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Private Placements Crucial To Growth

Editor's Note: For independents looking to grow their companies—and what independent doesn't?—private capital placements are crucial, but financing beyond the joint venture property level requires expertise and strategic planning. That is one of the central points made by Cameron O. Smith, founder and managing director of New York-based energy investment consulting firm COSCO Capital Management L.L.C., during an interview with Dwight Cumming, a special correspondent for The American Oil & Gas Reporter. Cumming, president of Dallas-based independent The Cumming Company Inc., caught up with Smith in Manhattan fresh from a private placement seminar he organized for an Independent Petroleum Association of America forum on capital markets.

Smith, a third-generation oilman and former independent operator with 17 years of exploration and development experience, has an insider's understanding of the independent's predicament in finding

sources of capital. Raised in Connecticut, he is a member of the influential Buckley family, whose 70 years in both public and private financing of oil ventures gave him access to venture capital markets in the "golden beltway" of the east coast. Smith's grandfather, William F. Buckley Sr., patriarch of the Buckley clan, which includes conservative pundit William F. Buckley Jr. and former New York senator James Buckley, is credited with "inventing" the farm-out in the late 1920s for leases he owned in Venezuela.

After earning a master's in geology from Penn State, Smith ran two E&P companies from Tulsa, Ok., and Calgary, Alberta, Canada. Intrigued with the idea of bringing his operational and geological expertise to the financial markets in New York, he established COSCO as a consulting intermediary representing both oil and gas companies and the "buy" side of investment institutions looking for energy opportunities.

Most small independents, Smith says,

understand raising capital at the property level for a specific deal or acquisition through local investors, relatives, associates or through a bank. Equity is exchanged for financing the project or assets are pledged at a high interest rate. Success or failure of the project or deal is critical. However, going beyond this stage of growth is a little like Columbus setting sail for the New World—with no maps in uncharted waters, success depends on perseverance and a whole lot of luck. Unfortunately, according to Smith, much of what E&P companies consider "fact" when it comes to accessing money is highly erroneous. To stretch the Columbus analogy a bit, it is like believing the world is flat. Many E&P companies, Smith says, do not even try to access the institutional financial markets because they believe it is simply too complicated and daunting. In italics are some of the questions The Reporter's resident independent producer/operator put to Smith, followed by his off-the-cuff responses.

Q: How has the drop in the price of oil affected the financial markets for energy issues?

The short answer is that the debacle in oil has killed the public market for energy issues, but to the benefit of those professional investors seeking to place private capital. You see, when the prices of oil and gas are high and energy companies' earnings are fat, the public takes notice. The reverse is true when prices are down. Private capital, which normally is managed by investment professionals, however, typically stakes out certain investment areas where it must maximize opportunity through good times and bad. Professional energy investors, therefore, see low prices as great opportunities to buy low and high

