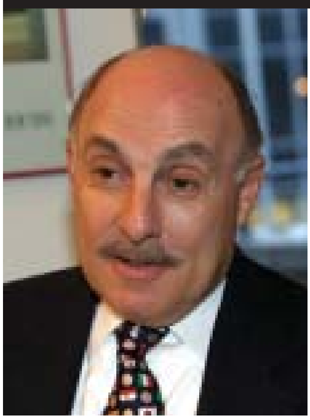
At the same time, Harris notes, waves of private-equity capital are coming into the E&P space because of high commodity prices and good profit margins in the sector. "In addition, this capital is noticing that new technology can be used to increase production from existing fields—fields that are increasingly becoming available to smaller operators because of divestitures by the majors or larger independents.

"This is the perfect breeding ground for younger upstream companies."

But a word of caution from Warburg Pincus vice chairman Howard Newman: this wall of private-equity capital will likely produce the same cyclical problems it has produced for every other business.

"Since there's a limited number of quality people and opportunities available in the energy sector, there's the potential for misjudgment by this new money, which is largely chasing hydrocarbon prices," he says. "The challenge for the industry will be how to wisely put to work all the money coming into it, not only from institutions but also from internal sources."

Newman notes that nearly 20 trillion cubic feet (Tcf) of gas is produced annually in the U.S., and that the price of this commodity is $2 higher than a year ago. "That's $40 billion of extra money the industry has got to redeploy. The U.S. also produces close to 2 billion barrels of oil annually, and the price of this commodity is $15 higher than a year ago. That's another $30 billion that must be spent wisely."



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Warburg Pincus' Howard Newman says the industry's challenge in 2005 will be to wisely put to work all the money coming into it, from both institutions and internal sources.

Stresses Harris, "The real issue for entrepreneurial E&P management teams is selectively choosing their financial partners—making sure they're not the hot-money players."

Although heavily involved in funding domestic growth opportunities for private upstream companies, Warburg Pincus' three most recent private-equity deals were international.

They include a $160-million commitment last March to Kosmos Energy, a Dallas-based E&P start-up focused offshore West Africa; a $45-million commitment last May to MEG Energy, a Calgary-based operator targeting Canada's oil sands; and the purchase from Statoil Innovation this July of Norway-based Electromagnetic GeoServices (EMGS).

"EMGS is pioneering a new oilfield-services technology called Sea Bed Logging, which uses electromagnetic signals to detect hydrocarbons in offshore basins prior to drilling," explains Harris. "This is one of those rare situations where a new technology has the potential to alter the economics of the entire offshore-drilling business."

Adds Newman, "It's important to note that none of these international investments are based on the recent rise in hydrocarbon prices. Rather, they're based on the fact that each will allow investors a good rate of return, even at $20 oil."

Secondary market

Cameron O. Smith, senior managing director of New York-based COSCO Capital Management LLC, observes that the amount of private capital now moving into the energy sector is much greater than at any other time during the past decade.

"Amid high commodity prices, hedge funds and general money have rediscovered energy as an investment class, and institutional investors have intensified their focus on private energy funds, given their strong returns," he says. "As a consequence, we're witnessing a huge push of capital into the private-equity space with the mandate to invest in energy."

During the past four years, COSCO Capital has raised some $300 million of private equity and $200 million of mezzanine capital as an intermediary, mainly for North American E&P companies. Concurrently, it has advised on some $370 million worth of upstream-related A&D transactions. Within the past 12 months, however, the firm has added a new dimension to its capabilities.

"Originally, private equity was a vehicle for long-term investors willing to commit to 10 or 12 years of investment," explains Warren Shimmerlik, a COSCO principal in New York. "But now, with some shorter-term investors wanting to trim their equity interests and other investors looking to add to their equity portfolios, a secondary market for the resale of private-equity interests is starting to grow.

"In short, liquidity is starting to build in what has historically been a very illiquid investment area, and for us, that means opportunity." A former Wall Street analyst, Shimmerlik specializes in knowing all potential buyers in the secondary private-equity market.

A year ago, when COSCO approached a Toronto institutional investor about coming into an upstream private-equity investment, the investor expressed interest but stipulated that in order to move ahead on that investment, it had to sell a block of equity it held in Opti Canada Inc., then a private Calgary-based producer.

"Through our broker-dealer affiliate, Private Energy Securities Inc., we located a U.S. institutional money manager that wanted to buy that block of shares," says Smith. "This was about a $10-million transaction and it took less than a week to complete."

Playing to its more established strengths, COSCO earlier this year helped Midcon Energy, a private Tulsa-based operator focused on waterfloods, raise $30 million of private equity from Yorktown Partners. This October, it helped a private Midland-based producer close a $3-million mezzanine financing from Goldman Sachs E&P Capital.

In Canada last spring, COSCO also helped Ausam Energy Corp., a publicly traded Calgary-based operator, raise C$8 million of private equity from affiliates of Wellington Management and other investors.

"This producer is taking underbalanced drilling technology from Canada and the U.S. and applying it to known hydrocarbon accumulations in eastern Australia particularly suited to that technology," says Smith.

"It's a good example of the type of operators we try to support—those with drillbit- or technology-driven business plans. Acquire-and-exploit business plans, by comparison, bring with them too much downside risk, particularly in today's high commodity-price environment."