



*COSCO Capital's Cameron O. Smith says there's a new generation of general funds coming into the energy sector, looking for start-up opportunities to place their high-return, institutional dollars.*

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*From left, Warburg Pincus' Jeffrey A. Harris and Greenhill Capital Partners' V. Frank Pottow and Robert H. Niehaus all expect strong commodity prices in 2004 and a high level of private-capital investing, aimed at funding upstream companies.*

# CAPITAL CORRIDORS

## Pools of Private Capital

The oil and gas industry is witnessing a confluence of events that will profoundly affect private-capital supply and demand in 2004.

"There's a steady flow of seasoned management teams coming out of publicly traded E&P companies today that are looking for it," says Cameron O. Smith, senior managing director of New York-based COSCO Capital Management LLC. "Meanwhile, a whole new generation of general funds is coming into the energy sector—alongside existing, freshly reloaded, energy-mandated funds—looking for start-up opportunities to place their high-return, institutional dollars."

During the past four years, COSCO Capital, with offices also in Hartford, Houston, Tulsa, Oklahoma City and Calgary, has raised as an intermediary some \$350 million of private equity for upstream companies and has advised on \$360 million worth of energy-related M&A transactions.

In 2004, Smith sees private capital primarily pursuing managements with drillbit strategies. "Given today's high oil and gas prices, there's more downside pricing risk to acquiring proved producing reserves than there is upside," he explains. "Right now, a lot of money can be made through the drillbit because the differential between service costs and product prices is so great *and* because there's a plethora of low geological risk, manufacturing-type plays like coalbed methane. All this appeals to the institutional investor."

Also, expect next year to see more private funding of international E&P opportunities. Both investors and private operators have regained a certain amount of confidence about putting capital to work in places like Venezuela, he says.

"I've also talked to a lot of private-capital

sources that are focusing on the U.K. North Sea, Europe and Australia. The fact is, fund investors are becoming very comfortable with an industry that has performed so well historically, on a return basis, and they're now much more willing to spread their wings."

Jeffrey A. Harris, managing director for Warburg Pincus in New York, confirms much of this investment mindset. "For the first time, we're seeing upstream management teams focused outside the U.S.—in Canada, the North Sea and West Africa—with the sort of appropriate business plan and skill sets that we've seen in the domestic onshore or offshore E&P industry. In fact, we may soon be providing equity for a private start-up focused on exploration drilling internationally."

Currently, Warburg Pincus' upstream portfolio consists of investments in eight U.S. producers, including privately held Antero Resources, Bill Barrett Corp., Carneros Energy, Gryphon Exploration and Latigo Petroleum.

This year, the firm invested \$125 million of private equity in these five operators. Ultimately, it expects that 10% to 15% of its latest \$5.3-billion fund will be earmarked for the overall energy sector. In the case of the planned backing of the start-up operator focused abroad, the capital provider will draw upon both that fund and its \$2.5-billion international fund.

"Our confidence in and understanding of the upstream sector has grown, and along with it, our deal flow," says Harris. "At the same time, a reset has occurred in investors' minds. They realize that natural gas is no longer a \$2 commodity and that oil is no longer an \$18 commodity. As a result, they're more comfortable that there are real invest-



ment opportunities in the energy sector—and they're showing that with their dollars.”

Also contributing to Warburg's deal flow is the increasing availability of talented management teams coming out of recent industry consolidations, as well as asset rationalizations by larger independents and major oils.

“There's more emphasis today by larger companies on return on capital employed versus growing the number of barrels they produce each year; as a result, they're divesting more noncore properties,” he says. “Concurrently, new drilling and seismic technologies are creating better opportunities for smaller producers with low overheads to earn attractive rates of return.”

Adds an optimistic Harris, “I would be surprised if our company next year doesn't invest nine figures again in the upstream oil and gas sector.”

**A**nother active player in private-equity funding for energy companies has been New York-based Greenhill Capital Partners LLC. Since October 2002, it has made nearly \$70 million of commitments to that sector. This includes \$10-million investments each in Everlast Energy LLC, Exco Resources and La Grange Energy LP. It has also committed \$20 million to Triana Energy Holdings Inc. and \$18 million to United States Exploration Inc.

“The past year or so has been a great time for investors to back strong management teams buying energy assets because there have been many motivated sellers,” says V. Frank Pottow, a Greenhill managing director. He cites the cases of Nisource Energy and Aquila Energy, which became over-leveraged and had to sell off cash-generating assets. This presented asset-buying opportunities for Triana and LaGrange, respectively.

“In the case of our other three energy investments this year, we had prior working relationships with management—Tim Goff at Everlast, Doug Miller and his management team at Exco, and Steve Durrett at United States Exploration,” says Pottow. “That's an important part of our investment strategy.”

Also important to Greenhill, which has another \$70 million available for energy investments, is capitalizing on industry trends.

“In the post-Enron era of increased scrutiny of corporate governance and fewer analysts providing research coverage, some operators feel that it's becoming too expen-

sive to run a small- or midsize public E&P company and that there's less of a public institutional market for those size companies,” observes Robert H. Niehaus, chairman, Greenhill Capital.

“Many believe it's easier to attract capital as a private company, so they're moving in that direction. One such operator is Exco, which we helped take private earlier this year.”

With the combination of continued strong commodity prices, an economy on the rebound, more credit available to support private-equity investments and asset divestitures by major oils and larger independents, Niehaus expects a higher level of private-capital activity in 2004 than this year or last.

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