# SCALING THE U.S. PRIVATE EQUITY CAPITAL PYRAMID

A seasoned E&P executive cum financial intermediary gives you a cook's tour of the world of private equity capital.

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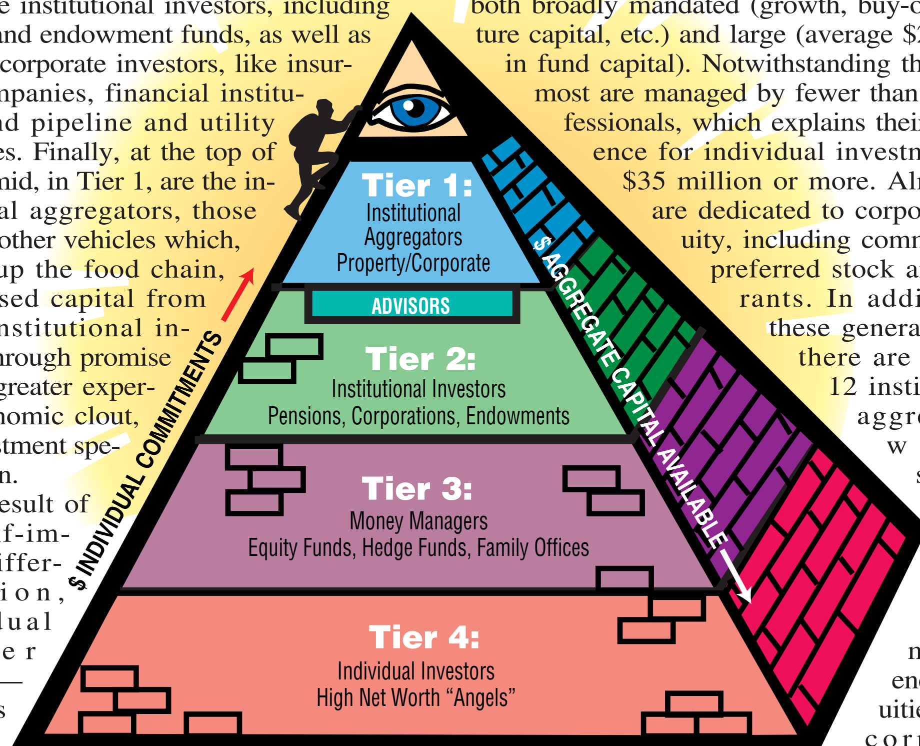
The equity capital market in the U.S., for those who do not study it professionally, can be most confusing, even alien and threatening. There are many sources of private equity capital, but they look at the oil and gas industry in different ways depending upon their investment objectives, and they are not accessed in the same ways.

To make sense of the myriad relationships and hierarchies that control both private and public capital markets, envision a great U.S. Equity Capital Pyramid, comprised of four distinct tiers. Starting at the bottom with Tier 4 are the individual investors, including high-net-worth "angels," so termed by Steven Galante, editor and publisher of *The Private Equity Analyst*. Above them in Tier 3 are the investment vehicles through which individuals' capital is itself routinely aggregated for the express purpose of accessing greater expertise and economic leverage. These generally can be grouped as money managers and include equity funds, hedge funds and family offices. In Tier 2 are institutional investors, including pension and endowment funds, as well as strategic corporate investors, like insurance companies, financial institutions, and pipeline and utility companies. Finally, at the top of the Pyramid, in Tier 1, are the institutional aggregators, those funds or other vehicles which, highest up the food chain, have raised capital from Tier 2 institutional investors through promise of even greater expertise, economic clout, and investment specialization.

As a result of this self-imposed differentiation, individual trigger power—the gross amount of money that can be committed by a single decision maker—climbs rapidly toward the apex of the pyramid. Conversely, the greatest aggregate capital, although spread most widely, is found at the base of the pyramid. Recognition of this simple truth provides the key to the capital pyramid and all its wealth.

Let us now focus on each individual tier to explore its common characteristics, starting at the top of the pyramid and working down to its base. Tier 1 investors, the institutional aggregators, are themselves comprised of two main subsets: general and specific industry funds. General funds, of which there are at least 13 which have significant energy components, are predominantly sponsored by the better known Wall Street investment banks or their former stars and are located near the institutional communities they serve. Examples are the proprietary investment funds managed by Warburg, Pincus; Goldman, Sachs; and Morgan Stanley Dean Witter.