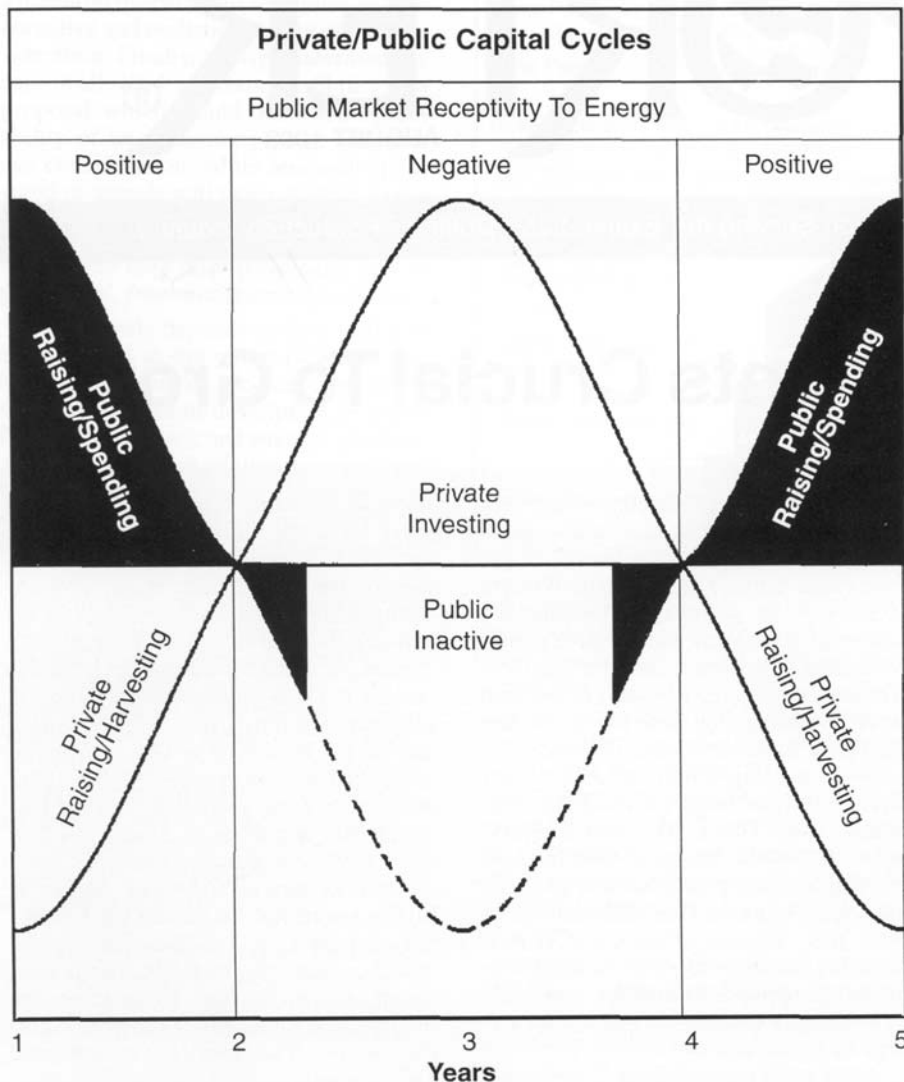
prices as great opportunities to sell high. Doesn't sound so difficult, does it?

Some time ago, I started depicting the U.S. capital markets as a four-tiered pyramid, with the broadest tier at the bottom representing individual investors. Above it, in Tier 3, are the aggregators of individuals' dollars. Above that, in Tier 2, are institutions like pension funds, endowments and strategic corporations. Finally, in Tier 1, are the professional aggregators of institutional capital.

Typically, investors in Tiers 3 and 4, which control the greatest aggregate amount of wealth, are generalists, meaning they can and do go wherever current fad or circumstances dictate. Investors in Tiers 1 and 2, on the other had, typically

are financial professionals who have attracted the capital under their care by virtue of expertise in certain investment fields, like buy-outs, venture capital or growth. When all the outward signs for energy investing are positive, therefore, the bulk of investors in Tiers 3 and 4 become receptive and the large investment banks satisfy this temporal demand with public energy offerings of both equity and debt, but the professional investors in Tiers 1 and 2 that are specialized in energy must stay the course, managing their investments whether prices are up or down.

When the markets are hot for energy is when the Tier 1 institutional aggregators, themselves, go to the market to fill up their funds with new capital. They



Source: COSCO Capital Management LLC

might as well spend this time raising new capital, because the lower cost of public money crowds out higher-priced private placements, making it a poor time to spend private capital. When the public market disappears, however, there is little competition for equity issues, no matter how attractive, leaving the field relatively open for the professional private investor. Therefore, the private and public markets are almost exactly counter-cyclical to each other, with the private capital harvesting their investments by taking their companies public during “good” times, refilling their coffers, and then making their bets once again when the public markets cool off.

Q: That’s all well and good, but if you already have a private capital source as an investor, and the price of oil or gas drops precipitously, are you guilty by association?

Not at all! Professional energy in-

vestors study and certainly think they know more about future commodity pricing than can most energy company executives because that is, after all, their business. If the price drops below expectation under their watch, and they have not arranged for price protection through hedging or other financial means, then they, not the oil company, are to blame. In any case, within the context of a three-seven year investment horizon, if the professional investor has chosen the right management team, an unforeseen drop in price simply precipitates further investment opportunities, and if more capital is warranted, so much the better!

Q: What are the criteria that most affect a professional investor’s decision to fund a company’s growth?

Management, management and management. In cooperation with the IPAA, I recently organized a private placement seminar in New York, during which ten

Tier 1 and Tier 2 investors, representing \$6.4 billion of private capital seeking private equity energy investments, participated on two buy-side panels. When addressing this issue, each one agreed that the first thing it assesses is the quality of the management team. In other words, each investor’s first order of business is look at such things as the company’s track record. Does it combine technical and financial acumen? Has it participated in the building of companies in the past? What is its standing in its community, and among its peers? Does it have the expertise to carry out the business plan for which it is seeking financial support?

