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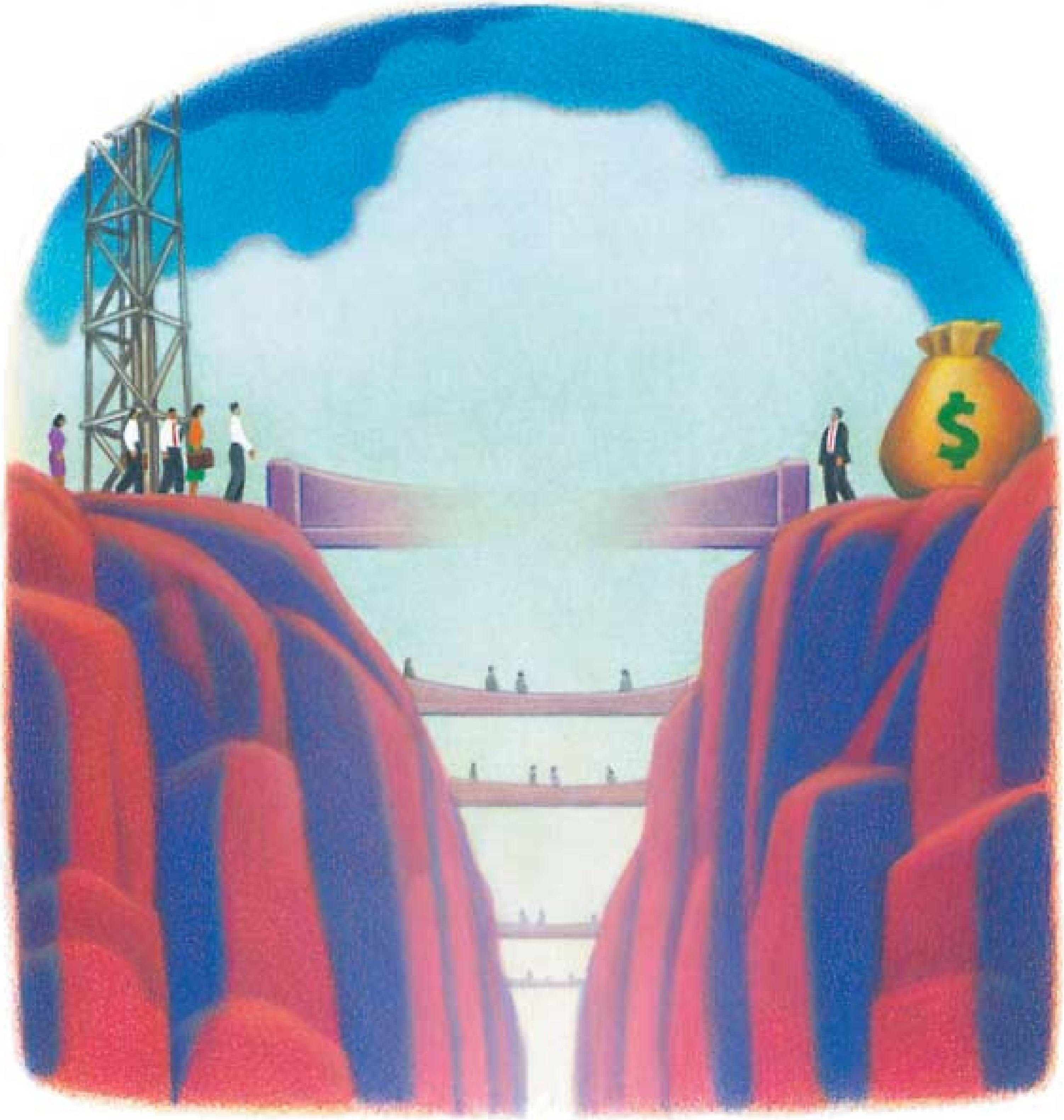

Getting it Right: Capital Formation 2003

June 2003

Growth Capital for Leading Energy Companies

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Money Turns The Drillbit

Even before *Oil and Gas Investor* published its first supplement or special report back in 1992—it happened to be a primer on capital formation for independents—the magazine had already zeroed in on the critical topic of access to money. It's part of our mission and a reason the magazine was established 22 years ago.

Money makes the world go round, and it turns every drillbit, too.

Capital formation is a part of the energy industry that can demand one's complete attention, and be quite vexing as well. Just when the time is right for an E&P company—due to lower drilling costs or new technologies or great prospects—money is tight or expensive. Then when money is plentiful or cheap, there seem to be fewer opportunities to spend it wisely.

Right now, a number of factors have converged to create a unique moment of opportunity for E&P companies, whether they are start-ups or long-established companies.

- Oil and gas appear to have set a new and higher floor price.
- U.S. demand for oil and gas is rising even as supplies tighten and deliverability or infrastructure bottlenecks occur.
- Drilling costs and costs for other field services are lower than they were a year or two ago.
- Technical advances for seismic interpretation, fracture stimulation, real-time reservoir monitoring and project management are taking the industry to new heights of efficiency.

As the summer of 2003 approached, people began to talk in cautious, quiet tones about activity increasing. Whether a commercial banker, an M&A advisor, an E&P executive or a landman chasing deals, they report they have been getting a few more phone calls. The U.S. land-rig count has risen almost every week year to date.

And on top of it all, capital is available—to managers with strong track records of success and who have well-thought-out business plans.

The coffers of private capital providers in particular are nearly full—in some cases, absolutely full due to their recent and highly successful accumulation of fresh funds. In the last six months, Quantum Energy Partners raised $240 million, Natural Gas Partners raised $600 million and newcomer Petrobridge Investment Management LLC has raised $200 million. That's more than a billion dollars of private equity and mezzanine funds looking for E&P opportunities.

Several small and regional banks in Houston, Dallas, Denver and Oklahoma City have stepped up their reserve-based lending capacity to attract those borrowers that no longer fit the profile of the mega-merged banking behemoths. The latter continue to be active as well. For example, 14 banks—led by JP Morgan Chase, Bank One and Bank of Montreal—just closed on a new $500-million credit for Plains Exploration & Production Co., for its acquisition of 3Tec Energy, to refinance existing debt and provide working capital.

Where's the Money?

Capital Source	Outlook	Comment
Bank debt	Positive	Market is thinner and more conservative than before, but interest rates are at historic lows.
Subordinated debt	Positive	Spreads have widened but T rates are at historic lows.
Mezzanine	Neutral	New entrants have reinvigorated a dying market.
Public equity	Neutral	The window appears open on a selective basis.
Private equity	Positive	Private investors or funds are flush with cash, although high oil and gas prices cause concern.

Source: Petrie Parkman & Co., April 2003

So, don't let the naysayers tell you capital is not available: It is!

A lucky few—the robust among mid- and large-cap companies—have accessed Wall Street and come back smiling. One midcap Houston-based E&P firm, Southwestern Energy Co., raised the number of new shares in its February offering from 5.5 million to 9.5 million and the offering was still oversubscribed—by three times! The company ended up issuing 37% more shares than it had outstanding at the start of the process, and it did so at $11.50 each—a full 30 cents higher than where the stock traded when the offering began.

And what's more, the net proceeds of $103.3 million were targeted for speeding up the drilling rate in a specific East Texas field, not for funding an acquisition, as is so common these days with stock offerings.

So, don't let the naysayers tell you capital is not available: It is!

But it always will be hard to raise in that it takes time, persistence, creativity and a good business plan for the use of proceeds. This supplement will help you get up to speed with some of the trends we and our sources see.

--Leslie Haines, Editor

Energy Finance 101

Starting an E&P company? Here's a quick course on how to proceed with capitalizing it, to maximize the payday.

ARTICLE BY T. PRESCOTT KESSEY and WILLIAM E. WEIDNER

Suppose the whole industry is short on quality oil and gas projects. You're a geologist and your partner is a landman. Together, you have developed better prospects and better ideas than any of your competitors. Notwithstanding, you think you have no choice but to finance your drilling projects by selling them to the large independent down the street that you know will drill exactly where you don't want it to.

Or suppose that you're a petroleum engineer with a proven track record at acquiring noncore oil and gas properties, enhancing them and then selling them, but you've always done this for your employer. Now, you would like to do it on your own, but you have no idea how to find the money.

Or let's just suppose that you're a successful midstream company executive with a great management team. You want to build a company out of the merchant-energy collapse, but to buy the large asset divestitures being thrown on the market, you have to demonstrate beyond a shadow of a doubt that you have the hundreds of millions in cash needed to play in that environment.

Or what if you've already done all the above, and you're thinking about raising money in the public equity or debt markets. Then, again, you think you might want just to sell your company, because you feel that it's more fun to grow from small to big than it is from big to bigger, and starting all over again might attract even more capital, anyway.

Growing an oil and gas company or project requires capital. Lots of it.

Knowing how, why and what kind of capital to raise is about as important to an oil and gas entrepreneur as knowing the location of the nearest gas station when your tank is nearly empty: if you don't have it, you're going nowhere.

Yet, the oil and gas executive has a much greater challenge. He has to keep track of who's got capital and who doesn't; who's exiting the money business and who's coming into it; and most importantly, with whom he can get along, and of course, with whom he can't. We teach teen-agers how to drive, but we never teach energy professionals how to raise money to finance an oil and gas business. And we always forget to pass on the first and foremost admonition: Know thyself!

The various financing styles on the "stairway to harvest" are well known, as are many of their advantages and drawbacks. The key is knowing how to match the stages in the growth cycle of a company with these financing styles. Only by assessing candidly your own merits as a candidate can you realistically determine which of the familiar financing styles in the life cycle of a growing oil and gas company you have high probability of capture.

With a project, value is created not by compressing time, but by compressing the amount of capital for which management is responsible.

The Four Basic Steps

A project or a company. Before raising capital, the issuer must first decide whether he's building a project or a company. This is a critical distinction. Those truly committed to building a company should probably raise equity, while those planning simply to develop a project, or a series of projects, should probably stick to debt or joint-venture financing. This process often requires a great degree of soul-searching.

Building a company implies developing and leading an exceptional organization that is very good at something that can be continuously repeated to add value over time. Good managements can almost always create more value faster by building a company with plenty of capital to fund that special something as many times as possible.

Capitalizing with equity allows a company to multiply the number of times that its special something can be repeated, thereby maximizing value by compressing time. For example, an exploration company would want to capitalize with equity to gain sufficient exposure to a number of prospects to ensure success within one or two industry cycles. Having achieved success, the company would have created real going-concern value as an organization. A company like Newfield Exploration might be a good example of this: during the early 1990s, it first developed a strong management team with repeatable skills and then capitalized the company for certainty of success over a series of prospects.

