Symbol & Substance: The Rise and Resonance of Lariat Petroleum Inc.

In January 2001, **Lariat Petroleum Inc.** merged into a wholly owned subsidiary of **Newfield Exploration Co.** Industry analysts commented on the accretive impact of the merger on Newfield's projected earnings per share (EPS) and cash flow per share (CFPS). Less obvious, but equally compelling, is the model that Lariat symbolizes for success in accessing private capital.

Lariat demonstrates that technical and business talent, when acting as investors and financed privately, can create extraordinary value for all stakeholders. Bottom line? In just over 3.5 years, Lariat returned $200 million on a private investment of $75 million, for an all-in internal rate of return (IRR) greater than 50%. (See table.) Management alone earned roughly $20 million on an investment of $1 million.

For private equity, therefore, Lariat is a paradigm of success.

In August 1996, Randy Foutch and his private mezzanine partner sold **Colt Resources Corp.** for $32 million. Three months later, Foutch came to Cosco Capital Management LLC, asking if it were possible to raise $5 million, this time in straight equity, to support exploration and acquisitions focused on the Anadarko Basin of western Oklahoma. Cosco advised that $5 million would be impossible, but $10 million might just be attainable. It turned out Cosco was overly optimistic; $10 million was still too small, but **Warburg Pincus** of New York thought $20 million might do the trick!

At the time, Warburg Pincus had made two previous investments in E&P and was just concluding its third to establish **Spinnaker Exploration** in the Gulf of Mexico. In early 1997, prices of oil and gas were high. As contrarian investors, Warburg Pincus favored exploration-based business plans over the acquisition/exploitation models, which were then in vogue in the public markets.

In less than two months from first meeting to funding, Warburg Pincus agreed to an initial $10 million investment in Lariat, and to advance a "line of equity" for another $10 million, provided Foutch and his management team invested material portions of their liquid net worth under the same terms as Warburg Pincus. The initial equity was split 95% to Warburg Pincus, and 5% to Foutch and his team. In addition, to further align the interests of Warburg Pincus and management, Foutch et al. were awarded options on 20% of the postexercise shares outstanding, subject to an initial performance hurdle of 20%.

Eight months into the execution of Lariat's business plan, oil and gas prices collapsed, precipitating two major decisions, key to Lariat's success and to an understanding of Warburg Pincus' brand of private equity. First, Lariat's board, comprised of Foutch, two Warburg Pincus representatives, and two industry outsiders, decided to take advantage of low pricing, and the industry's lack of capital, to expand Lariat's focus on acquisitions.

Second, Warburg Pincus, which had come to appreciate Foutch's forthright communication and management style, agreed to back this plan with significant new capital, while freezing the option hurdle and refreshing management's economic incentives.

In quick succession during the next six months, Lariat consummated major acquisitions with **EEX Corp.** and **Phillips Petroleum**, both of which Foutch had cultivated for years. True to its word, Warburg Pincus stepped in with an additional $50 million. Rather than advance all equity, drastically diluting the minority stock- and optionholders and again eroding management incentives, this time Warburg Pincus contributed the majority of the new capital in the form of subordinated debt. (See table.)

The Phillips acquisition closed in March 1999, the last month before oil and gas prices jumped off bottom. With Warburg Pincus' backing and despite the roughest downturn in decades, Lariat had grown from minimal production and seven employees in April 1997, to 40 million cubic feet per day and 65 employees by mid-1999.

During the latter half of 1999 and throughout 2000, Foutch and his team worked furiously to reduce costs and increase production on their recent acquisitions, as well as on their exploration and development projects, which by then were contributing materially to revenues and reserves.

By the second half of 2000, Lariat was in fine form: production exceeded 60 million cubic feet of gas a day, reserves topped 250 billion cubic feet equivalent, and annual EBITDA was just under $50 million. Oil and gas prices had also begun to sustain new highs, properties and companies were trading privately at attractive levels, and even the public market, as evidenced by Spinnaker's successful IPO, was beginning to reawaken to energy issues.

Lariat Petroleum Inc.

Capital Source	Capitalization $MM 1996-98 Equity	Debt	Total	Monetization $MM Jan 2001 Equity	Debt	Total
Warburg Pincus	$40.0	$34.0	$74.0	$157.2	$39.8	$197.0
Management**	0.7	0	0.7	20.9	0	20.9
Total	**$40.7**	**$34.0**	**$74.7**	**$178.1**	**$39.8**	**$217.9**

**Nets out the exercise cost of stock options.

As a vice president for **Dyco Petroleum** in the early 1980s, and as an exploration manager for **Anschutz** during the 1970s, Foutch was no stranger to cycles. Recognizing that the ineluctable cyclicality of the energy business could at any moment suck down Lariat's values and deny for years comparable exit opportunities, Foutch requested that Warburg Pincus and his board consider corporate alternatives. Cosco was again engaged, along with others, to analyze Lariat's value and appeal in the private capital markets, review the potential for an IPO, and identify likely merger or acquisition candidates.

After reviewing numerous strategic options, the Newfield transaction emerged as the winner. Not only did Lariat present Newfield with all the right strategic and commercial considerations, but as importantly, the merger permitted both companies to preserve almost completely intact the management team and staff that Foutch had assembled in Tulsa. With Foutch also agreeing to join Newfield's management and board, continuity was assured. For all, a good fit and a thoroughly rewarding experience.

The Foutch-Warburg Pincus-Lariat Petroleum experience reinforces the value of combining excellent, seasoned management with mature, sophisticated capital that has discovered the alchemy of properly aligning incentives among management and investors. This potion permitted Lariat to embrace change and act decisively on both buy and sell signals. For this, Lariat should be remembered as a symbol of, and a prescription for, extraordinary success in the annals of private capital.

—Cameron O. Smith,
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