Sure, the nature of the business plan is also important—certain professional investors have expertise and experience, themselves, in one or more areas that make them comfortable in assessing that particular style of business risk. However, most professional investors realize that a business plan is no more than a momentary expectation, and the minute one invests in a company, as distinct from a specific project, the investor must depend on management’s day-to-day decisions to adapt and expand the plan in ways wholly unpredictable at the outset.

The final element that professional investors typically consider is scale. If you and four others are running a \$1 billion fund and the most each of you can manage at any one time is five investments, you had better have a pretty strong conviction that you can commit at least \$40 million to a given company, or you will run yourself ragged and never be able to contribute the strategic and financial expertise that helps so many of the investee companies achieve expected returns. And if a company cannot achieve an imputed market value of at least \$100 million within three to five years, an investor will not have available the Holy Grail of private capital—the initial public offering—as a potential equity enhancer, and exit.

Q: Flip the issue around: When is it appropriate for a company to seek outside capital?

Ultimately, the question of seeking outside equity capital comes down to your conviction that the benefits of use of this capital will far out pace the dilution that you will suffer in order to obtain it. A case of a smaller piece of a much larger pie. Obviously, there is a time and a place for each form of financing: commercial debt, mezzanine debt, property joint ventures, private and public corporate equity. So much money has crowd-



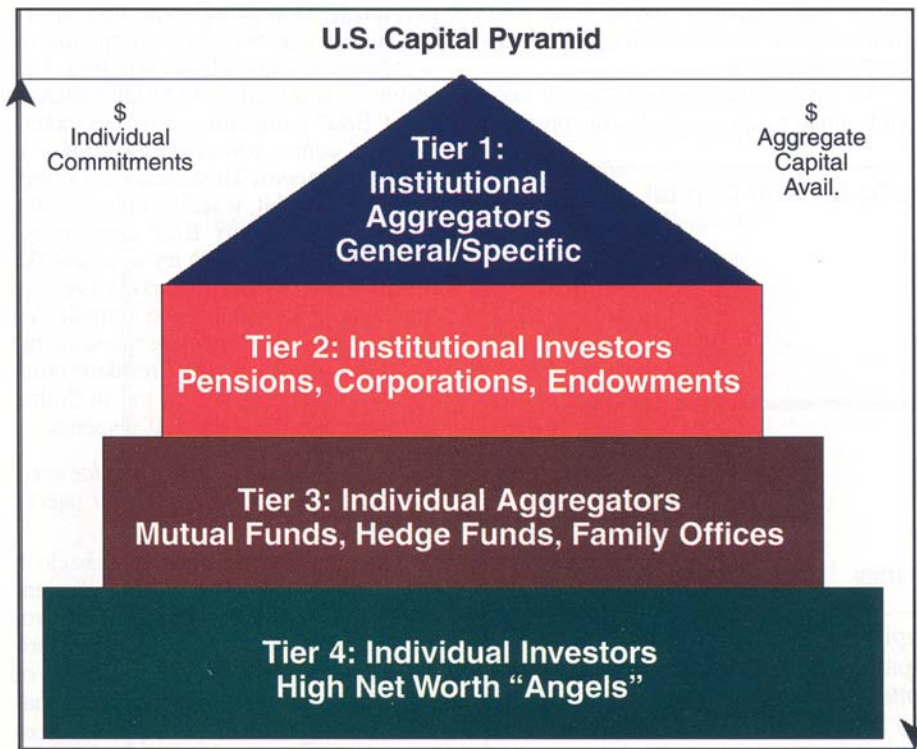
ed into the marketplace over the past several years that many of the traditional boundaries between these various financing sources have either blurred or shifted en masse, typically accommodating more risk than in years past. Part of this is the result of competition. However, a significant factor is also the trend toward professional managers with greater experience responsible for investment decisions, thus accommodating risk.

It is important, however, for companies to recognize the cost of each form of capital, and to the extent possible, match cost to risk. Joint venture financing, arguably the most expensive form of capital, may be quite suitable for high-risk exploration ventures, but it is totally unsuitable for development drilling. Similarly, mezzanine debt may have a higher rate of return than commercial debt, but it is typically far less expensive than joint venture financing or the sale of common equity, and may be the only way a small independent can bootstrap itself from dependence on friends and family to the stage where it becomes a candidate for the professional equity markets.

Q: Could you provide us with a “litmus” test of questions an independent should ask itself before seeking private capital?