Building a project is quite different. By identifying, designing and executing a project that may or may not be repeatable, but which, by itself, provides a fairly certain outcome, a good technical team can generate significant added value. With a project, value is created not by compressing time, but by compressing the amount of capital for which management is responsible. The less equity that management must share in a predictable project, the more value creation it keeps for itself. For example, an acquisition-oriented company would want to capitalize primarily with debt if it could acquire reserves, enhance them, pay off the debt, and then live off the cash flow from the property.

Often a little introspection at the start of the capital-formation process provides important insight into the correct path. Moreover, the desire to build a company usually requires that one first prove oneself by successfully building a few projects. Before starting off on the money-raising trail, think about this important distinction. Building a company requires great management, a great track record and a repetitive business plan. Building a project requires a great project. Management has to be at least adequate, but it needn't yet have a track record.

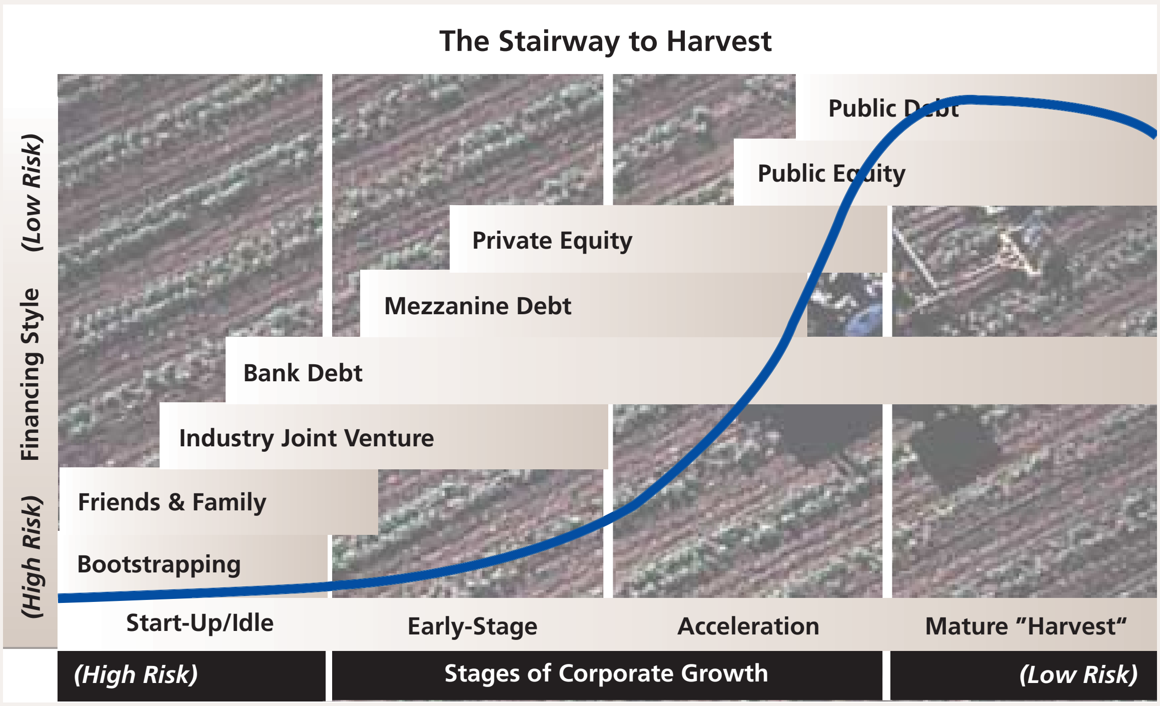
Track record. Everyone has a so-called track record, but very few people have taken the time to

FINANCING STYLES

Outlined here are the most common styles of financing available to energy entrepreneurs. Each is more or less suitable to one or more of the stages in a company's growth, based on risks and costs, but as the adjoining article points out, the first step is to come to a realistic appreciation of where one stands on the "stairway to harvest."

Bootstrapping. Many oilmen have started a business with minimal capital. Some continue to rely on bootstrapping beyond the start-up stage because, by preserving 100% ownership, they think they're pursuing the highest risk/highest return financing option. However, bootstrapping severely limits growth by constantly shifting time and energy to cash crises and away from that special something that a business might repeat over and over to generate real value in less time.

Friends and family. Friends and family already know the issuer's track record and—often despite this—agree to help management avoid the perils of bootstrapping. However, tapping friends and family can introduce fledgling companies to crippling, often irrational emotional dynamics. Do business with friends and family if you wish, but be warned!



When starting an E&P company, it is essential to choose the correct types of capitalization. The curved line represents a typical pattern of production or cash flow growth during a company's life cycle.
Source: Cosco Capital Management

document it. Compiling a track record represents possibly the most important step in raising money to finance an oil and gas business.

Most people claim they cannot document their track records because it would require rooting through the files of former employers or taking credit for successes and failures for which the outcomes involved many others. Aspiring entrepreneurs should develop the habit of recording their roles in completed tasks and their financial results, thus becoming the owner of their own track records. This information becomes a key prerequisite when raising capital.

Those lacking a commercially viable track record must get one, and the best way to do so during the start-up stage is by building a project, often by bootstrapping, tapping friends and family for capital, or by entering into creative joint-venture or option arrangements.

For example, a company lacking a track record, but having a viable project, might offer the entire project to a joint-venture partner, while retaining an option to buy into the project on the same terms during a defined time period. This arrangement allows time for eliminating project uncertainty, attracting debt financing, and, hopefully, establishing that indispensable track record.

Industry joint venture. Joint-venture financing is actually very expensive, nonrecourse structured debt, where two companies agree to participate disproportionately in costs and revenues before and after payout. Joint-venture financing may be appropriate to advance a project; it is rarely the best option for a company, unless to mitigate risk.

Too often, however, companies sell to a joint-venture partner a relatively low-risk project that took years of sweat equity to develop. This is expensive money, particularly if, as indicated in the table, there is opportunity to tap any of the overlapping financing styles.

Bank debt. Banks generally advance 50% to 65% of the present value, minus 10% (PV 10%) of predictable cash flow streams from proven properties. Since bank debt costs the least among conventional sources and becomes available as soon as, and as long as, a company has producing assets, a company's managers should resort to it wherever possible, reserving their equity capital to that special something that entails greater risk, but consistently builds value. This permits a company to realize a substantial compounding effect from repeated generation, leveraging and redeployment of field-level cash flows.

Mezzanine debt. Mezzanine debt is characterized by high advance rates, which are ideally suited for project financing, in exchange for strict repayment terms and restrictive covenants. Interest rates range from 350 to 1,000 basis points over comparable term U.S. Treasury issues, and often are accompanied with equity participation rights.

Notwithstanding, compared with joint ventures, mezzanine debt almost always costs less, a fact too often lost on independent producers stuck in traditional financing styles. Used with discipline, mezzanine debt is a great means to jump-start from start-up, or even the early stage, to acceleration.

Private equity. Private equity allows management teams to harvest a smaller piece of a much bigger pie within a three- to seven-year time-frame. Four keys to attracting private equity? First, emphasis is on funding management teams, not their assets. Second, the interests of all parties must be aligned, usually by requiring management to co-invest and delaying their "promote" to back-ins upon success.

Third, board participation, if not control, is usually required. And finally, since private-equity investors require an exit, business plans must begin with an exit in mind. Private equity can be arranged at start-up, if management has an outstanding track record from prior experiences, but is most often available once a company has reached the early stage, established its own track record, and requires significant growth capital.

Public equity. Once a company has demonstrated consistent capacity to grow, assuming it has achieved a scale sufficient to attract institutional interest (now considered at least $300 million) then the public equity market is an option. In terms of financial cost, public equity is the least expensive style of equity, but it has its drawbacks in regulation, management of investors and analysts, and conflicting expectations of timing and success.

Also, public equity directly is not an exit, at least not initially. It can become one through time and secondary issues. Indirectly, however, the public market is the ideal exit, as a manager builds his private company to scale, times his exit to a period of public interest, and reaps the premium that public companies can pay because their own costs of capital are so low.

Public debt. Public debt, when the market is open, is the lowest cost of all capital styles. It can become a debilitating—even deadly—drug, however, as with its ease and size it mesmerizes its devotees, often hypnotizing away fear of covenants and repayment terms. Public debt can be a marvelous financial option, but like all debt, it requires immense discipline. Like public equity, it is not an exit in itself, but it indirectly fuels the ability of others to pay more and more for seemingly endless growth (and the purchase of the company). It creates the harvest, but beware the sickle.

Those entrepreneurs who have established a track record by bootstrapping with debt or joint ventures, and whose company has graduated to the early stage will find it far easier to raise private equity to fund continued growth. A company like Energy Partners Ltd. might be a good example of this, having first used joint-venture and debt financing for projects, before raising private equity and then later, public equity.

Everyone has a so-called track record, but very few people have taken the time to document it.

Find a compatible financial partner. A company seeking capital must focus on finding a financial partner who, in addition to cash, has compatible business goals and attitudes about risk. Established companies in the acceleration or mature stages with access to public equity and debt markets determine compatibility among faceless public partners through the terms of the debt or equity issue itself, including control provisions, restrictive covenants and repayment or reporting requirements.

With private capital, however, the personalities and attitudes of the capital provider often bear greater importance on the success of the marketing effort, let alone the partnership, than do the underlying terms of the issue.

Private capital issuers should focus on compatibility for two key reasons. First, by confidently interviewing investors, management puts itself on the same level as the investor. The company's message should be its confidence in its plans and its desire to eliminate capital uncertainty. Companies simply looking for money will likely experience greater investor skepticism and may never develop the important investor rapport that is required to jointly build a company.

Second, issuers must assess how potential investors will behave under various circumstances and the degree to which the investor may become involved in running the business. Some issuers seek investor involvement, while others seek to avoid it. Private companies that obtain investment from family members, friends or groups of individuals sometimes find that the emotional interaction among disparate, non-management owners can become an obstruction to the value-creation process of the company, or worse, force its liquidation. Professional investors usually provide a much greater degree of consistency, so issuers must ensure that this consistency will wear well over time.

Always talk too soon to investors. No company can afford to postpone capital-formation efforts until the money is needed. By developing a program of periodic and candid communication with the investment community, companies will almost certainly know those investors with whom they are compatible, and the investors will certainly know the company's track record and the quality of its management.

Federal regulations require this discipline from public companies, but private companies ignore it at their own peril. Strong investor communications and rapport-building are a common characteristic of almost any successful company, whether public or private.

By consistently following these four basic steps, oil and gas companies and their management teams will be well positioned to understand in which stage of the company cycle they are laboring and with which of the many styles of capital available to the industry they are best suited.

