CAPITAL-FLOW FLUX

Anyone motor-boating on a crowded lake on a hot summer day has encountered confused water, where waves collide from multiple directions, creating a chop with no rhythm. So it is today in the global capital pool, where liquidity flows from conflicting sources in response to new factors.

Certain capital influences have simply grown larger. Government has bloated, both in the growing scale of its spending and borrowing and in the breadth of its socialization of credit and monetization of debt. Gas supplies in storage are much larger too, as are liquefied natural gas shipments and the reported initial flow rates of onshore gas wells. Time was, a shale section sat dormant behind casing, not even worth logging. No more.

Meanwhile, other capital influences have diminished. Many endowment funds contracted by 30% instead of expanding by over 20%, as had become the norm in recent years. The rig count is smaller, and so is the number of double-digit 2008-vintage gas futures contracts, the delivery and settlement of which diminishes bank borrowing bases, reducing bank credit to independents.

> *"Money seems abundant despite certain evidence to the contrary…"*
> *William E. Weidner, Rodman Energy Group*

Unchanged factors. Then there are certain factors that remain unchanged. The U.S. still consumes, and China still lends and buys up commodity businesses. America's debt-to-GDP ratio rose during 2008, and incredibly, it continued to rise even during the first quarter of 2009. And the worrisome limits to oil-production capacity that contributed to the 2008 oil-price peak still remain today, despite reduced demand and brimming inventories.

In short, the factors that contributed to last year's bull case for oil and gas ownership continue today. But private capital for private oil and gas companies has yet to arrive at the bovine party, while public-equity and debt capital remain plentiful and remarkably unchanged. Normally, private capital takes advantage of downcycles while public capital stampedes for cover. Yet, new factors, mentioned here, have triggered capital flows not normally associated with downcycles.

Comparison Of Announced Public-Equity And Debt Issues

	First-Half 2008		First-Half 2009		
	No. of Deals	Amount ($B)	No. of Deals	Amount ($B)	Increase/decrease
Public Equity	117	$10.1	83	$9.7	4% decrease
Public Debt	80	$22.9	74	$24.2	6% increase

Source: Rodman Energy Group

Earlier this year, hoards of investors crammed into Treasuries, shunning risk and basking in the perceived lack of inflation threats to paltry returns. After all, we were in a deflationary environment marked by too much debt and not enough income. What could be safer than government debt? Credit spreads yawned their widest since 1932. So wide was the gap that the reduced number of mezzanine lenders still open for business proudly announced their affinity for publicly traded investment-grade debt while openly shunning the debt-with-kicker deals that nurture the base of the E&P food chain.

'Denominator effect.' Private equity grew scarce this year, partially due to the "denominator effect." Institutions that had been funding these investment firms with oil and gas capital allocations (the numerator) are shocked to find themselves over-allocated to oil and gas as their overall portfolios (the denominator) have shrunk. This naturally depressed the capital available from private-equity sources. Hedge funds suffered from the same downward pressure, compressed further by the collapse of their more-leveraged capital structures. The Treasury bubble and the denominator effect are temporary events that will abate over time.

Meanwhile, public capital flows demonstrate no similar restraint. Indeed, the accompanying table illustrates a counterintuitive reality—namely, that public equity and debt remained just as plentiful during the first half of 2009 as they were during the first half of 2008, before the economy fell off the proverbial cliff and loans slowed to a trickle. Not so, say the facts. During first-half 2008, 80 public-debt issues delivered $22.9 billion to small- and mid-cap oil and gas companies, while during the first half of 2009, 74 such debt issues contributed $24.2 billion, a nearly 6% increase during a deep recession in which lenders reportedly failed to lend. Also during first-half 2008, 117 equity issues added $10.1 billion to oil and gas company balance sheets, while during the first half of 2009, 83 issues added $9.7 billion, a slight 4% decline in dollars funded.

Many of these public-debt issues have simply refinanced existing indebtedness while taking advantage of tightened second-quarter credit spreads at longer terms. One could argue that long-term fixed-rate debt is filling the gap left by shrinking bank debt. A close examination of these data shows this is the case. Fully one-third of the $24.2 million of public debt issued consisted of five- to 10-year term notes with coupons ranging from 6.5% to 12% to repay existing debt, allowing producers to lengthen the duration of their debt obligations while locking in what may be a low point in an interest rate cycle that cannot remain government-suppressed over the same time period. Furthermore, nearly 10% of the debt issued was earmarked for working capital purposes only, ranging from five- to 30-year terms at 5.75% to 10%, and in one case, at a coupon yield lower than the issuer's stock dividend yield.

Additionally, many of the public equity issues during the first half have effectively served to strengthen the balance sheets of previously over-leveraged companies. And while some dilution has occurred, the ready availability of all this capital from both equity and debt providers hardly supports a deflationary theme based on money shortage.

We believe the facts support an opposite view. Money seems abundant despite certain evidence to the contrary, which may portend a coming inflation that supports the investment theme of commodity ownership. While the denominator effect and a collapse of gas prices may have frustrated the private-capital market from taking full advantage of a down-cycle so far this year, we expect this situation to self-correct soon as the public-security portfolios denominating oil and gas allocations expand further. The clear abundance of capital, in general, as illustrated by robust public-equity and debt markets during a time when such capital sources usually retreat demonstrates that capital is not in short supply. Indeed, there may be too much of it in relation to real assets.

—William E. Weidner, managing director, The Rodman Energy Group

Excerpted from *Oil and Gas Investor,* August 2009, Copyright©Hart Energy Publishing, 1616 S. Voss Rd. Suite 1000, Houston, TX 77057 • (713) 993-9320