The first question an independent must honestly answer is whether it is willing to accept—in fact, avidly wants—a financial partner as a shareholder, and most probably with voting control. You see, a professional investor brings with it expertise as well as capital. “Financial engineering” is as essential to an independent’s growth as any of the other technical disciplines, and arguably even more so.

There are many other standard criteria an independent must consider: As I indicated, you need to have a realistic perception of how you and the rest of your management team stand up relative to your peers, and what you and your company are worth in the current marketplace. You need to have a compelling use of capital and a business plan that demonstrates your capacity to add significant value. You need to be willing to entertain or provide an opportunity for the investor ultimately to achieve liquidity. All of this needs to be cogently and concisely laid out in an executive summary, which covers management, current financial and operational status, business plan and required capital, projected financial results, proposed financing terms, and resulting potential returns to the investor—all in 15 pages or less!



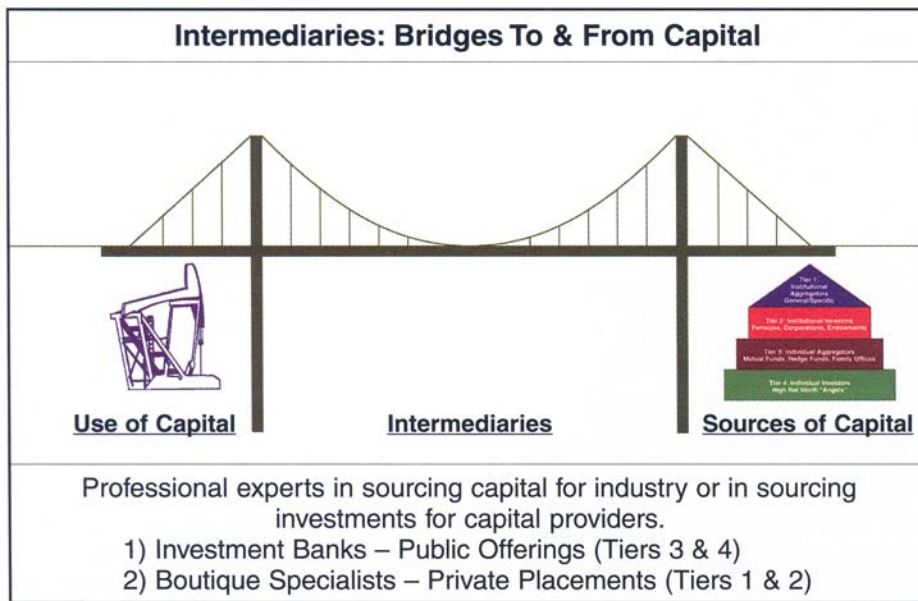
Source: COSCO Capital Management LLC

Q: What is the best way for a company to prepare itself to access outside capital?

At the risk of appearing self-serving, the best first step in undertaking any crucial project in which one is not himself specifically trained is to hire the best expertise one can afford. In this case, I am referring to a financial intermediary. If a company is of the size and has the capacity to undertake a public offering, then the financial intermediary will most likely be an investment bank, which has the

resources and personnel to access the mass of investors in Tiers 3 and 4.

If a company is too small for a public offering or the amount to be raised is less than \$50 million, the expertise is most likely to be found among boutique intermediaries for which the private placement process is their chosen field of expertise. The intermediary then assists you in assembling the information that will be required by a potential investor, helps you craft the executive summary, and



Source: COSCO Capital Management LLC

hopefully, matches you to those sources of capital most likely to appreciate your particular business plan and style and size of capital need.

One of the most important issues an experienced intermediary can assist with early on is determining a company's true strengths, and how best to highlight those advantages over peer companies. An intermediary can also help you place a value on your company, and structure a deal that a potential investor will recognize as both attractive and realistic—worthy of his consideration. Finally, the right intermediary can, itself, lend a certain credibility to a proposal, which should enhance the probability of its receiving prompt and serious consideration, while less well-sponsored proposals will never make it to the top of the in basket.

Q: How long does it typically take to get capital, from initiation to financing?

This largely depends on how well you are prepared at the outset (whether you have good financial records, engineered reserves, a corporate description, in-house financial expertise), and whether you have already established relationships with potential investment sources. The general rule, however, is that it takes a month to prepare the executive summary, another month to arrange initial meetings, a third month to carry out follow-up meetings and due diligence in preparation for negotiation of term sheets, and a final month for documentation and closing. Assuming all goes well, you are looking at a four-month undertaking at the least. Once you have closed a private placement, however, and assuming you are performing to expectation, if you have the right investor, an additional \$10 million or even \$100 million for a compelling opportunity can be arranged in a matter of days.