General institutional aggregators tend to be both broadly mandated (growth, buy-out, venture capital, etc.) and large (average $2 billion in fund capital). Notwithstanding their size, most are managed by fewer than 10 professionals, which explains their preference for individual investments of $35 million or more. Almost all are dedicated to corporate equity, including common and preferred stock and warrants. In addition to these general funds, there are at least 12 institutional aggregators which specifically pursue private investment in energy equities at the corporate



level. Examples of these specific funds include Natural Gas Partners, Yorktown Partners LLC and EnCap Investments LC. Specific funds typically average $300 million in available capital and, with five or fewer managers, tend to invest in smaller increments of $5- to 20 million, as opposed to the general funds' $15- to 50 million. Some specific funds, like R. Chaney, SCF Partners, or First Reserve, advertise an investment focus even narrower than just energy, concentrating on energy service or energy technology. In contrast to general funds, almost all the specific energy funds are based or represented in the oil patch itself, and are populated by industry graduates with relevant technical backgrounds.

The advantages of these Tier 1 investors, whether general or specific, are that they possess thorough generic knowledge about energy, and many have niches in which they are exceptionally expert. Finally, they all have an underlying mandate to invest. The disadvantages are that they are so large and managed by so few that even the specialists among the specific funds prefer initial investments above $10 million and almost all are inclined to ignore unsolicited or unreferred submittals.

To approach Tier 1 institutional aggregators, it is critical that from the outset a company distinguish itself from the pack, but please recognize that Tier 1 investors receive an average of at least five proposals a week. Simply claiming to be "unique" can condemn a company as hopelessly unsophisticated or egotistical. A company has to establish its credibility through highlighting the particular talents and experience of its management team, emphasizing the attributes of its business plan, and even through selection of a financial intermediary whose own track record with such aggregators lends its own credibility.

In addition to being distinctive, a company must also demonstrate convincingly that it has the potential within three to five years to grow into a viable candidate for introduction to the public market. Without this, the financial investor can itself see no exit, and without the "bump" in multiples typically provided by an investment graduating from private to public sectors, Tier 1 investors are unlikely to achieve the 35%-plus financial returns for which they are looking.

The general and specific funds referred to all concentrate on investment in corporate equities. In addition, many Tier 1 specific funds specialize in investing at the oil and gas property level,

## TIER 1 INSTITUTIONAL AGGREGATORS

| Aggregator | Location | ($MM) Capital | Comments |
|---|---|---|---|
| **I. Private Corporate Equity Providers** | | | |
| A. 13 General Funds | Golden Parkway, or on coasts | $23,207 | Typically >$35MM/deal, all fresh capital |
| B. 12 Specific Energy Funds | Various | $3,391 | Half >$15MM/deal; half <$20MM/deal, all recent/current recapitalizations |
| **II. Direct Property Investors** | | | |
| A. Equity Investors | | | |
| 12 Specific Energy Funds | 10 TX, 2 NY | $5,390 | 4 active, 8 passive re: operations |
| B. Mezzanine Investors | | | |
| 7 Funds, all Specific Energy | All TX | $3,505 | Fresh capital, great variety |

## TIER 2 INSTITUTIONAL INVESTORS

| | |
|---|---|
| I. Pension Funds | Primarily Invest through Aggregators |
| II. Endowment Funds | Primarily Invest through Agents/Aggregators |
| III. Corporations (Strategic Investors) | Considerable Variety: Active/Passive, Corp./Property |

## TIER 3 PROFESSIONAL MONEY MANAGERS

703 (100%) with Aggregate Energy Investments>$10MM
57 (8%) with Aggregate Energy Investments>$1B
258 (37%) Invested in Micro Caps (<$150MM Market Cap)
314 (45%) Located along Golden Parkway (Baltimore to Boston)
576 (82%) With Services/Equipment Companies in Portfolio

** Source: IDC's The Gold Book (March, 1997)*

both in equity (working interests through joint ventures, limited partnerships or special purpose limited liability companies), and in subordinated debt or production payments often coupled with non-working property interests.