Remember: Be honest. Be professional. If you can't judge yourself objectively, seek the help of professionals who do this all the time. But time is the issue, because if you aren't prepared to assess yourself and your appropriate stage on the "capital stairway," you're wasting the time of those you're approaching, and, worse, you're wasting your own. ■

T. Prescott Kessey is a principal and William E. Weidner is a managing director of Cosco Capital Management LLC. Kessey is based in Houston; Weidner in Avon, Connecticut.

FOUR BASIC STEPS

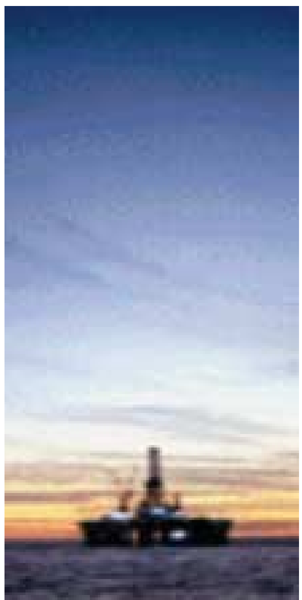
1. Decide if you are building a project, or a company. This determines the best kind of capital to pursue.
2. Document your track record.
3. Find a compatible financial partner with similar goals and attitudes about risk.
4. Always talk too soon to investors. Don't postpone capital formation until the money is needed.

Please see our “Profile” on page 42

BLACK ROCK

ENERGY CAPITAL, LTD.

BlackRock Energy Capital, Ltd. was formed in 2002 as an independently owned oil and gas finance company. BlackRock provides capital ranging from $0.5 million to $5 million to independent producers for reserve-based acquisitions and monetizations with associated production enhancement and/or development. BlackRock's investment structure is a non-recourse financial production payment via a limited term overriding royalty. This simple structure results in minimal documentation, closings generally in less than 30 days, and nominal closing costs. No third-party engineering report is required as all technical analysis is performed by the partners of BlackRock, all seasoned E&P professionals who have been active in the E&P industry for over 20 years, with 10 years focused in the mezzanine finance arena. The ideal customer will have an established track record, regional expertise, operational excellence and a definitive development plan. BlackRock is looking to create long-term relationships with producers as we assist in growing his or her business.



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The partners of BlackRock originated and managed the Producer Finance business at Tenneco Ventures in 1993, which subsequently became Domain Energy and later Range Energy Finance Corporation.

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We are a group of seasoned E&P professionals providing capital resources and technical expertise to independent oil and gas companies desiring reserve based growth and development.

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Mezz Money

Mezzanine capital for the E&P business is making a comeback. Here are some of the players and their assessment of the current field.

ARTICLE BY JODI WETUSKI

In finance, trends come and go. This year, mezzanine lending came back in style, after falling out of favor with cash-strapped energy merchants that were so enamored with it just two years ago.

Executives who managed these energy merchants' now-defunct producer-finance divisions are launching their own investment firms. Large banks that never left the mezzanine market are reminding independents that they have money to loan for the right projects. And at least one overseas bank has opened a Houston office to connect with the oil and gas community.

"I think it will take some time for the [mezzanine lending] volumes we have seen in the past to return, but I suspect we will get there," says Scott Johnson, co-founder of Weisser, Johnson & Co., a long-time Houston-based provider of financing and advisory services to producers.

The level of mezzanine financing for the oil and gas industry was running between $1- and $1.5 billion in 2000 and 2001, thanks largely to the deep pockets of the energy merchants' producer-finance divisions, Johnson says. But that money fell off the map in 2002 when many of those companies were forced to pare their spending in the wake of financial scandals that affected almost every company with an energy-trading arm. Enron soon exited the business, followed by Mirant and Aquila. Duke recently has too. Separately, as a result of a strategy-change, oil giant Shell has too.

The ideal mezzanine loan involves an acquisition that provides generous development-drilling opportunities.

For producers, mezzanine is a fairly pricey form of capital, Johnson says, with lenders generally seeking returns in the 20% range. Investment is usually comprised of a secured loan with a coupon return between 9% and 10%, plus an overriding royalty, which will generate the additional return needed to get the total near 20%. So, to provide adequate return to the lenders and to the operators, the project would need to generate a 25% to 30% total return.

The ideal mezzanine loan involves an acquisition that provides generous development-drilling opportunities. "Production alone does not offer a high enough return to satisfy a mezzanine lender," Johnson says. "The higher returns come from the development, so there needs to be a significant amount of development to do."

Scott Johnson, Weisser, Johnson & Co.

Very long-lived reserves are more difficult to finance with mezzanine money because it is fairly expensive money, he adds. Mezzanine deals usually work best when the pay-out can occur pretty quickly—in two to four years.

Rob Lindermanis and Mike Keener were with two of the mezzanine capital providers that exited the business—Mirant Americas Energy Capital and Shell Capital, respectively. Each saw continued opportunity for the market, however, and formed Petrobridge Investment Management LLC, raising $200 million for investment in E&P companies. The firm will lend capital in the form of stretch senior secured debt, subordinated debt, mezzanine debt and volumetric production payments (VPPs).

Petrobridge's investors agreed with Lindermanis and Keener that the exit of the energy merchants left a void in the market that needed to be filled. "Our investors saw a unique opportunity," Lindermanis says.

What helped was that the energy merchants' producer-finance portfolios were for sale while Petrobridge was raising money, Keener says. Potential investors were able to look at those portfolios and see what kinds

of deals were being done. They were able to get comfortable with the risk profile of mezzanine lending.

Another new entrant—at least to the Houston scene—is Macquarie Energy Capital, part of the Sydney, Australia-based Macquarie Bank Group. Macquarie has begun lending to the E&P business, including in mezzanine form.

Mezz partnerships

"A distinct difference between the energy-merchant lending groups and the new investment firms is that the latter are much more willing to bring co-investors into a deal," says Paul Beck, executive vice president of Macquarie Energy Capital. These co-investors include active financiers and less-active entities such as insurance companies and hedge funds that are interested in the market but don't want to start their own firm.

"A distinct difference between the energy-merchant lending groups and the new investment firms is that the latter are much more willing to bring co-investors into a deal."
— Paul Beck, Macquarie Energy Capital

In fact, Macquarie and Petrobridge teamed on a deal to provide funding for the Northstar Gulfsands LLC, Houston, acquisition of a 50% interest in Unocal Corp.'s stake in the Eugene Island 32 Field in the Gulf of Mexico. That deal was done even before Petrobridge had permanent office space.

Keener says this kind of partnering would never have occurred between energy merchants: "No way." But for start-up investment firms such as Petrobridge, partners mean added protection in case an investment turns sour. "We just can't afford to have a deal kill us," he says.

Tim Murray, executive vice president and energy group manager at Wells Fargo in Houston, says the bank will find partners to help finance mezzanine deals that are well above Wells Fargo's "sweet spot" of $10- to $15 million. The energy merchants preferred larger deals. With them out of the picture, there may be more partnerships to come, Murray says.

In addition, Wells Fargo is finding opportunities to refinance some of the deals that were in these large portfolios, adding some less expensive bank debt to the mix. "Unlike those firms, we have a cheaper, more flexible capital source than they have—the bank," he said.

Wells Fargo recently did such a refinancing with Arena Energy LLC, a Gulf of Mexico shelf operator that was previously financed by Shell Capital. Arena was paying Shell a rate in the low-teens, but Wells Fargo refinanced that revolver at about 4%, and added in a $6-million mezzanine facility to be used for future project development, he says.

During the mezzanine boom of 2000 and 2001, there were deals being done that didn't fit the profile of a true mezzanine loan, Murray adds. "I think there was a little bit of an artificial boom in the mezzanine business in the past couple of years. Mezzanine is the middle floor. Mezzanine needs to have some equity under it, and oftentimes has senior debt above it…Some of these firms were financing deals with mezzanine debt 100%."

In addition, some firms treated mezzanine as a long-term form of capital, when it should be treated as a shorter-term financing option, Murray adds. "If you finance a project and it's successful, by our definition, you ought to be able to refinance it, because mezzanine was never meant to be permanent. Some of these firms treated it as permanent capital."

Mezz debt's beginnings

The originator of the mezzanine market for E&P companies was Trust Company of the West (TCW), a private money-management firm that launched the TCW Debt & Royalty Funds I—the first mezzanine fund for producers—in 1982, says Kurt Talbot, senior vice president of TCW in Houston.

Mezzanine funding started out as a debt-styled instrument that took some reserve and commodity-price risk that commercial banks at that time were wary to take. Generally, the sponsor would have some skin in the game, perhaps 10% to 20% of the capital, and the project would have a component of producing reserves, perhaps 25% to 50%.

But over time, with the appearance of the energy merchants on the scene, the mezzanine structure morphed into more of an equity-styled instrument, one in

Some E&P Mezzanine-Capital Providers*

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- **Petrobridge Investment Management,**
  Michael Keener and Ron Lindermanis, 713-490-3860
- **Wells Fargo,**
  Tim Murray, 713-319-1360
- **Royal Bank of Scotland,**
  Jim McBride, 713-221-2426; Phil Ballard, 713-221-2418

*Several other mezzanine sources are included in the directory in this issue.

Cathy Sliva, BlackRock Energy Capital Ltd.

which the capital provider supplied 100% of the capital, with no equity supplied by the project sponsor. The projects relied heavily on drilling, with little to no producing reserves as part of the mix.

TCW has primarily stuck to the debt-styled variety of mezzanine financing, though it has taken on some equity-styled deals on a limited basis, Talbot says. Its newest fund—TCW Energy Fund X—will be focused mostly on traditional mezzanine deals. A minimum of 50% of fund monies will be dedicated to E&P companies. A first closing is expected this month, and the eventual target is $500 million. The preferred E&P deal size is $20- to $40 million.

Mezzanine Energy Lending ($MM)

1996	$1,298
1997	$1,063
1998	$1,175
1999	$667
2000	$1,341
2001	$1,346
2002	$234
1Q 2003	$35

Source: Wells Fargo

Meanwhile, the main focus of GeosCapital, another new mezzanine capital provider, is to offer project equity, says Carl Tricoli, president. The Houston-based capital provider is also willing to do true mezzanine deals, where the debt is layered in the middle of the mix, he adds.

GeosCapital, which is a business of J.M Huber Corp., had not closed any deals as of press time, but was reviewing several. At one time, the capital provider was called Axiom, and it included a risk-management practice.

Serving the mezzanine-capital market for $500,000 to $5 million—which is smaller than the preferred range of many other mezzanine providers—is BlackRock Energy Capital Ltd. The Houston-based firm was formed in the spring of 2002 while other mezzanine providers were being folded by their parents.

