

# PRIVATE CAPITAL

There's more of it available to the energy industry in 2003 than at any time in the past 10 years. And some of it will back exploration.

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**At right, COSCO's Cameron O. Smith says drillbit-focused business plans are drawing favorable nods in the private-capital market.**

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With Wall Street's doors all but closed today to energy companies with asset sizes lower than \$500 million, small independent producers and service companies are taking a harder look at private capital for growth. Simply put, there's plenty of it—more so than in the past 10 years—versus the public markets where investor appetite for underperforming energy issues is relatively poor.

“Last year, almost every source of energy-focused private equity went back to the market and raised a new fund that was typically larger than the previous one,” says Cameron O. Smith, senior managing director of COSCO Capital Management LLC, a New York-based investment-banking firm specializing in private placements and advisory assignments exclusively within the oil and gas industry.

Among those raising a new fund were Houston's Quantum Energy Partners, which raised \$225 million, and New York-based Yorktown Partners, which raised \$588 million.

Overall, since 2000, private-equity providers throughout the U.S. have raised more than \$6.3 billion to back the energy industry—and most of that capital is still available for investment.

Greenwich, Connecticut-based First Reserve Corp., for instance, still has \$800 million available to the industry from its latest, nearly \$1.4-billion fund. Says the Houston-based affiliate of another major Northeast-based private-equity fund, “We've invested more than \$900 million in the energy sector in the past two years, and we have that much more left to invest.”

Meanwhile, although the start of 2002 saw a meltdown of such oil and gas mezzanine-debt providers as Duke Capital Partners, Shell Capital, Aquila Energy Capital and Mirant Energy Capital Americas, a spate of new players has entered this arena, including Houston's Macquarie Energy Capital and Petrobridge Investment Management. The latter entry, headed up by Rob Lindermanis and Michael Keener, has just put together a \$200-million equity and mezzanine fund.



In addition, Royal Bank of Scotland has snapped up, for an undisclosed sum, Shell Capital's mezzanine portfolio while Morgan Stanley Private Equity has completed the private-equity-sponsored buyout of Aquila Energy Capital—now to be called Concert Capital Resources. Concurrently, lenders like Wells Fargo and Union Bank of California have stepped up their mezzanine activity.

“The point is, a lot of private capital, both equity and debt, is now available to the energy sector—in a wider range than before,” says Smith. “This is in no small part due to the fact that private funds aimed at the energy sector have in recent years witnessed superior returns versus the public market, hence this is where institutions want to put their money.”

The investment strategies of private capital? COSCO Capital Management LLC and seven sources of that type of funding nationwide discuss parameters.

## **COSCO Capital Management LLC**

During the past three years, COSCO has advised capital providers on more than \$400 million of private-equity transactions, and independents on the private placement of more than \$150 million of equity and \$100 million of mezzanine financings.

Within the past 12 months, the firm has advised on a \$25-million line of private equity for Aurora Gas, a private Houston- and Anchorage-based operator focused on onshore gas development in the Cook Inlet area; a \$20-million equity infusion for Cannon Energy, a Durango, Colorado-based private producer focused on coalbed-methane drilling in Colorado's Piceance Basin; and an \$11-million equity and mezzanine funding for Purcell Energy, a publicly traded Calgary-based operator.

Says Smith, “Notably, all three of these companies have drillbit-focused business plans for growth. That's what is selling now because acquisition prices are so high.”



## Warburg Pincus

“Based on the strong returns generated by equity investments that we and others have made in private E&P companies in recent years, there’s a much warmer feeling today toward the sector among institutional investors,” says Jeffrey A. Harris, managing director, Warburg Pincus LLC, New York. “That’s important because the public markets are demanding bigger scale before a company can go public.”

Last year, the firm closed its latest fund—the \$5.3-billion Warburg Pincus Private Equity VIII LP fund—about 15% of which is available for investment in the oil and gas industry. Already, it has used that pool to lead equity-financing programs for three private producers that total better than 8% of the overall fund.

This includes a \$255-million funding program for Denver’s Bill Barrett Corp., in which JPMorgan Partners and Goldman Sachs Partners also participated; a \$300-million program for Tulsa’s Latigo Petroleum Inc., in which JPMorgan Partners again participated; and a \$260-million program for Denver’s Antero Resources Corp., in which Yorktown Energy Partners V LP and Lehman Brothers Merchant Banking Group participated.

“The management teams of each of these producers have successfully built companies before, and have areas of geological, technological and geographical expertise that provide us a high level of comfort as to where and how our money will be invested,” says Harris.