Among these Tier 1 property equity investors, there are also at least three subsets: Some like EnCap, First Reserve and TCW, invest directly in properties as an adjunct to their other energy financing activities; others, like Morgan Guaranty, RPI and UBS, select and support oilfield operators as limited or joint venture partners; and finally, a third group, including the likes of Enervest, Floyd Oil, Merit Energy and Torch Energy, have built independent operating entities with institutions either as share or unit holders, or through the equity provided by after-payout reversionary interests. These property equity investors participate under financial terms comparable to those available from industry partners. From one perspective, the lack of technical expertise in the first two sub-sets makes them operationally less intrusive and, therefore, preferable. From the other, they have little to add except capital, and less expensive financing is readily available. Whatever the reasons, this category of capital on a stand-alone basis has dwindled markedly over the past decade.

The second major division among the property oriented Tier 1 aggregators is composed of the often-misunderstood and much-maligned mezzanine investors. These are the aggregators, numbering at least seven, including Associated Energy Managers, EnCap and Resource Investors Management Co. (RIMCO), which purport to provide the preponderance of capital required by an operator to undertake a particular development project. They receive in return high-yield debt instruments or production payments tied solely to such properties, coupled after payout, as defined, with vestigial equity interests in such properties or occasionally in the host company, itself.

The pejorative connotation for mezzanine investors appears to stem from their initial, unfortunate contrast to commercial lenders. More properly understood, most mezzanine financing is far less expensive than standard industry joint ventures or farm-outs, with which it is more accurately comparable. Furthermore, because mezzanine capital often is available in small increments and is the most flexible of all Tier 1 capital, it can, in fact, provide smaller independents with the essential mortar to cement a base of assets necessary to access more conventional equity financings.

In summary, Tier 1 aggregators, in all permutations, are knowledgeable, professional and motivated to invest. So many such funds have in fact raised so much capital over the past two years specifically for investment in energy that they will actually compete for attractive investment opportunities. This can materially increase the likelihood of successfully concluding a private placement, while reducing attendant costs, making Tier 1 aggregators particularly attractive sources of private capital in the current environment.

Below Tier 1 are the Tier 2 institutional investors, including the pension funds, endowment funds and strategic corporations mentioned at the outset. Institutions typically function as fiduciaries for Tier 4 individual investors which have entrusted them with their hard-earned capital. As such, an institution's primary concern is preserving capital. Many, if not most, of these institutional investors in the late 1970s and early 1980s were savaged by energy, and, thus, with a few notable exceptions, over the past decade, most pensions, endowments and insurance companies have retreated from direct selection of individual energy investments.

Instead, those that still venture into energy delegate individual decisions to advisors, otherwise known as gatekeepers. The advisor's professed role is to help an institution select an appropriate investment or investment vehicle within the specific industry in which it claims expertise. Cynics suggest their unpublished *raison d'etre* is to insulate the institution's manager from blame, should the investment sour. While there is an immense amount of wealth represented by Tier 2 investors, the effort required to break through the gatekeepers is typically too exhausting to warrant serious consideration for an individual offering. If a company's aim, however, is to establish its own fund, the effort, spread over repeated financings, can be well worthwhile, but it must be prepared for unparalleled due diligence and at least a 12-month courtship.

One subset of Tier 2 institutional investors which has evolved into a clear exception to these rules is comprised of certain large corporations with significant cash flow and a strategic commitment to the energy sector, itself. Examples include First Union Capital Partners, GE Capital, Heller Financial, ING Capital and Stratum Group, all of which on behalf of their controlling affiliates actively pursue one or all of the financing modes described above, including providing corporate or property equity and sub debt. Also included in this subset are many of the pipeline and utility companies, whose financing affiliates, with names like Enron Finance Corp., Williams Energy Services, Koch Producer Services, Duke Energy, and Cambrian Capital, also provide financing to the energy sector—often with an eye to enhancing their affiliates' other services or access to the underlying commodity itself.

Because of their diversity of size and style, these Tier 2 investors represent particularly attractive private capital sources, especially for offerings of less than $15 million.

Below the institutional investors, in Tier 3, are the money managers, including equity and hedge funds, family offices, and other congregations of capital, also largely sourced from the angels in Tier 4. The advantages of money

More properly understood, most mezzanine financing is far less expensive than standard joint ventures or farm-outs.