BlackRock has seen a few new clients in the past year that normally would have sought money from a larger portfolio, says Cathy Sliva, president and chief executive officer. "There were a few people during the past 12 months or so who have come to us and said, 'I was going to do $30 million with so-and-so, but I really only need $5 million," Sliva says. "That has happened a few times."

For these mezzanine financiers, there are plenty of deals out there that could be good candidates for their kind of funding, says Johnson at Weisser Johnson. First, more development-drilling projects will be required to satiate the growing U.S. demand for natural gas. Second, acquisition activity among smaller independents is showing signs of a rebound, he says.

Mezzanine funding began as a debt-styled instrument, but it has morphed into an equity-styled instrument in some instances.

"So both of the major uses of mezzanine capital, acquisitions and drilling, should be on the upswing going forward."

Keener says a decent gauge of the size of the mezzanine market is acquisitions of $100 million and under—the preferred range for mezzanine financing. That market has been stagnant for two years, as buyers and sellers alike have been waiting for commodity prices to stabilize enough to strike good deals, but Keener thinks the dam of deals is about to burst. "I think that market is coming and is going to come hard."

And as that market comes back, producers are happy to have new options for their mezzanine finance needs. "My phone is ringing off the hook," Keener said. "Clearly, the industry liked what we were doing. Clearly there is a role for us." ■

COSCO Capital Management LLC

Corporate Background:

COSCO Capital Management LLC is an energy-focused investment and merchant bank, specializing in arranging private financing for energy projects and companies. COSCO's technical and operational experience, coupled with its New York/Connecticut base and heritage, makes it unusually well qualified to build sound, sustainable, and profitable relationships between the financial and operational segments of the energy business.

Since its establishment in January 1992, COSCO has worked with most of the professionally managed, U.S. or Canadian-based sources of capital dedicated to, or with a history of, investing in the energy business. Over the past three-plus years, alone, COSCO has assisted investor clients to purchase or sell over $400MM of portfolio companies and has worked with energy companies, themselves, to access over $350MM of private capital (see table below). In addition, during this period, COSCO has worked with over fifty buy and sell-side clients, assisting them with investment strategies, effecting mergers and acquisitions/sales, and generally assessing and improving management practices.

COSCO managing directors Cameron O. Smith, right, and William E. Weidner. Missing is Lane W. McKay, the newest managing director.

In addition to its offices in New York, Hartford, and Stamford, COSCO has personnel and colleagues in Houston, Tulsa, Oklahoma City, Phoenix, and Calgary. The majority of COSCO's personnel, moreover, have worked within the energy business before joining COSCO, and two of COSCO's three Managing Directors have advanced technical degrees in geology. COSCO, therefore, has an unparalleled capacity to source investment opportunities and conduct primary due diligence on individuals, companies, and specific projects, making it one of the preeminent investment banking energy specialists in North America.

COSCO Services

Capital Formation. COSCO specializes in assisting energy companies to raise private capital, particularly corporate equity and project mezzanine debt. Often this capital is sourced from those very

$750Million — Energy Private Placements and Transactions (January 2000—April 2003)

Industry Client	Financing Source/Size	Purpose
Southern Pacific Petroleum N.L. (Brisbane AU) April 2003	Sandefer Capital Partners Secured Convertible Bonds $30MM (US)	Development of Australian Shale-to-Oil Plant
Cannon Energy, Inc. (Tulsa OK) March 2003	Kayne Anderson Preferred Stock $18.75MM (US)	Development of CBM Resources in Rocky Mountains
SKH Energy Fund, LP (Houston TX) January 2003	Various LP Units $40MM (US)	Acquisition of Leasehold & Minerals
Purcell Energy (Calgary AB) Nov, Dec 2002	Crown Capital Partners Inc. And Others $11.2MM (C)	For Exploration and Development in NW Territories and NE BC
Aurora Gas, LLC (Anchorage AK) May 2002	Kaiser Francis Oil Company Common Stock $25.3MM (US)	For Development and Acquisitions in Cook Inlet AK
Carneros Energy, Inc. (Houston TX) May 2001	Warburg Pincus Common & Pref Stock $75MM (US)	For Exploration and Acquisitions in California
Mannix Oil Company, Inc. (Tulsa OK) April 2001	Williams Production $36MM (US)	Sale of Company
Crutcher-Tufts Resources, L.P. (New Orleans LA) July 2000	Aquila Energy Secured Notes $76.9MM (US)	For Private Partnership's Infill Drilling Program in California
Action Energy Corporation (Calgary AB) June 2000	Natural Gas Partners Common Stock $7.2MM (C)	For Private Canadian Exploitation/Development Company
Mannix Oil Company, Inc. (Tulsa OK) January 2000	Shell Capital Inc. Secured Notes $40MM (US)	For Coalbed Methane Development in Arkoma Basin

Capital Source/Client	Transaction Size	Purpose
Morgan Stanley Private Capital (New York NY) December 2002	$200+MM (US) (Exact Amount Not Disclosed)	Purchase of Aquila Oil & Gas Mezzanine Portfolio
Emerging Markets Partnership (Washington DC) August 2000	$30.7MM (US). Common & Pref. Stock	Investment in PAE Mauritius Ltd for Development and Acquisitions in Africa
Warburg Pincus (New York NY) April 1999	(Not Disclosed)	Sale of Canadian Portfolio Company

professional investors to which COSCO has provided advisory services. This establishes immediate credibility for COSCO's clients, but also imposes considerable responsibility and discipline on COSCO's selection of the entities, and particularly the management teams, it represents. COSCO ensures that each client has a realistic appreciation of its own value in the private marketplace and understands the full range of financing structures acceptable to the Private Capital community. COSCO assists clients to prepare necessary descriptive documents and marketing materials, arrange meetings with financing candidates likely to appreciate them and their business plans, negotiate term sheets and agreements, and close financings on terms fair to all stakeholders. COSCO typically invests in all equity financings it arranges.

Advisory. COSCO provides financial, investment, and organizational advice to both professional investors and oil and gas companies, alike. For investors, these services include consultation on investment strategies and execution, specific due diligence, and intelligence regarding peer competition. Clients have included Warburg Pincus, Morgan Stanley Private Capital, Lime Rock Partners, and Emerging Markets Partnership, among others. For companies, services include generational succession planning and financial and business advice designed to focus managements on their own competitive advantages, business opportunities, and financing potential. Advisory clients within the Industry include Shell Canada, Arena, Tufts, Novus, and Momentum, among many others.

In the COSCO team are, seated from left, William E. Weidner, and Cameron O. Smith. Standing, from left, are Reva White, Scott Kessey, Christopher Tasik, and Sharon Younger. Missing: Lane W. McKay (in Canada).

Mergers & Acquisitions/Divestitures. Because its personnel and strategic partners are located in almost all of the principal energy centers of North America, COSCO is well positioned to match industry clients with acquisition, divestiture, or merger candidates on a negotiated basis. COSCO's senior management members, moreover, have years of industry experience, permitting it insights into management and projects that often elude Wall Street or Bay Street investment bankers. COSCO's experience in structuring deals and in raising capital is often crucial in completing successful transactions.

Management. COSCO personnel have occasionally assumed interim responsibility as officers and directors of companies requiring restructuring or remedial action. Members of COSCO's senior management have started, built, and managed successful energy companies in the U.S. and Canada. On behalf of clients, they have managed bankruptcies, as well as major reorganizations. As a result, COSCO is particularly effective for financial stakeholders who require alternate management perspectives, implementation of transition strategies, or experienced board members to oversee their investments.

Research. COSCO maintains current information on over one-hundred professional investors active in energy investment. These include energy specific funds and affiliates of corporations that allocate budgets each year to finance energy projects or provide capital to energy teams. COSCO is the only firm that through questionnaires and annual conferences collects critical data on these investors regarding their current investment criteria, capital availability, and investment activity. COSCO also has developed a calling base of over 500 institutional investors that regularly invest in energy, principally through these funds.

Education. From the outset, COSCO has worked diligently to inform the energy industry in the U.S. and Canada about the virtues of private capital. COSCO personnel write a quarterly column on private capital for *Oil and Gas Investor* and regularly contribute articles and interviews to it and other industry publications. COSCO has founded three annual private capital conferences, two of which it continues to host each year in Houston and Calgary.

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Banking on Debt

You may meet more fellow E&P executives in line at the bank this year, wanting to finance some of the many producing-property deals that are coming on the market.

ARTICLE BY BRIAN A. TOAL

Compared with the previous five years, 2002 was absolutely anemic in terms of investment-grade loan volume in the oil and gas sector. It totaled only $28 billion—less than half a prior-year volume of $57.3 billion and the weakest level of activity since 1997. In sharp contrast, 2002 loan volume for non-investment-grade borrowers hit $27 billion—the highest level in more than a decade.

"Last year, overall M&A activity in the oil and gas sector plummeted, resulting in a meager $7 billion worth of total loan volume versus $22 billion the year before—so that explains a significant part of the sharp decline in 2002 investment-grade lending volume," says Jim Davis, president and chief executive officer for Loan Pricing Corp. (LPC). The New York-based firm collects, analyzes and publishes loan-data activity across all industries. Its data on the oil and gas industry includes aggregate loan volume across five sectors—E&P, oil service, pipelines, refining and integrateds.

1Q-4Q 2002 Domestic Oil & Gas Lead Arranger Volume

Rank	Bank Holding Co.	Lead Arranger Volume	# of Deals	Market Share
1	JPMorgan	$18,062,290,000	40	33%
2	Bank of America	8,767,700,000	30	16%
3	Citigroup	5,279,900,000	13	10%
4	BANK ONE Corp.	4,403,000,000	45	8%
5	Lehman Brothers	2,925,000,000	4	5%
6	Wachovia Securities	2,490,850,000	11	5%
7	RBC Capital Markets	1,400,000,000	2	3%
8	FleetBoston	1,260,000,000	7	2%
9	Barclays	1,250,000,000	1	2%
10	BMO Nesbitt Burns	1,100,000,000	5	2%
11	Credit Suisse First Boston	1,096,500,000	4	2%
12	Credit Lyonnais	773,149,000	3	1%
13	Deutsche Bank	740,000,000	2	1%
14	TD Securities	602,680,999	4	1%
15	Wells Fargo & Co.	524,228,396	12	1%
16	Royal Bank of Scotland Plc	500,000,000	2	1%
17	ABN AMRO Bank N.V.	460,000,000	2	1%
18	SunTrust Bank	460,000,000	4	1%
19	Union Bank of California N.A.	447,500,000	5	1%
20	Commerzbank AG	437,500,000	1	1%
21	UBS Warburg	425,000,000	2	1%
22	BNP Paribas	308,000,000	4	1%
23	Hibernia Corp.	235,000,000	3	0%
24	Mizuho Financial Group	170,000,000	1	0%
25	PNC Bank	153,500,000	3	0%
26	Scotia Capital	150,000,000	1	0%
27	Bank of Oklahoma N.A.	145,000,000	2	0%
28	CIBC World Markets	142,680,999	2	0%
29	Fortis Bank	135,000,000	1	0%
30	U.S. Bancorp	130,000,000	2	0%

Source: Loan Pricing Corp.