“Bill Barrett and his team look at prospects and see potential that other producers have missed,” explains David B. Krieger, a Warburg Pincus associate. “Latigo’s Randy Foutch, with whom we worked on his successful growth of Lariat Petroleum, knows his way around the Mid-continent basins. Antero’s Paul Rady, former head of Pennaco Energy, has demonstrated his ability to develop tight-gas plays and is now looking to use that expertise to develop new opportunities in the Rockies and Midcontinent regions.”

Through earlier funds, Warburg Pincus during the past five years has made some \$500 million of equity investments in newly formed E&P companies, including Carneros Energy, Gryphon Exploration, Newfield Exploration, Spinnaker Exploration and Encore Acquisition—the latter three of which went public.

Says Harris, “Backing exploration plays like Spinnaker, Gryphon and Carneros may appear risky to some. But our philosophy is to look at the capabilities and experience of management, be convinced that their business plan holds water, then put capital behind that plan.”

## EnCap Investments

Gary Petersen, senior managing director for EnCap Investments in Houston, is looking for slightly less private-capital deal flow this year versus last.

With the exodus of the financing arms of Duke, Aquila, Shell, Mirant and Enron, fewer sources of private capital are available to the industry, despite

the emergence of new entrants, he says. “Also, America seems frozen in time right now. With war jitters and concerns about high oil and gas prices, a wait-and-see attitude has settled in among investors. As we work through events in the Middle East, however, and commodity prices return to more normal levels, buyers and sellers of upstream assets will be able to get together more easily and the pace of private-capital transactions should improve.”

Last year, EnCap closed a \$625-million private-equity fund, aimed exclusively at private and public E&P companies. To date, commitments from that capital pool total about \$140 million, with funding close to \$50 million.

The funding includes an \$8-million backing for a private Fort Worth producer looking to buy Oklahoma and East Texas properties, a \$10-million infusion for a private Houston operator seeking to acquire Gulf Coast oil and gas properties, and a \$30-million investment that allowed a Dallas management team to buy Maynard Oil and take it private.

Although it has backed start-ups, EnCap is looking to fund producers that already have a management team in place, a track record of acquiring and exploiting solid assets and a desire to grow their existing asset bases from the \$10- to \$100-million range to the \$300- to \$500-million level.

“With such companies, we can eventually monetize our investment by taking them public or selling them,” says Petersen. “In fact, the latter scenario is occurring with publicly traded 3-Tec Energy—a company in which we invested \$60 million through our prior \$480-million fund. It’s now being sold to Plains Exploration & Production Co., another public Houston producer.”

Petersen adds that fund managers and institutional private-equity investors look at two things: an annual rate of return in the mid-20% to low-30% range and an overall return on investment of 2:1.

During the past 15 years, EnCap’s 10 private-capital funds, both equity and historically mezzanine, have achieved an average annual rate of return of 24%.

## Credit Suisse First Boston

Out of midtown Manhattan, Credit Suisse First Boston Private Equity runs \$25 billion worth of funds, the largest of which is DLJ Merchant Banking Partners III—a \$5.3-billion fund. An industry vertical affiliate of that fund is Global Energy Partners. During the past two years, that affiliate has sourced more than \$900 million of energy investments for the MBP III fund—\$135 million of that E&P related.

“We expect more opportunities for private equity in the energy sector this year than historically,” says Steven A. Webster, chairman of Global Energy Partners in Houston. “The fundamentals of the natural gas business look attractive. As we see it, \$2 gas is history.”

Also, with the dislocation occurring within the merchant-energy sector and the transition of the majors out of the U.S., we’re going to see attractive upstream divestitures—and many producers that don’t have access to the public markets will be looking to private-capital providers like ourselves to fund these opportunities.”

**At top, Warburg Pincus’ Jeffrey A. Harris says that when it comes to investing, there’s a much warmer feeling today toward private E&P companies among institutional investors. The firm’s David B. Krieger cites the recent \$200-million funding for Antero Resources Corp., a private Denver operator.**



Says Michael Ranger, managing director, Global Energy Partners, "As merchant-energy companies like El Paso, Dynegy and Calpine try to shore up their balance sheets, we expect to see some \$400- to \$500 million worth of E&P properties up for sale."

