

HOW TO RIGHT THE UPSIDE DOWN

Don't let low value determinations block value-creation and capital-raising efforts. Focus on the strategy ahead and consider these ways to raise funds.

ARTICLE BY
WILLIAM E.
WEIDNER

ILLUSTRATION BY
MARK SHAVER

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1616 S. Voss Rd.
Suite 1000
Houston, TX 77057
(713) 993-9320

As boom follows bust, bust follows boom. Within the bust cycle, however, proud oil and gas entrepreneurs trying to raise equity capital at boom-time valuations may never see the boom again. Attempts to raise capital at out-dated price scenarios may fail by waving off serious takers. Or worse, successful capture of cheap money may dull a management's sense of discipline, leading quickly to misallocation of the precious capital it raised.

The steep opportunity cost of either outcome looms large in the oil patch, following the swift arrival of the late-2008 bust. Cash, as they say, is king. Whether it was raised at M&A asset valuations of \$100,000 per daily flowing barrel of oil equivalent, or \$75,000, hardly seems relevant, now that such flows can be purchased for substantially less.

A pile of cash today buys discounted drilling and completion services to extract flowing barrels or natural gas from previously expensive or expiring leaseholds. This could result, at a low cost, in a growing production stream for sale when prices resume their former trajectory.

Yesterday's pile of cash raised cheaply can become today's once-in-a-lifetime treasure trove.

Managements too often miss this point. They frequently fixate on their own corporate valuation, when they should focus on their business plan and its potential for value creation. And if presented clearly and thoroughly, a well-marketed business plan will ultimately realize its market value, which is the price at which smart money will participate, but above which it won't. (Dumb money is expensive, but that's a subject for another essay.)

A misplaced emphasis on pre-finance value most often endangers those management teams who raised early-stage equity from so-called friends and family or other devotees to the hope of growth and capital appreciation. In these situations, hope often triumphs over reality. Managements, not wanting to disappoint, often permit and perpetuate out-of-the-market perceptions of corporate equity value that may obstruct their paths to true money-making opportunities.

Let's look at this example, from recent fi -

ancing archives. Management of Company A firmly believes its plans will lead to ownership of fully 7% of the entire oil and gas reserves within an oil-rich basin in the U.S. So far, so good. This means Company A plans ultimately to control production of 21,000 barrels of oil per day, which, depending upon the time period (boom or bust), may range in value from \$1- to \$2 billion—an impressive exit valuation for any private-equity-backed firm. This is a client financiers are anxious to assist.

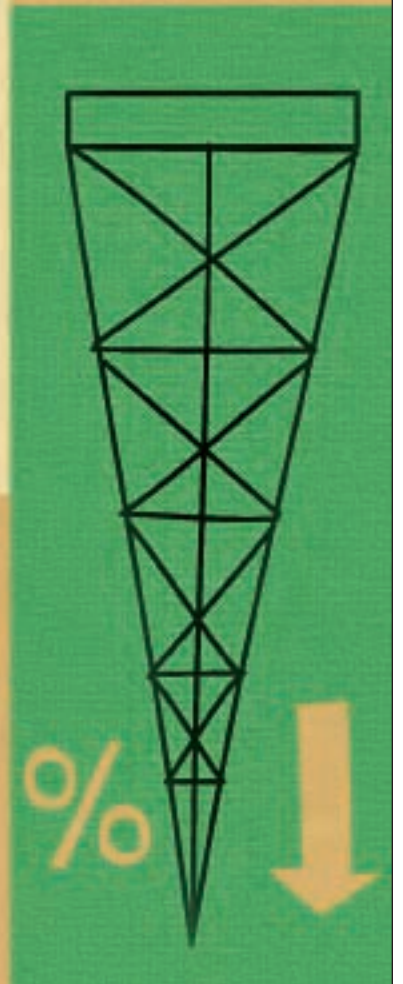
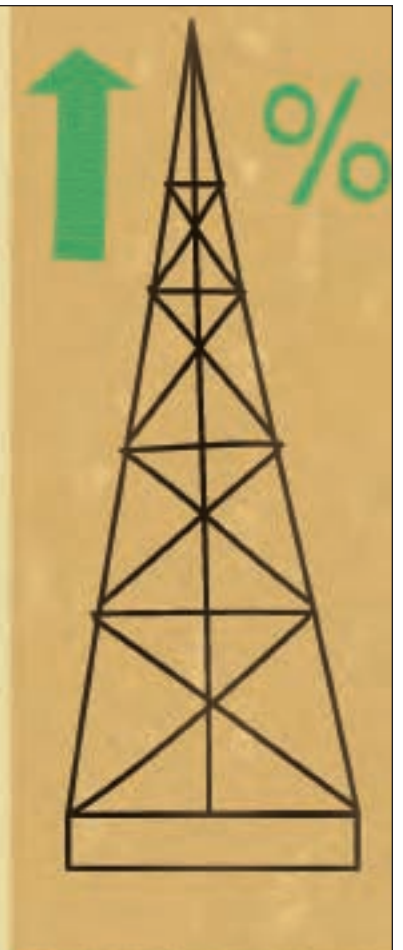
But wait! Management has promised existing early-stage investors a pre-money value on the order of \$60 million, which is about \$30 million above market. And even worse, it plans to avoid dilution by raising only \$10 million of equity, hardly enough dry powder for the ambitious goal.