Q: Have you ever completed an initial financing more quickly, and can you provide some general examples of financings that illustrate the procedures you have described?

At the private placement seminar I organized, I set up one panel of five companies that had recently participated in the private placement process. All told, they had raised \$185 million (\$100 million in equity and \$85 million in debt) from seven capital sources, representing each of the tiers of the capital pyramid.

Also, the uses of capital were extraordinarily varied: Lariat Petroleum Inc. of Tulsa had arranged a \$20 million private placement of common stock with E. M. Warburg, Pincus & Co. for the principal purpose of pursuing three-dimensional seismic-based exploration projects in Oklahoma. Inland Resources Inc. of Denver, on the other hand,

Company	Private Capital Raised	Private Capital Source	Primary Use Of Capital
Domain Energy Corp.	\$30.00 (common) 8.0 (sub-debt)	First Reserve Corp.	Management Buyout
Inland Resources Inc.	25.0 (cmn. & pfd.) 10.0 (preferred)	Smith Management Enron	Lease Acq., Prop. Acq. Dev. Property Acquisition
Lariat Petroleum Inc.	75.0 (sub-debt) 20.0 (common)	Trust Co. of the West Warburg, Pincus	Development 3-D Exploration Acquisitions Exploitation
Probe Exploration, Inc. Vista Resources, Inc.	13.5 (warrants) 5.0 (common)	Centennial Natural Gas Partners	Acquisition/Exploitation Acquisition/Development
Total (5 Companies)	\$183.0 (Equity & Debt)	7 Sources	Wide Range

Source: COSCO Capital Management LLC

had arranged \$85 million of preferred stock and subordinated debt from Enron and Trust Company of the West for property acquisition and development. Domain Energy Corp. (now Range Resources, see preceding story) received \$38 million through the placement of common stock and sub-debt with First Reserve Corp. for effecting a management buyout of Tenneco Ventures from Tenneco Inc. Vista Resources Inc. of Midland, Tx., raised \$5 million from Natural Gas Partners in the form of common stock for acquiring and developing properties in the Permian Basin. Finally, Probe Exploration Inc., a Canadian public company, raised \$13.5 million through the private placement of special warrants with Centennial Partners of New York to finance the acquisition of the Leduc Field in Canada.

In Probe's case, this financing was completed in less than 30 days because its president, Steve Gibson, had prepared the way by conducting numerous meetings over the months preceding the acquisition, during which he had laid out his game plan and investment philosophies, preparing potential investors to pull the trigger almost immediately when called upon. In each case, the panelist discussed the pros and cons of private financing, but concluded that the benefits were overwhelming—not only in terms of accelerated creation of shareholder value, but also in collateral issues of business opportunities, credibility, and speed with which future opportunities could be captured.

Q: What are some common misconceptions independents have about financing their companies?

I cannot tell you how many proposals I read in which by the second paragraph, third sentence, a company claims to be

“unique.” Most independents have no perception whatsoever of how they stand up relative to their peers and whether or not they possess unusual strengths worthy of financial support. The other prevalent misconception is that the “private” in the private placement process is the same as “secret.” In a survey I conducted last fall, I identified more than 35 Tier 1 institutional aggregators and an additional 19 Tier 2 institutional investors actively seeking private equity investments in energy companies. At the time, these sources controlled well in excess of \$35 billion altogether. In the past six months, many of these funds have raised new capital, doubling or even tripling the size of their previous funds, and several new funds have been launched. This amounts to an enormous amount of private capital seeking contrarian investments at a time when energy is supposedly out of favor with capital markets!

If the private placement process is secret, it is no more secret than a good oil prospect: a company has to do its own work, hire the required expertise, risk some of its human and capital resources, and trust that its innate merits will reap appropriate rewards. To achieve success in this business, you need capital and lots of it. Capital is there in abundance and with a degree of professional expertise unknown five years ago. It is more than anxious to find a home, and willing to accept all the responsibilities of co-ownership. To my way of thinking, independents that do not investigate and avail themselves of these new sources of private capital are destined to struggle, while those that embrace these advantages will prosper as they never have before. Private placements are not an elective; they are a necessary element in the maturation of any modern independent. □