2007 Inspires Capital Confidence

There's ample reason for oil and gas producers to be confident about capital in 2007, despite an exodus of momentum capital during the past six months, according to the manager of one New York-based capital source.

By Bridie Isensee, Contributing Editor

Unlike retail investors, the closed-end private equity funds are not pulling up their stakes in the energy sector, says Cameron Smith, founder and senior managing director of **COSCO Capital Management LLC**. Since about August 2006, when oil and gas prices began to fall, coupled with the high-profile drops of hedge funds Amaranth and MotherRock, all but the largest or most experienced open-end fund managers have fled the energy market, dropping public share prices, icing IPOs, pinching PIPES, squashing SPACS and otherwise leaving the field for those that relish fundamentals. These include hedge funds, mutual funds, trusts and family offices—all aggregators of individual capital.

This has helped dampen activity and related costs and incubated a ripe opportunity for "energy-experienced, professionally-managed, closed-end private equity and debt funds to step back into acquisition and growth financing," says Smith.

Closed-end private equity and debt funds, particularly those with energy experience, will find the energy sector increasingly appealing, as the momentum funds move out and stay out, he says.

The only fly in the ointment for E&P financing may be the change of party control on Capitol Hill, he adds.

"The Democratic Congress has already signaled its desire to roll back incentives for E&P companies to drill for new supplies, which means accessing land and drilling permits will become far harder, making it more difficult for drill-bit focused companies to drill wells and private capital to be confident they can put their equity or debt to work. These policies will, however, have the perverse effect of setting the stage for a rebound in petroleum pricing," Smith says. "That means those with confidence in cycles will be spending now, particularly on acquisitions, while prices are relatively low, with relative assurance that assets and reserves will be floated higher when the price tide returns."

Cameron Smith

Restricted land and permit access could also impact which regions private capital will favor in 2007. During the past couple of years, the more experienced private equity managers had been avoiding acquisitions and focusing on drill-bit, mostly unconventional resource, plays in the Lower 48. While they were largely avoiding Canada, as access to capital through their public markets was so easy, driving up costs, Smith says, private equity managers were beginning to invest in other foreign regions, particularly in the North Sea, West and North Africa and parts of the Far East, which proffered reward and scale, he says.

"All this may have changed in the past six months, however, because the excess competition that drove these strategies has receded, clearing the way for private capital's favored strategies—domestic acquisition and exploitation—strategies that bequeath the twin virtues of lower risk and greater scale," Smith says.

As a result, in 2007, while private capital focuses on relatively low-cost acquisitions close to home, resource plays, which take time to mature, may become less able to be financed, and foreign business plans may take longer to fund. Now that the Canadian public market is dormant and the tax structure is about to change for Canadian royalty trusts, making it once more a level playing field for corporate buyers, Canada, itself, might become one of the largest beneficiaries of the next round of private capital, as it targets large acquisitions of, or from, the Trusts, he says.

All this means the best of all worlds for private capital, the perfect storm of distress in the public markets—uncertainty about price, panic among newcomers and almost certain return down the road to higher pricing—once the Democrats have restricted domestic supply, and the markets have balanced, says Smith.

"In fact, producers should recognize that there is more private capital, both equity and mezzanine debt (VPPs, convertible stock and notes, partnerships, you name it), looking to support growth through acquisitions in this environment, in both the U.S. and Canada, than at any other time in recent memory," Smith says. "The stars have aligned, and private capital has noticed. It simply needs a wise man or three to show it the way." ●