"Also, there was a lot of uncertainty in the market in 2002—about how long oil prices were going to stay at artificially high levels, about the instability in the Middle East and about the direction of the economy," says Davis. "In such an environment, borrowers didn't want to run out and put on more debt."

In addition, the banks themselves last year showed that they're no longer interested in lending the way they once did, he says. "There are fewer banks around versus six years ago, and more of them have been scrutinizing what their real risk-adjusted returns are, and whether the loans they're making are meeting the internal hurdle rates they've set. A byproduct of this in 2002 was lower loan volume—with respect to all industries."

Why then the bounce last year in non-investment-grade oil and gas loan volume? "There was an increase in restructurings in that market in 2002—by troubled diversified energy companies, leveraged refineries, and pipeline affiliates of distressed utili-

Tod Benton, JPMorgan Chase

ties—and these deals were often quite large relative to normal non-investment-grade borrowings," explains Meredith Coffey, senior vice president and director of analytics for LPC.

Her oil and gas loan-volume outlook for 2003? Within the non-investment-grade sector, it could move higher. "We see troubled utilities and diversified energy companies disposing of assets that might be attractive to independent oil and gas producers, and many upstream buyers may use bank debt to finance those purchases."

However, in the investment-grade oil and gas market, further retrenchment in loan volume is likely, says Coffey. "The larger companies will likely continue to shift their financing needs to the bond market. At the same time, banks will remain reluctant to lend where they're not getting enough return on relationship dollars."

Market share

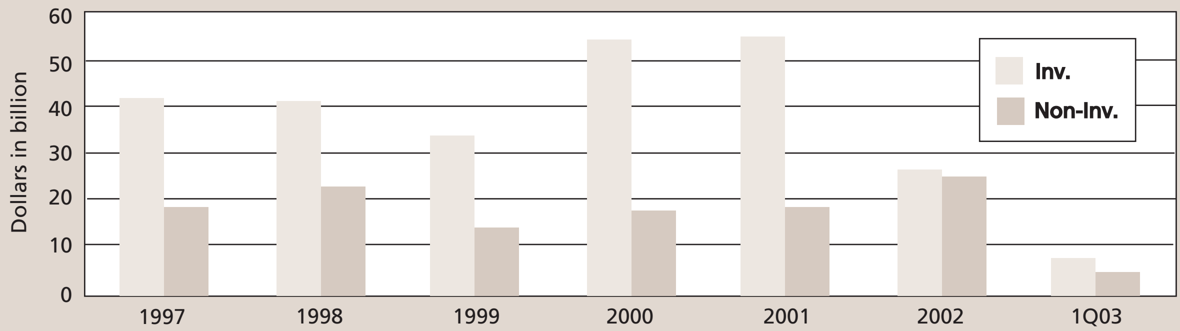
While top-ranked JPMorgan Chase lead-arranged $18 billion worth of oil and gas loans in 2002, that volume was well off its $27-billion level of comparable activity in 2001. "Clearly, the sharp drop in M&A activity in 2002 was one of the main causes for the decline," says Tod Benton, managing director and co-head, oil and gas and power, syndicated and leveraged finance, in Houston.

Another factor dampening the bank's 2002 loan volume: many of its oil and gas clients elected to access the highly attractive public bond market and term out a lot of debt to reduce their reliance on the bank market.

Looking ahead, Benton sees oil and gas loan volume possibly increasing in the investment-grade sector as many large clients continue the trend of moving away from 364-day facilities to multiyear credits. "While a typical three-year facility might cost more to execute, many companies don't want to deal with market risk every time they roll over a 364-day facility." Not only could interest rates change, but also the bank market could change, in terms of borrowers being able to access that kind of capital at reasonable costs.

On the non-investment-grade side, the banker is sanguine that oil and gas loan volumes will likely edge up in 2003 as M&A activity picks up again. "The majors are really focused on profitability, not so much on production and reserve growth any more—so they're looking to sell non-strategic E&P assets," explains Benton. "In addition, we're seeing many merchant energy companies having to divest upstream assets to shore up their balance sheets. I expect that to continue throughout the year."

1997-2002 Oil and Gas Loan Volume



In most years, loan volume for investment-grade companies out-paced non-investment-grade volume, but bankers expect the latter to increase in 2003.

In 2002, JPMorgan Chase did $15 billion worth of investment-grade oil and gas loans; $3 billion in the non-investment-grade market. In first-quarter 2003 alone, the bank's loan volume in the latter sector had already reached $2.8 billion while lending in the former sector was slightly above par for first-quarter 2002, at $4 billion.

Besides anticipating higher oil and gas loan volume this year, the bank is also expecting improved profitability from its various financial services.

"Historically, the loan product has been priced below where it needed to be to provide us adequate returns," says Benton. "We're now trying to lead the way, in terms of getting compensated at levels that make sense for providing capital."

For instance, the bank has selectively gone out to the market with a relative-value pricing concept, which ties the pricing on drawn amounts of loan commitments to bond spreads. "It's simply an attempt to make the loan product attractive to the bank market again, in terms of return on capital."

Growing portfolio

Unlike many money-center banks, Wells Fargo & Co. doesn't focus on lead-arranging multibillion-dollar, investment-grade oil and gas loans. "Rather, we focus on middle-market, non-investment credits for E&P, oil-service and midstream companies," says Tim Murray, executive vice president and manager of the bank's energy group in Houston.

"Understandably, this isn't something that's readily apparent when looking at league tables because 'oil and gas' loan volumes actually are an aggregate of credits across five different industry segments, each of which involves very different types of financing and deal structures."

Looking behind LPC's numbers for 2002, 60% of Wells Fargo's $524 million of lead-arranged oil and gas loans were for oil-service companies; 15%, for E&P companies; and 25%, for midstream operators—virtually all of them non-investment-grade clients.

"While the overall oil and gas syndicated loan market last year was off versus the prior year due to fewer megamerger transactions, our 2002 loan volume was up slightly from 2001," says Murray. "That's because we gained market share in the oil-service sector and, to some extent, in the E&P sector."

This year, he expects to be even busier in the service sector—there are few banks active in that area. Also, 2003 loan volume in the upstream should increase as the majors and large independents begin divesting more assets and smaller producers look to finance the purchase of those assets, he says.

Recently, the bank's A&D group, Wells Fargo Energy Advisers, handled a large asset divestiture for BP in the San Juan Basin and another BP sale of properties in the Rockies, Oklahoma and the Gulf Coast. Concurrently, the bank has seen its loan volume spike as the result of consolidations in the service sector, as well as the financing of midstream companies that are acquiring assets from merchant-energy companies.

Tim Murray, Wells Fargo

Bankers think loan volume for non-investment-grade companies will increase in 2003, especially if M&A activity picks up.

Says Murray, "Through first-quarter 2003, we've already arranged $174 million of oil and gas loans, with the average deal size moving up to $60 million versus $44 million last year."

However, the real profit opportunity for Wells Fargo this year lies in oil and gas mezzanine financing. (For more on this, see "Mezz Money" in this issue.)

"A lot of merchant-energy companies have exited the mezzanine-capital business, with Duke Energy being the latest," says the banker. "Our mezzanine and equity capital group, Wells Fargo Energy Capital, is prepared to fill that void. It provides higher-return, nonrecourse project financings, in the $1- to $20-million range." ■

Weisser, Johnson & Co.

Corporate Background

Weisser, Johnson & Co. is a leading investment banking advisor to oil and gas companies and other energy companies on private equity and mezzanine financing, and assists in property sales and merger transactions.

The two co-founders offer clients extraordinary experience in energy investment banking, spanning a combined 54 years, 30 of them on Wall Street. Prior to forming Weisser Johnson, they had successful careers with top firms: Goldman Sachs, Merrill Lynch, Morgan Stanley, and Bear Stearns. Additional professionals bring experience in the oil industry, petroleum engineering, and energy consulting. This team has successfully completed deals with clients spanning the spectrum from private start-ups to large public companies in the upstream, midstream and service sectors.

Private Financings and A&D

Weisser Johnson arranges private placements of equity, project and mezzanine financing, and senior and subordinated debt with institutional investors. The firm also acts as advisor on mergers, property sales, and acquisitions.

Weisser Johnson has raised over $300 million of financing, and has advised clients on over $500 million of mergers and sales. Financings are typically between $15 million and $50 million, but the firm has completed larger and smaller transactions.

The firm helps clients assess valuation and a financial investor's or buyer's likely perception of risk profile and of a business strategy's strengths and weaknesses. Weisser Johnson then advises a client on the financing or marketing approaches most likely to bring success, and helps to package and present their story in a way that will attract the greatest interest from the targeted market. The goal is to bring multiple investors or buyers to the table in order to receive maximum value and to choose a counterparty that best fits the client's needs. Focused targeting and optimal presentation are even more important than ever in the current challenging environment.

Client Profile

A&D clients are private and public energy companies of all sizes seeking to grow and/or optimize their asset portfolios. Financing clients are often small to mid-sized independents and other energy companies seeking capital to fund accelerated growth, focused on specific niches of expertise. Equity investors usually expect a rate of return of at least 25%-30% and focus on finding a management team with a demonstrable record of success in making money with a strategy similar to the proposed business plan. Mezzanine investors concentrate on drilling projects and acquisitions with high quality development and exploitation opportunities, usually with some existing production, where they

From the left, David Taylor, Scott Johnson, Frank Weisser and Lynn Bass.

Examples of Recent Deals

Sago Energy	$38 million preferred equity and senior debt for midstream acquisition
Tarpon Offshore	$15 million senior debt with equity kickers for offshore acquisition and development
Osprey Petroleum	$51 million mezzanine (debt with royalty) for offshore exploration and development
Tipperary	$22 million mezzanine for development of Australian coal seam gas project
Antara Resources	Sale of substantially all of the company's assets, in Colorado and on Gulf Coast

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Weisser Johnson

Banking Tales

Three small and midsize independents talk about the state of oil and gas commercial banking.

INTERVIEW BY BRIAN A. TOAL

The world of oil and gas lending has changed dramatically during the past five years. With so many consolidations, the commercial-banking world has shrunken dramatically. Just what do small and midsize E&P companies think of all these changes?

