

CASH FLOWS

Will the Last One to Monetize Please Turn Out the Lights?

For a good perspective on how the private capital cycle rotates through the oil and gas sector, one merely need examine transactions of the last 12 months. Private capital providers have been diligently monetizing their formerly illiquid portfolio investments in impressive numbers this year, pocketing cash from significant gains and distributing it back to happy investors. And from whence cometh this cash? From publicly traded oil and gas companies, of course.

And that's just the beginning. Now that many of these private capital providers have performed so well, they are well positioned to obtain new capital from their boards or investors, thus starting anew in 2002 with the build up of illiquid investments until the next propitious time to monetize comes again.

Until then, however, these investors are adapting their investment profiles to capitalize on the current environment, anticipating a reverse in the flow of assets as publicly traded oil and gas companies shed noncore properties to privately backed management teams anxious to repeat this cycle.

When times are good, much of the cash generated by public companies flows to private hands. When times are more challenging, fresh stores of cash from private sources flow back to public companies, again to finance the exchange of assets.

The difference is, private capital buys low and sells high, while public companies do the reverse!

Cosco Capital Management LLC, a New York-based investment firm specializing in private capital for energy, conducted a midyear poll of a dozen familiar names in the oil and gas investment business (see table) to uncover some enlightening patterns.

Monetizations Our respondents reported 42 monetization events in the last 12 months, resulting on average in 33% of their investment portfolios turning back to cash. This was particularly true for the Tier 1 (Fund) investors that typically purchase corporate equities, seeking capital gains during periods of high commodity prices. Tier 1 monetizations averaged 36%, while Tier 2 (corporate investors) averaged only 19%. One Tier 1 investor reported that 40% of his portfolio had been monetized and that he ex-

pected to have turned over 50% before year-end.

More than 60% of these liquidity events were achieved by selling portfolio companies and assets to larger, public companies with plenty of cash and too few projects.

Other sources of liquidity included balance-sheet restructurings (18%), initial public stock offerings (10%) and the distribution or sale of securities that were already public (10%).

While 9% of monetizations resulted from the acceptance of unsolicited offers, the vast majority rewarded the deliberate efforts by company managements to satisfy the appetites of larger public companies hungry for assets and projects (see table).

This cycle peak stands in stark contrast to the last one, in 1996-97, when a surge of cash from public equity and debt offerings provided the liquidity needed to monetize private investments. This time, the cash inflow derives from commodity price-driven corporate earnings.

Impact on Investment Strategies The impact of public companies awash in cash flow—but short on projects—was repeatedly cited by our respondents as the driving factor in the current market.

With assets flowing toward larger public companies at relatively high valuations, private investors and their management teams chose not to compete for deals, but to sell instead. With considerable cash to invest, however, private capital providers are challenged to adjust their investment styles to accommodate the current environment.

Some of the Tier 2 investors, normally mezzanine lenders, have expanded their repertoire to include project equity or funding subordinated notes issued by the public companies on the receiving end of the deal flow. Tier 1 investors, however, have been more firm in their investment profiles, choosing instead to refinance experienced or familiar management teams fresh from a successful monetization event, or focusing on those business plans that are more drilling or technology-oriented and independent of the acquisition market.

Compressed Fund Management Cycle The flurry of investment realizations has allowed Tier 1 fund managers

Private Capital Respondents

Tier 1 (Funds)

EnCap Investments
Energy Spectrum Capital
First Reserve
Kayne Anderson Energy Fund
Lime Rock Partners
Natural Gas Partners
Quantum Energy Partners
Warburg, Pincus Equity Partners
Yorktown Partners

Tier 2 (Corporate Investors)

Aquila Energy Capital
Shell Capital
Mirant Americas Energy Services

to distribute cash back to their investors in a much shorter time frame than originally anticipated. Several of the managers polled began investing in 1997, anticipating a seven- to- 10-year cycle. With this year's realizations, these same fund managers fully expect to complete this cycle in a third to a half this time.

Moreover, with such an impressive turnaround (and so many poor results in nonenergy markets), Tier 1 fund managers are already reporting firm commitments by their investors to their next funds. Indeed, five out of the nine Tier 1 investors polled are in the market for an aggregate \$1.7 billion as 2001 draws to a close.

It would appear that ample supplies of private capital are poised to fund another round of growth during the next down cycle, perhaps initially focusing on specific projects, but definitely anticipating renewed acquisition financing. Many of the respondents reported that the acquisition "food chain" should become replenished soon, once the pooling-of-interest restrictions on recently merged major oil companies have lapsed. Others noted that the value gap between buyers and sellers is beginning to close as commodity prices settle to a more agreeable level.

One investor summed up the next part of the cycle by saying the next three years look like an outstanding investment period, as locked-up assets break free from the majors and reverse the deal flow toward successful recycled managements supplied with private capital.

—William E. Weidner,

Cosco Capital Management LLC

Last 12 Months Monetizations as of 8/1/01

Tier Investor	# of Monetizations	% of Portfolio	Stimulus for Event			Type of Event			
			Mgmt	Investor + Mgmt	Unsolicited Offer	Public Co. Purchase	Refin/Restruct	IPO	Securities Distrib/Sale
Tier 1 (9)	37	36%	8 (22%)	25 (68%)	4 (10%)	24 (65%)	6 (16%)	3 (8%)	4 (11%)
Tier 2 (3)	5	19%	5 (100%)	0	0	2 (40%)	2 (40%)	1 (20%)	0