Success in marketing to a Tier 4 "Angel" first requires a sales pitch on the industry itself.

managers are that they are again paid to invest capital, and, therefore, a significant proportion have developed the skills to understand, evaluate and act decisively on energy investment opportunities. For the most part, however, Tier 3 aggregators, unlike those in Tier 1, do not operate with fixed funds, but in environments where investors routinely add or withdraw capital. Money managers, therefore, as a rule look for relatively liquid investments, from which they can exit swiftly, depending on their views on the market and their own investors' capital needs. Most suitable for them are private placements of already-public stock, with no or a short lockup period, and in the individual investment range of $250,000 to $5 million. For such offerings, targeting Tier 3 investors can be quite rewarding.

To indicate how extensive and diverse is this Tier, according to the Investment Data Corp.'s 1997 edition of *The Gold Book*, in 1996 there were over 700 money managers in the U.S. and Canada which had at least $10 million dedicated to energy equities. Fifty-seven reported investing over $1 billion, and 258 included "micro-caps" (companies with a market cap of less than $150 million) in their portfolios. Although *The Gold Book* does not capture this information, many of these money managers do court private placements. As a consequence, if a company's management has established a personal relationship with a money manager or can somehow discern which among them are likely to respond positively to an investment proposal, Tier 3 can prove an excellent hunting ground.

Finally, in Tier 4 (at the base of the pyramid) is the home of the greatest aggregate investment capital and the province of the individual investor. Clearly, some Tier 4 angels are legend: Richard Rainwater, Marvin Davis, Phillip Anschutz, among others. The difficulty of approaching this tier is that, in the main, success again requires an existing personal relationship, which is difficult to engineer retroactively. However great in aggregate the dollars in Tier 1, those available per decision are, with singular exceptions, relatively small, typically less than $1 million. Moreover, this class of investor was in fact that most "burned" by the excesses of the 1970s and the crash of the 1980s, from which it has yet to recover.

Success in marketing to a Tier 4 investor, therefore, requires a sales pitch on the industry, itself, even before getting to the merits of a specific company or deal. In summary, absent personal relationships or star appeal, Tier 4 requires enormous work to raise capital of any consequence—unless raising money in mammoth size is, in fact, one's main business.

This raises another major confusion: The role of investment banks. Part of the confusion stems from the fact that many of the better known Wall Street firms are, themselves, among the largest Tier 1 aggregators. A significant portion of most investment banks' business, however, stems from raising capital, typically huge amounts of capital. Because Tier 4 contains the largest aggregate capital available, most of the larger investment banks have organized themselves to undertake the daunting task of contacting and culling the vast numbers involved in order to ensure their ability to deliver on their underwritings.

With the exception of most angels, Tier 4 investors are also the least sophisticated within the capital pyramid. Offerings to them, therefore, are required to be registered with the Securities and Exchange Commission, increasing substantially their complexity and cost. The larger investment banks overcome this conundrum by participating only in offerings generally greater than $50 million, large enough to pay for the overhead required by this Herculean effort. Once having equipped themselves to distribute these offerings among the Tier 4 hoards, moreover, they certainly can manage the logistics of Tier 3, and once established as giants on Wall Street, these firms can also develop the symbiotic relationships necessary to provide comfort to Tier 2 institutional investors. As a consequence, the Wall Street community can undertake large offerings with great confidence, provided they are not bucking the conventional tide.

Paradoxically, for the very reasons they excel in retail placements, the larger investment banks enjoy nil standing with the more sophisticated, successful Tier 3 money managers, Tier 2 corporate investors, and Tier 1 institutional aggregators, which together constitute the private capital core. This core looks on Wall Street investment bankers at best as competitors in the public arena for deals they would have preferred to have remained private, and at worst as "hired guns" paid simply to supply what currently is in favor, not to divine and package what the market has overlooked.

Understanding the U.S. Private Equity Capital Pyramid is critical to accessing appropriate capital and to achieving a company's business goals and corporate ambitions. A good marriage of capital and technical ability is absolutely essential to the creation of shareholder value. In isolation or even in unequal measures, capital and technical ability cannot achieve the growth and financial rewards both seek. With proper preparation, any company which deserves and requires capital in sufficient measure can scale the Capital Pyramid with confidence, knowing that its inhabitants have erected it as a beacon for all to see and to use for enlightened mutual benefit. □

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