To find out, Oil and Gas Investor *recently talked with the heads of three independents: Mark Hellerstein, chairman and chief executive officer of St. Mary Land & Exploration Co., a publicly traded, midcap Denver-based operator; Paul Dougan, president and CEO of Equity Oil Co., a small-cap Salt Lake City-based independent; and Tim Leach, chairman and CEO of Concho Resources, a privately held Midland, Texas-based producer.*

Their remarks are both candid and constructive.

Investor Mark, what trends have you noted in lending to oil and gas producers during the past five years?

Hellerstein The biggest trends have been the consolidation among commercial banks and with investment banks. That has resulted in a number of changes, with respect to the nature of lending itself and lenders' relationships with their customers.

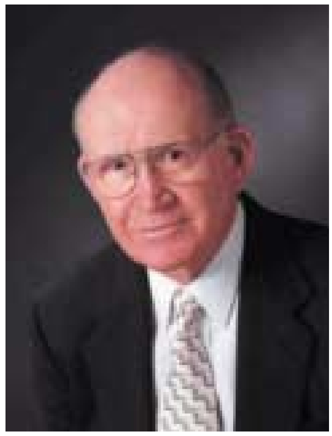
Today, commercial banks are trying to steer borrowers towards more high-margin investment-banking services. Also, cost pressures have caused many banks to restructure their services and let people go. Now, there are fewer bankers per number of customers—and that has changed the personal nature of banking.

In addition, the lending limits of consolidated banks haven't grown proportionately with the new, larger sizes of those banks. Generally, most banks' hold positions are still limited to $25- to $50 million, even though the size of many of them has doubled. With fewer banks out there, this makes it harder to put together a larger syndication amount.

Investor You say the relationship nature of banks has changed. Elaborate.

Hellerstein The lending process of some banks has become very mechanical. The relationship manager just passes the reserve report along to the engineers and they come back with a borrowing-base number—and that's pretty much the extent of the "relationship."

There are, however, a lot of qualitative components to a reserve base and to a producer's management, strategy and track record, which tend to get overlooked. And these components are very important, particularly if there's a downturn in the industry and normal borrowing bases are exceeded.



Paul Dougan, Equity Oil

Investor Paul, you've served on two bank boards. What recent trends have you noticed?

Dougan Like Mark, we see fewer banks around today in the E&P business. In fact, our former bank left the energy-lending business, so we had to get a new one—and finding a lender wasn't easy, given that oil and gas prices at the time were low.

But even though some banks have moved out of energy and others have consolidated, I believe producers like ourselves are still being served well.

Investor Tim, you started your career as an energy lender. What's your take?

Leach Mark and Paul make good points. The trend toward banking consolidation has translated into fewer lenders. Also, as has been noted, just because two banks with $50-million hold levels combine, that doesn't necessarily mean that the new, merged bank will have a $100-million hold level. Simply put, major energy lenders aren't using their balance sheets to hold loans the way they did five years ago.

Investor How does that affect small, private producers?

Leach If you're trying to pull together a large bank facility for a major acquisition, you're now going to need more banks involved than ever before—at a time when the universe of energy lenders has shrunk.

Investor Is it easier or harder to get a loan now than five years ago?

Dougan It may be a little harder, simply because there are fewer banks, plus there may be some aversion by lenders to back smaller E&P companies. However, if an operator has a good balance sheet, good properties, a good story and a good use for funds,

Mark Hellerstein, St. Mary Land & Exploration

then it's not any harder to borrow than before.

Hellerstein The ability to borrow really isn't all that different from before. But because there are fewer competing banks out there and because we've grown in size, we've had to move from "club" deals, where maybe two or three banks are involved, to syndicated relationships.

And the change we've seen there is the commoditization of bank terms, that is, loan agreements can't be tailored quite as much to a producer's specific needs—they've been made more standardized so that other banks can be brought in.

Leach From my perspective, the ability for small independents to get loans hasn't really changed in the past five years. Loans are still based on a producer's credit quality.

Investor What lending criteria are banks using today with respect to producers?

Dougan Banks want a producer's asset base to be 60% to 70% proved developed producing (PDP) reserves. They want to be very certain they bank as solid an operator as they can. And if a producer has a fairly high component of proved undeveloped (PUD) reserves, they want to know that there's a well thought-out plan for developing those reserves and adding them to the PDP column.

Investor What kind of advance ratios on reserve-based loans are banks typically using today?

Dougan Typically, they'll accept 100% of the value of your PDP reserves, then advance 50% to 60% of that amount. For PUD reserves, they might accept 50% of the value of those reserves, then advance about half that amount.

Hellerstein The actual reserve-based lending criteria of banks during the years hasn't changed all that much. However, whereas banks have historically tended to offer borrowers other financial services such as cash-management and hedging products, they're now looking to offer clients investment banking.

And if they see that the customer doesn't want those services, they may conclude that providing straight lending and traditional relationship services may not be enough to support the returns they're now seeking.

Also, banks are now trying to make the lending product more profitable on a stand-alone basis. While interest-rate spreads haven't changed all that much, there are more front-end fees on loans and the loan period has been shortened, so that you have to renew your loan more often. As such, front-end fees become more expensive when amortized over shorter periods.

Investor What kind of front-end fees are you speaking about?

Hellerstein Arrangement fees for arranging or syndicating a loan.

Investor Tim, what criteria do you see banks using today in their upstream lending?

Leach They prefer to have borrowers that are growing their companies—not liquidating them—because a growing company is a healthy company. In particular, lenders look for operators with sufficiently strong cash flow to not only pay the interest on a loan, but also to pay off the loan on time.

Also, with such companies, they see the opportunity to provide more financial services than just loans, including M&A advisory and investment banking.

Investor Paul, do you find banks encouraging borrowers to use more fee-based services, apart from straight lending?

Dougan Yes, they're always looking for ways to earn more fees, by handling such things as cash-management and foreign-currency transactions. In Equity Oil's case, our bank last year required us—as the result of a major acquisition we made of California gas properties—to hedge about 50% of our production for a period of time.

Although we could have used any counterparty for that hedge, we used the bank's commodities group—which they very much encouraged—and got as good a transaction as we could have anywhere.

Leach An oil and gas loan gives a bank the opportunity to describe and offer the other financial products and services they have, but I can't say that I've seen them insist on linking those services with their lending product.

Investor Overall, are the terms and pricing of bank loans today much different than they were five years ago?

Dougan Generally, the terms of the loan covenants are about the same, but loan interest rates are a lot lower today. We have the choice of borrowing at Prime or Libor (London Interbank Offering Rate) plus 225 basis points—which makes for very cheap money. But that varies, depending upon how much we've drawn down on our loan facility.

Another difference we're seeing is taking place in the syndication market. Banks are looking to make

smaller bets on any given company—even smaller ones like ourselves—to limit their loan-risk exposure.
Leach We, too, haven't seen much change in loan terms during the past five years. As a rule of thumb, banks still want operators to have the capacity to pay off a loan within the half-life of their oil and gas properties, that is, the period of time it takes for those properties to produce one-half of the cash flow they would generate over the life of those properties.

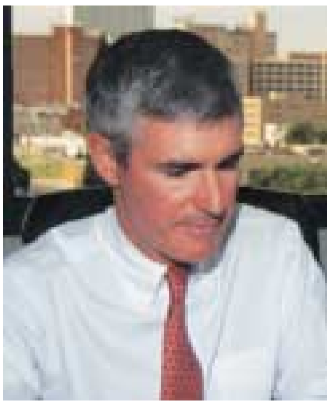
Investor Would you like to see longer loan maturities?
Leach No. Our philosophy has always been to try to maintain excess borrowing capacity with our banks, meaning that we can always go back to them and draw down more money if we need to or think it's appropriate.

Investor What commodity-price decks are banks now using, and are those decks realistic?
Dougan Bank price decks are significantly below market prices. In the case of oil, it's a few dollars below the forward curve for that commodity for the balance of the year; in the case of natural gas, it's around $2 below the one-year forward strip.

Is this conservative? It is. But if I were on the bank's side of the table, I would probably use similar prices.
Hellerstein Paul's right. Generally, the price decks of banks probably aren't as aggressive as recent 12-month strip prices. For 2003, they're probably using a $4.50 gas price, then $3.50 to $3.75 in future years. On the oil side, $22 to $25 for this year.

That said, when one looks at the combination of their price decks and the percentage of reserves banks are willing to lend on, they're walking the line well between providing producers reasonable levels of credit and not taking losses on reserve-based loans, even during downturns.
Leach We also see banks tending to trail the forward strip in their price-deck assumptions. Recently, they've been using $21 to $22 oil prices for 2003, with a 3% annual price escalation thereafter.

For natural gas, they've generally been using a price of $3, with subsequent prices rising 3% annually. While some may feel those decks are a bit too conservative, we think they're just about right. You have to keep in mind that banks tend to have longer memories than oil and gas operators and are very conscious of commodity-price volatility.


Tim Leach, Concho Resources

Investor What would you like to see lenders do more of—and less of?
Leach There isn't anything I'd like to see banks do differently. They're very capable of assessing risk and evaluating whether a company is well run and creditworthy. If I've seen any change in the past five years, it's that they've gotten even better at doing this.

Investor Mark?
Hellerstein We look to the banks for excellent service in managing a loan and beyond that, good operational cash-management and trust services, as well as helping us identify potential acquisition opportunities.

However, for this to happen, there has to be a very strong personal relationship between the lender and borrower. Not only does that help the bank in identifying possible business opportunities for a client, but also it creates a level of trust, such that when there's a downturn, the bank knows enough about the client—quantitatively and qualitatively—to help solve a problem without overreacting to it.

Investor And what should they do less of?
Hellerstein The banks need to get a decent return on their capital, just as producers do. And I have no problem with them offering a variety of financial services. But when they get overly motivated and focused on selling services—and those services become an implied condition of maintaining a lending relationship—it can destroy that relationship.

Investor Paul?
Dougan I'd like to see more stability in their lending-officer groups. I'd like to know that people assigned to my account are going to be around for a while. Also, while we currently have a three-year credit facility, we'd prefer to have a slightly longer term because by the end of the second year, we have to start thinking about negotiating for loan renewal the following year. However, the banks don't seem willing to go out past three years for a revolving credit.

In addition, if there were a very standardized way that loans could be made to producers, across the board from bank to bank, the banks might be able to take packages of loans—much the same way mortgage loans are bundled by the likes of Fannie Mae and Freddie Mac—and turn them into a security that could then be sold to a broader base of investors.