The efforts to reward and protect early supporters stem from good intentions, which is admirable. But these good intentions can trap the business. This is especially true when early-stage investors occupy board seats used unwittingly to perpetuate unrealistic value perceptions, and even worse, to zealously introduce management to friends in the investment world who oblige with meetings that perpetuate the illusion of progress, but go nowhere.

Company A had all this. But good intentions and unrealistic expectations to date have blocked its access to needed equity capital to support a good business. To wit: if Company A really believes it has the opportunity to grow to \$1 billion in value, shouldn't it raise the amount of equity capital needed to achieve such a goal at a value that makes it achievable? It should. And in Company A's case, above-market value expectations may have prevented it from stocking up on capital right before the recent commodity and credit collapse, imposing on it and its seed investors an incalculable opportunity cost.

To temper a valuation obsession of this kind, oil and gas companies may use one or more of these financial structures.

Rights offerings. First, early-stage investors may be given the opportunity to participate in a follow-on equity financing at the prevailing corporate equity value, whether higher or lower



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than their own entry valuation. If lower, such a rights offering is known as a “down round.” Down rounds provide the early-stage investor the opportunity to dollar-cost average the investment over time, as the company’s business plan progresses and its ability to attract needed capital develops.

Managements needn’t be ashamed of the need to issue a down round. After all, the entry price of a corporate equity investment is an approximation, a guesstimate that changes over time. Hindsight is 20-20. Growing companies and their seed investors should always plan on down-round rights, particularly if circumstances suggest that opportunities warrant such an offering.

Anti-dilution rights. Alternatively, a company may offer early-stage investors anti-dilution rights that automatically protect them from subsequent equity issuances at increasingly lower values, resulting in dilution. Such rights may occur as costless, additional equity grants to first-round investors that vest upon a dilutive capital raise.

Anti-dilution rights necessarily must come out of somebody’s hide, however. For example, the early-stage investor may be induced to purchase equity at a higher valuation than seems appropriate, provided anti-dilution rights are offered to protect the downside. As another example, management may get squeezed between the anti-dilution rights of an early-stage investor, on the one hand, and a later-stage private-equity investor, on the other. Anti-dilution rights are more expensive than a simple rights offering, since only so much room exists to protect an early-stage investor from the folly of having overpaid.

Fortunately, typical private-equity incentive structures are designed to cushion management from undervaluing its initial assets by providing disproportionate participation in success at the back end, when a company is sold. To ensure that the interests of management and seed investors do not drift out of line, many private-equity investors also permit and, in fact, encourage, participation by pre-finance investors in a portion of the management incentive. What the private-equity investor may take up front, therefore, management and early-stage investors may more than recover upon realization of commercial success at exit.

Look-backs. Another way to manage around a valuation problem is for the new private-equity investor to punt on the value argument altogether, and simply agree to use a look-back provision upon exit, or upon reaching a certain milestone.

For example, the incoming private-equity investor may simply agree to a buy-in price and begin funding capital at that price, regardless of how reasonable it is. Upon exit, however, the original share is back-calculated to determine what the entry price should have been to deliver

a preferred rate of return, say 8%, followed by an after-payout, 20% step-down in value. This value solution amounts to a wager, with the new investor on the short side of the bet and management on the long side, where it always resides anyway.

Preferred equity. Preferred stock provides a similar and more distinctive structure that serves to overcome differing opinions of initial value. Since a potentially high buy-in price equates to increased risk for a new investor, the trade-off is often to buy into an enterprise in a position senior to existing common-equity holders, if management insists on a high pre-money value.

As with the look-back structure, preferred shareholders often overcome value disagreements by insisting on dividends, which, if unpaid, may accumulate in the form of additional equity, thus closing the value gap over a few years, unless converted or redeemed. A host of additional covenants, provisions and structures may accompany preferred stocks, all of which exist to bridge the value gap, and some of which can be very debt-like.

Spin-offs. A company can also use a more project-oriented means to overcome value disparities by spinning off into a new, special-purpose company certain growth assets on which value both parties actually agree. The new private-equity investor can then fund the spin-off at the agreed-on value. This structure introduces other complexities, such as assuring an alignment of interest and sufficient focus from a management that now has to run two companies, but it can provide an ideal value compromise if a specific subset of the issuing company’s assets represent the primary attraction to the new investor.

Any one or more of these five methods may offset value disagreements, thus allowing company managements to access capital and maintain or even accelerate business-plan momentum. If management generates superior value as a consequence, it will be disproportionately rewarded by back-ended participation in the value it has created. Management creates value because it has ideas, knows how to capitalize on them and is incentivized to strive for success. Even better, an upstart oil and gas company, flush with cash during a bust, may transform itself into a \$1-billion-plus enterprise value after just a few years. Initial corporate-equity valuations have to be reasonable, however, to secure capital necessary to provide such rich rewards to both managements and investors alike. Unreasonable initial valuations run a high risk of causing a company to coast, or worse, stall out.

To be cash-rich today, allows investors and managements to one day look back at yesterday’s rounding errors with a smile. □

William E. Weidner is a managing director for The Rodman Energy Group, a unit of Rodman & Renshaw in New York.