In 2000, the MBP III fund made a \$40-million equity investment in Michael Petroleum, a private Houston operator with production in South Texas. A year later, the fund monetized that investment through the sale of Michael to Calpine, realizing \$135 million for its interest. Subsequently, it took a \$50-million equity position in publicly traded Brigham Exploration, an Austin, Texas-based operator, and 40% of an initial \$5-million funding for Medicine Bow Energy, a private Denver operator, with the expectation of larger commitments for future acquisitions.

"As our support of Brigham suggests, we don't shy away from exploration business plans," says Webster. "It's all a function of whether the economics of the plan make sense at the time and whether the team we're backing has enough of a track record to mitigate exploration risk. Brigham, with its emphasis on 3-D seismic technology, has that record."

The fund has also backed Basic Energy Services, a private Midland-based supplier of onshore workover rigs and fluids services. Its \$80-million equity infusion allowed that company to triple its rig fleet, to 250.

"We also co-led with Riverstone Holdings a \$150-million equity investment in Seabulk, a publicly traded Ft. Lauderdale supplier of tankers, offshore supply vessels and tugs," says Ari J. Benacerraf, New York-based managing director for DLJ Merchant Banking Partners. "Tanker fundamentals [in the U.S. market] are very positive, and improvements in U.S. drilling activity should lead to greater financial performance for our service-vessel business."

### Natural Gas Partners

"During the past six years, the minimum asset size for oil and gas companies to access the public markets has risen from \$100 million to around \$500 million," says Kenneth A. Hersh, managing partner for Natural Gas Partners in Irving, Texas. "So for small energy companies with asset sizes in the \$10- to \$200-million range, private capital has become a much more viable and stable source of funding."

Since 1988, Natural Gas Partners has made more than \$1 billion of private-equity investments in some 50 public and private producers, oilfield-service providers and midstream companies. Its recent \$370-million fund, Natural Gas Partners VI LP, has invested about \$320 million in 20 such companies.

This March, the firm was in the process of raising a new \$500- to \$600-million fund, Natural Gas Partners VII LP, which will target the same type of industry players.

"Within the E&P sector, we've tended to concentrate on companies that pursue an acquisition and exploitation strategy," says Hersh. In line with this investment strategy, the firm this past January

provided Pecos Production Co., a private Midland-based producer, \$21 million of equity backing to purchase Anadarko Petroleum's gas properties in southeastern New Mexico. Last year, it provided \$25 million of equity for Rising Star Holdings, which allowed that private Dallas-based operator to purchase the Texas Gulf Coast and California oil and gas assets of Seitel subsidiary DDD Energy. The capital provider is similarly backing six Calgary producers with aggregate funding of US\$50 million.

Also active in the midstream sector, Natural Gas Partners last fall was the lead investor in a \$265-million transaction that allowed ETC Holdings LP, a private Dallas-based gas gatherer and processor, to acquire Aquila Energy's midstream business in Texas and Oklahoma.

Says Hersh, "Our job is to find great management teams, make sure they have continued access to capital, then get out of their way." That approach seems to have paid off. The firm's 14-year, compounded annual rate of return across its 50 oil and gas investments has averaged 26%.

### Lime Rock Partners

"Central to our investment thesis is the belief that most of the world's oil is going to be found in fields and reservoirs where it's currently being produced—so in both the E&P and oilfield-service sectors, we're looking to invest in companies that are creatively addressing how to extract additional resources from existing fields."

So says Jonathan Farber, managing director of Lime Rock Partners in Westport, Connecticut. The private-equity provider recently closed the \$320-million Lime Rock Partners II LP fund and has already committed \$40 million of that capital to three oilfield-service companies and one upstream operator, all with an international focus.

"We're also currently evaluating four domestic E&P opportunities—a Rocky Mountain play, a San Juan Basin play, a South Texas play and a shallow-water Gulf of Mexico play—each a potential \$15-million funding," says John Reynolds, another Lime Rock managing director.

"Meanwhile, we're looking at \$10- to \$15-million financings for three separate U.S. oilfield-service companies—a provider of drilling services in the Rockies, a provider of offshore-platform services in the Gulf of Mexico and a provider of onshore and offshore natural gas- and fluid-treatment technology."

In the midstream, the firm is evaluating two U.S. investment opportunities: a potential \$10-million funding for a Gulf Coast company that owns a gas-processing plant and proprietary technology for processing gas; the other, a potential \$20-million investment in a Denver company with a gas-gathering system.

Says Farber, "Companies like El Paso and Dynegy are beginning to sell off not only major pipeline assets to strategic players, but also smaller midstream assets that have been managed less intensively and where there's greater opportunity to enhance value."