Investor What impact might that have?
Dougan It might make more credit available to smaller companies, that is, better advance ratios on a particular class of assets, and on possibly better interest-rate terms, because the loan risk would be shared by a broader base of investors. ■

Comerica Energy Finance Group: Still Focused on Lending

Comerica's Energy Finance Group has financed the independent producer sector in North America since 1977. Comerica has remained consistently committed to the independent producer market throughout the many cycles the industry has endured over this period.

Additionally, Comerica has expanded its focus on energy lending to encompass other segments of the oil and gas industry. Last year, the bank hired manager Mona Foch to establish a group focused exclusively on the oil field services market in Houston and the Gulf Coast. Although active in the midstream sector for a number of years, Comerica has also significantly expanded its recent level of commitments in this area and is looking for more opportunities within the pipeline, gathering, processing and storage industries.

Another unique feature that Comerica offers to the energy industry is full-service commercial banking in Canada. Comerica has a long history of banking in Canada through its branch in Toronto and the US Energy group retains responsibility for all upstream finance activities in Canada. "The bank's Energy Finance Group provides funding in Canada for both U.S. and Canadian-based customers, to support upstream and midstream operations north of the border. We view this as an active and attractive oil and gas province, and we are excited about the possibility of expanding our presence in the marketplace," says Mark Fuqua.

The current low interest rate environment is another positive for Comerica's energy lending focus. "The cost differentials for commercial loans versus other financing methods, such as mezzanine and equity, are significant and the time is now to lock in those low rates," says Mark Fuqua.

In addition to providing credit to the industry, Comerica also offers its customers a full range of traditional banking products and services, from state-of-the-art treasury management services, to interest rate risk management products, trust services, and personal financial services.

Mark Fuqua

Dallas based Matador Petroleum, a privately held exploration and production company with operations in the Permian Basin and East Texas, is a good example of a Comerica assisted success story. A decade ago, Comerica made an initial $5 million loan to Matador, and the firm has repeatedly turned to Comerica to help finance its expanding asset base and increased level of drilling activity over the years. This relationship has culminated to date in a $100 plus million credit facility that Comerica has successfully arranged and syndicated to the energy bank market.

Another recent success story illustrates Comerica's ability and commitment to assist start-up operations in creative and innovative ways. Rockford Energy Partners, LLC of Tulsa was formed in 2002 by Chuck Perrin. Rockford was formed as an acquistion company with minimal initial assets, but with significant equity support. Comerica put in place a bank facility that would accommodate the company as it made asset purchases as well as provide some level of financing based on the support provided by Quantum. The Company has made three significant acquisitions to date, all financed under the Comerica facility, which has grown to over $20 million in credit commitments.

Comerica assists the strong management teams of companies like Matador and Rockford with its own top-notch managers and client relationship officers in the Energy Finance Group. Mark Fuqua has over 20 years of experience in the industry and Charles Hall, with 18 years of experience, manages the Houston office. With a veteran lending team, strong internal engineering staff, and local decision-making, Comerica is well positioned to serve the lending needs of the domestic energy industry.

Much of Comerica's 153-year history has been built around support of manufacturing and heavy industry as the bank grew with the development of the automotive industry in Michigan. As Comerica Bank expanded into other markets, such as Texas, banking the oil and gas industry turned out to be a natural fit. The cyclical nature of the auto industry prepared Comerica well for the challenges in financing companies like those in energy. This commercial lending culture has been recognized nationally, with Comerica ranked as the number one bank holding company in the U.S., in terms of loans as a percentage of total assets. * In 2001, 48% of Comerica's assets were found in commercial and industrial loans.

With $55.8 billion in assets, Comerica has the size, expertise and resources needed to continue serving the financing needs of the North American oil and gas industry.

Mark Fuqua
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Canadian Dollars

Funding start-ups still dominates Canadian energy-finance activity, in the growing shadow of the oil and gas royalty income trusts.

ARTICLE BY BRIAN A. TOAL

It's not exactly a bulletin that robust commodity prices during the past 18 months and attendant strong producer cash flows have had a dampening effect on the demand for bank debt.

Indeed, while syndicated lending accounted for 50% of all funding for North American oil and gas companies in 2002—to the tune of US$55.1 billion—that was considerably below the US$77 billion of credit demand generated by the sector during 2001.

Given generally sluggish stock prices within the sector during the same period, an aversion by cash-flow-rich E&P companies to issue shares in that environment, and investor skittishness about the sustainability of $30-plus oil prices, 2002 was also a lackluster year for public equity deals—except in Canada. There, oil and gas income trusts had no trouble raising capital.

In 2001, there were about C$2.2 billion worth of oil and gas deals within the Canadian public equity markets, mainly for income trusts, says Chris Fong, managing director and head of global energy credit for RBC Capital Markets, Calgary. Last year and through first-quarter 2003, C$4.1 billion worth of oil and gas equity deals took place in Canada, with much the same emphasis, he adds.

"Institutions and retail investors, in particular, are increasingly turning to this tax-advantaged, yield-oriented investment product. This is true not just of Canadian investors, but also U.S. investors."

RBC Capital Markets, which during 2002 and first-quarter 2003 led or comanaged C$1.8 billion of equity offerings for Calgary-based oil and gas income trusts, completed two crossborder trust transactions last fall. These were a lead-managed C$282-million offering for Penngrowth Energy Trust and a comanaged $207-million offering for Enerplus Resources Trust.

Concurrently, it advised Nal Oil & Gas Trust on the purchase of producing assets from Calpine and lead-managed for that trust a C$45-million equity financing. This February, it led a C$144-million equity offering for ARC Energy Trust.

The appeal of trusts

The publicly traded oil and gas income trust is designed to own producing assets, to manage the production of those assets efficiently—minimizing costs—and to pay out to investors an average 85% of the trust's cash flow stream, with a cash-on-cash yield currently in the range of 15% to 23.5%.

Chris Fong, RBC Capital Markets

One of the principal reasons why the trust is such an efficient capital structure is that it doesn't pay any income tax. No income tax accrues until money is distributed to investors, explains Gordon Ritchie, managing director, RBC Capital Markets, Calgary. This is in contrast to the corporate structure, where investors are paid from after-tax earnings, and these dividends are taxable again, at the investor level.

Meanwhile, because a trust's cash distributions are treated as both a return of capital as well as a return on capital, the investor pays current-year tax only on that portion of the distribution that is deemed return on capital. The tax on that portion of the distribution deemed return of capital is deferred until the investor sells the trust's units. In addition, the investor stands to benefit from any market appreciation in the price of the trust's publicly traded units.

Says Ritchie, "Because interest rates are still declining in the U.S., investors there are hungry for a high-yield investment product such as this."

Ritchie sees oil and gas income trusts in Canada as a growth area for the next couple of years. "As large producers continue to high-grade their asset portfolios, they'll sell those assets they've fully developed to these trusts. That, in turn, will cause the trusts to turn to the public capital markets—both equity and debt—for acquisition financing."

A number of Canadian oil and gas trusts successfully accessed the U.S. debt markets, where they've benefited from more competitive pricing, both in the private-placement market and the high-yield market.

Canadian debt market

The larger Canadian oils, with solid credit ratings and strong balance sheets, have been busy accessing the public debt markets—largely in the U.S.—to extend maturities and fix interest rates at the bottom of the cycle. Meanwhile, Canadian banks are continuing to meet those companies' short-term liquidity needs, including bridging facilities, commercial-paper backup credit lines, and day-to-day operating cash, says Fong.

"Banks, however, aren't prepared any longer to lend for the sake of lending. Rather, they want lending to be part of an integrated financial-services relationship."

Mike Jackson, managing director and industry head, oil and gas and pipelines, for Scotia Capital, Calgary, agrees that Canadian oil-patch financing has been relatively quiet during the past 18 months, except for oil and gas royalty trusts.

Since the backup of the dot-com phenomena, the general equity market has been looking towards more stable investments, in particular yield product—and in Canada that means the royalty and income trusts, along with income funds for other types of industries, he says.

"Investors like the idea that as cash flow is generated by these oil and gas trusts, it's paid out to them right away. Comparatively, the track record of reinvesting cash flows by the rest of the Canadian energy sector hasn't been all that great."

Responding to this market appetite, Scotia Capital is providing what it terms a "full-meal deal" for these trusts. Explains Jackson, "We like to identify [acquisition] targets for them; advise the trust client on the acquisition; underwrite the bank credit associated with it, including any bridge-financing requirement; then lead both the public equity and debt offerings for the permanent funding requirement."

Last fall, Scotia identified KeyWest Energy Corp., a junior Calgary-based producer, as a potential acquisition target for Viking Energy Royalty Trust. It then advised Viking on the C$321-million purchase and subsequently led a C$75-million convertible debenture issue to help provide permanent financing for the buy.

A year earlier, Scotia Capital helped Advantage Energy Income Trust complete its purchase of another Calgary-based producer, this one with oil and gas properties in the Medicine Hat area of Alberta. "Advantage Energy was successful in the bid for the operator, but needed to show proof of financing," says Jackson.

Mike Jackson, Scotia Capital

"They came to us on a Thursday. By the following Monday, we were able to put in front of them a fully underwritten $129-million bank credit to refinance their existing debt with another bank and fund the cash portion of their purchase of the private producer. Subsequently, we completed a $46-million bought deal of equity that refinanced our bank bridge facility."

Art Korpach, CIBC World Markets

Scotia Capital's committed credits to 13 Canadian oil and gas trusts and five pipeline trusts currently total in excess of C$1 billion. Besides the cited Viking and Advantage deals, its 2002 and 2003 underwritings for oil and gas trusts include leading separate C$110-million and C$155-million equity issues for PrimeWest Energy Trust, a C$55-million equity offering for APF Energy Trust, a C$104-million joint issue of convertible debentures and equity for Provident Energy Trust and a separate $55-million convertible debenture issue for Advantage.

Crossborder finance

Scotia Capital is also actively attempting to grow its crossborder, public-debt underwriting capabilities.

"Most Canadian senior producers and integrateds now seek to issue debt in the U.S. rather than the Canadian market because of the availability of longer maturities, larger deal sizes and superior pricing on those transactions," explains Jackson. "Last year, we were in the underwriting group for U.S. debt issues by Canadian Natural Resources, Suncor, Nexen, Husky Energy and Compton Petroleum."

On the private debt side, the managing director notes that a lot of Canadian banks right now are pulling back on lending. "Scotia Capital, on the other hand, considers it a core product and we're planning to grow our lending book this year.

"We're very aggressive on underwriting acquisition credits and syndicating them. Take the case of Canadian Natural Resources. Last year, it called us late on a Sunday afternoon to help them with a C$500-million credit related to their acquisition of Rio Alto Exploration. By midnight, we provided them with a committed term sheet for the whole amount."

As the result of crossborder consolidation during the past four years, much of the middle-tier sector of the Maple Leaf oil and gas industry has been rolled up into larger U.S. entities like Devon Energy, Burlington Resources and Conoco. This means financing that would have previously been done in the Canadian markets is now being done through the U.S.-based parent companies, says Arthur N. Korpach, managing director and

Michael Tims, Peters & Co.

head of Calgary investment banking for CIBC World Markets.

Also, he points out, the bigger upstream projects in Canada such as deep-gas drilling, oil-sands development and East Coast offshore development are suited to larger industry players, many of which are either foreign-owned or have financing outside the Canadian equity and debt markets.

Given strong commodity prices, the need for external financing by Canadian producers has lessened. On top of that, many E&P companies are focused on value and profitability versus production growth. "As a result, they're now more likely to spend within their cash flow limits."

Despite these industry trends that have dampened financing activity within the Canadian oil patch, CIBC is taking advantage of the stepped-up market appetite for royalty and income trusts, which have driven M&A activity and energy equity-financing volumes in Canada during the last two years.

"These trusts offer relatively superior returns in what is generally a low interest-rate environment, with annual yields averaging 12% to 20%" says Korpach. During 2002 and year-to-date 2003, the practice has lead-managed or co-led more than 44% of income-fund offerings across all Canadian industries, including oil and gas trusts.

A recent high-profile financing was the one CIBC did for Canadian Oil Sands Trust in February. It advised the trust on its purchase of an added 10% interest in the Syncrude Project in Alberta, assisted it in raising public and private equity totaling C$752 million to help finance that acquisition, and supported it with debt financing to close the C$1-billion deal, says Korpach. "It was a complete capital solution."

In mid-2002, the capital provider advised Paramount Resources on its C$350-million acquisition of Summit Resources, and on the subsequent creation and unit distribution of the Paramount Energy Trust to corporate Paramount shareholders. As part of its full capital solution, the firm also provided bridge debt financing, which allowed Paramount Resources to complete the Summit acquisition, and was one of the dealer-managers on a C$150-million rights offering by the new fund to acquire additional properties from Paramount.

Junior oils

With a focus on Calgary's junior oils, CIBC last fall provided debt financing and led a C$55-million equity offering of flow-through and common shares for Canadian 88 Energy to fund that operator's exploration and development program and a small asset acquisition.

"We've seen a huge reemergence of the junior oils—both public and private—and we've built a focus on that sector," says Korpach.

Michael J. Tims, chairman of Peters & Co. Ltd. in Calgary, says he is seeing in the Canadian markets the start-up of many private oil and gas companies by seasoned management teams, significant M&A and equity-issuance activity by Canadian royalty trusts, and continuing investor interest in flow-through-share financings.

Because the royalty and income trusts in recent years have been major purchasers of Canadian oil and gas assets, that has meant added M&A advisories for Peters & Co.—to those producers targeted by the trusts. During the past two years, the firm has advised Cabre Exploration on its C$500-million sale to Enerplus Resources Fund, and Ionic Energy on its C$200-million sale to Shiningbank Energy Income Fund.

But around Calgary, Peters & Co. has recently become more known by its investment-banking peers as a leader in advising and arranging for experienced management teams private-equity financing for their new, privately held, start-up E&P companies.

Currently, there are large pools of private capital available to previously successful managements within the Canadian oil and gas sector from conventional institutional investors, such as pension funds and insurance companies; specialized energy partnerships and funds; and individual investors, says Tims.

Accessing such sources, Peters & Co. this January helped raise C$20 million of private equity for Tiger Energy Ltd., a private Calgary-based producer whose management team came from Genesis Exploration. Last year, it sourced C$30 million of private equity for Fairborne Energy Ltd., another private Calgary oil.

Fairborne's management team originally came from Pan East Petroleum, for whom Peters & Co. acted as advisor on its sale to Poco Petroleums a few years earlier, says Tims. This management team subsequently formed Canadian Midstream Services Ltd., a private gas-gathering and -processing company, for which Peters & Co. raised around C$30 million of private equity. Subsequently, that team sold Canadian Midstream to Duke Energy for roughly C$275 million.

In addition, Peters & Co. raised C$24.4 million of private equity last year for Deer Creek Energy Ltd., a privately held oil-sands developer whose management team came from Mark Resources. Concurrently, it arranged for that company another C$27.5 million of private equity for a joint venture with a division of the Enerplus Resources Fund.

Private Capital Sources

During the past two years, Calgary has seen a huge groundswell of private-capital supply for the Canadian oil and gas sector—and an equally abundant demand for such capital. A lot of top-flight management teams, unemployed by the recent wave of consolidations among public Canadian oil and gas producers, have set up new, private, start-up exploration and production companies.

Rather than taking the initial public offering route, these start-ups are being made for an eventual sale to a larger E&P buyer. The private money for getting started is coming from sources that include insurance companies, pension funds and the private-equity divisions of banks.

"A significant number of previously successful Canadian E&P management teams have decided, with their new upstream ventures, to keep those start-ups private until they've grown those entities to the size where they can be sold to a third party, either Canadian or U.S.," explains Cameron O. Smith, senior managing director of Cosco Capital Management LLC, New York.

The energy private-placement and advisory firm co-sponsored an oil and gas private-capital conference in Calgary this past February. "Private capital is far better suited to start-up E&P situations than public capital because it's more patient money for long-term reserve, production and cash flow growth," says Smith.

"Also, private capital in Canada is now available from a surprisingly large number of sources. These are people who made a great deal of money from their oil and gas investments in the 1990s and are currently looking, through individual investments or the start-up of their own private-capital funds, to reinvest again in the energy sector."

Among Calgary-based private-capital funds now being formed, Smith cites Kern Energy Partners, Canadian Energy Equities, Enercap, Overture Capital, Olium West and Jog Capital. "These entities, in aggregate, are in the process of attempting to raise more than C$400 million."

Some Sources of Private-Capital Funds for Canadian Companies

Source	Initial/Available Capital (US$MM)	Investment Range (US$MM)	Investment Preference
ARC Financial Corp.	400/100	5-25	Corp. equities for E&P, oil service, new energy and non conventional energy companies in North America.
Camcor Capital Inc.	120/30	2-10	Corp. equities for early-stage E&P companies in Canada.
Canfund VE II Management Ltd.	80/80	1-10	Corp. equities, debt upstream, midstream and service companies in Canada.
Crown Capital Partners	150/30	1-10	Corp. equities, corp. mezzanine debt for E&P and service companies in Canada.
North West Capital	30/30	1-10	Corp. equities for upstream, midstream, power and non conventional energy companies in Canada.

Source: Cosco Capital Management LLC, New York

In 2001, the investment banker also arranged C$60 million of private-equity funding for Duvernay Oil Corp., a private Calgary-based operator headed by the former management team of Berkley Petroleum.

Says Tims, "We should see some of these entities eventually come to the public market, either through an IPO or merger with an existing public company. At that point, we would hope to again be able to help them."

Another trend in Canadian financing, this one in the public-equity market, is the offering of flow-through shares by many E&P companies. The attractiveness of purchasing a flow-through share is that it allows an investor to claim a tax write-off for the issuing company's exploration and development expenses.

"These shares, which typically come to market every year during the third or fourth quarter, also benefit the issuers," says Tims. Because the shares are tax-advantaged, they can be sold at a 15% to 20% premium to where an issuing company's stock is currently trading. ■

Finance: A Directory

Although not exhaustive, the firms noted here are among known providers of capital to the upstream energy industry. They include commercial banks, investment banks, capital intermediaries and private-capital sources. In some instances, commercial banks are listed once although they may have a non-bank-regulated capital-provider business as well.

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QUANTUM ENERGY PARTNERS

CORPORATE PROFILE

Quantum Energy Partners ("Quantum") is a leading provider of private equity to the energy industry. We invest in oil & gas as well as midstream companies. We consider oil & gas opportunities ranging from acquire and exploit strategies to exploration strategies. Quantum currently has over $325 million in capital under management.

Quantum is an ideal financial partner for successful energy entrepreneurs who want to take advantage of our substantial experience gained as owners, operators, financiers and advisors of oil & gas and midstream companies. Additionally, the Quantum investment team truly understands your business as its principals combine a multidisciplinary expertise in finance and tax, M&A, engineering, geology, geophysics and operations.

Quantum is seeking investment opportunities in the U.S. and Canada. Our target investment size is $10 to $35 million, with the ability to make larger investments when needs warrant. Unlike most other private equity funds, Quantum will invest in limited partnerships or LLC's, which creates significant tax advantages for its portfolio company management teams.

Our investment strategy is to invest in companies that focus on building portfolios of assets that will be attractive acquisition candidates for larger companies, whereby the following are present:

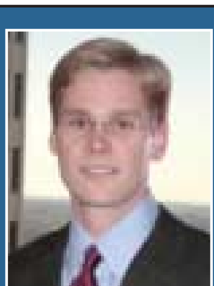
- Proven entrepreneurs with a track record that can demonstrate a history of successful risk/return analysis and capital allocation decisions;
- Entrepreneurial management team that possesses strong technical, financial, managerial and operational capabilities;
- The company has sustainable competitive advantages within a defined geographic region or segment of the industry; and
- Management team that is willing to invest a meaningful portion of their liquid net worth alongside Quantum.

Quantum currently has 11 active portfolio companies, including:

Saxet Energy Ltd.	TriQuest Energy Corp.	Pointwest Energy, Inc.
Meritage Energy Partners, LLC	EnSight Energy Partners, LP	Cougar Hydrocarbons, Inc.
Tri-C Oil & Gas, LP	Rockford Energy Partners, LLC	Linn Energy, LLC
Sago Energy, LP	Denali Energy Partners, LP	

In addition we have successfully realized investments in five other companies, including:

Aspect Resources, LLC	Parks & Luttrell Energy Partners, LP	Crown Oil Partners, LP
Texoil, Inc.	Highpine Oil & Gas, Ltd.	



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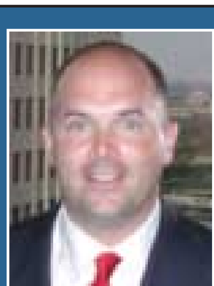

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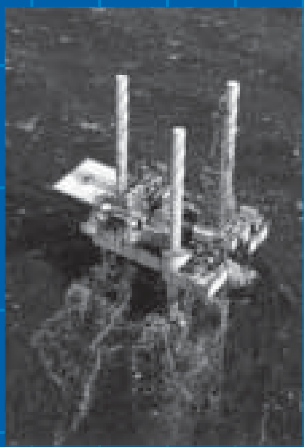

You know what these acronyms stand for.

Does your lawyer?