In all its energy investments, Lime Rock zeroes in on proven teams that have managed similar



**At top, Global Energy Partners' Steven A. Webster expects more opportunities for private equity in the energy sector this year than historically. Lime Rock Partners' Jonathan Farber (center) and John Reynolds say their firm is evaluating four domestic E&P opportunities, each a potential \$15-million private-equity funding.**

businesses through different commodity-price environments. "We're also looking for any competitive edge those teams may have, in terms of generating economic value through a certain play type, a certain geographical area of expertise or a certain technology," says Reynolds. "In the end, we're looking for teams that can generate 20%-plus annual rates of return for our investors."

### **JPMorgan Partners**

Producers that are already prospect-rich and can immediately grow via the drillbit will be afforded very positive interest from private-capital sources because the realized prices on their production will probably stay relatively high for some time and generate good rates of return for investors, says Christopher C. Behrens, partner, JPMorgan Partners, New York.

What this implies is that it's probably going to be tougher for acquisition-focused operators to attract as much attention from private-capital providers. "A high commodity-price environment, where producing assets and cash flow streams can't be bought cheaply, makes it harder for investors to achieve private-equity rates of return on such investments."

Through its new \$7.8-billion JPMorgan Partners Global Fund, the firm has provided equity funding for Bill Barrett Corp. and Latigo Petroleum, with aggregate commitments totaling nearly \$170 million.

Says Behrens, "The managements of these companies have strong domain knowledge, the ability to attract talent and a disciplined use of capital across a diverse portfolio of high-risk/high-return and low-risk/low-return investment opportunities—with the potential of generating on a blended basis mid-20% annual rates of return."

The private-capital provider is also eyeing midstream-financing

opportunities because of the problems that midstream firms are now having raising capital in the public markets. The most interesting type of transaction: one the firm completed in January 2000 for Bear Paw Energy LLC, a private Denver gas gatherer and processor.

Through 1999, Bear Paw was owned by Transmontaigne Inc., which at the time needed to sell assets to pay down debt. The parent was looking for a buyer that could move quickly. Partnering with Tom Edelman in January 2000, JPMorgan Partners backed Bob Clark and his Bear Paw team in a roughly \$150-million management buyout of that entity from Transmontaigne.

"As a separate private company, Bear Paw realized greater operating efficiencies, expansion of contractual relationships in the Powder River Basin and accelerated execution of its business plan," says Behrens. "A year later, we were able to sell Bear Paw to Northern Border Partners for about \$375 million."

This is a classic example of a buyout where private capital was the only real solution—and it's still relevant today, he insists. "Many midstream executives may be thinking, 'I've got to raise cash, but the banks are shutting me out, the public equity markets are closed and so is the high-yield market. So where do I turn to raise capital?'"

### **Kayne Anderson**

Robert V. Sinnott, managing director for Kayne Anderson Capital Advisors in Los Angeles, sees a great many upstream acquisition opportunities this year in need of private-equity capital. "The disparity between current commodity prices and the valuations of E&P companies is very great, and if oil and gas prices remain high relative to those valuations, a lot

of independents will be seeking opportunistic purchases. In effect, it'll be cheaper to buy reserves and production in the market than to drill for them."

In addition, many operators are having trouble finding drilling inventory, therefore they'll be taking aim at those producers that already have it, he says.

The recently closed, \$240-million Kayne Anderson Energy Fund II is 80%-plus slanted toward equity investments in public and private E&P companies; currently, some 20% of that raised capital has been committed to the up-stream sector.

This includes an initial \$5-million equity funding for a private Oklahoma start-up looking to exploit Midcontinent oil and gas properties, a \$23-million funding for a private Denver operator seeking to make acquisitions, and exploit its current asset base in the Rockies, and a \$13-million investment in a private Houston producer that wants to exploit its acquired Canadian properties. The latter backing straddles Kayne Anderson's latest fund and its earlier \$112-million fund.

A further spur to private-capital transactions: the divestiture of midstream assets by both distressed merchant-energy firms and the major oils. "There could easily be \$150 billion worth of midstream assets on the market during the next five years," says Sinnott. "But the recent principal purchasers of midstream assets—the master limited partnerships—have grown so fast during the past five years that they've constrained the capital markets.

"With the [debt and equity] capital of those partnerships only about \$35 billion, they won't be able to access the public markets sufficiently to take advantage of those likely asset sales. That's an opportunity for private-capital providers like ourselves." □

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