a Supplement to

Oil and Gas Investor

Here's the Money: Capital Formation 2005

MAY 2005

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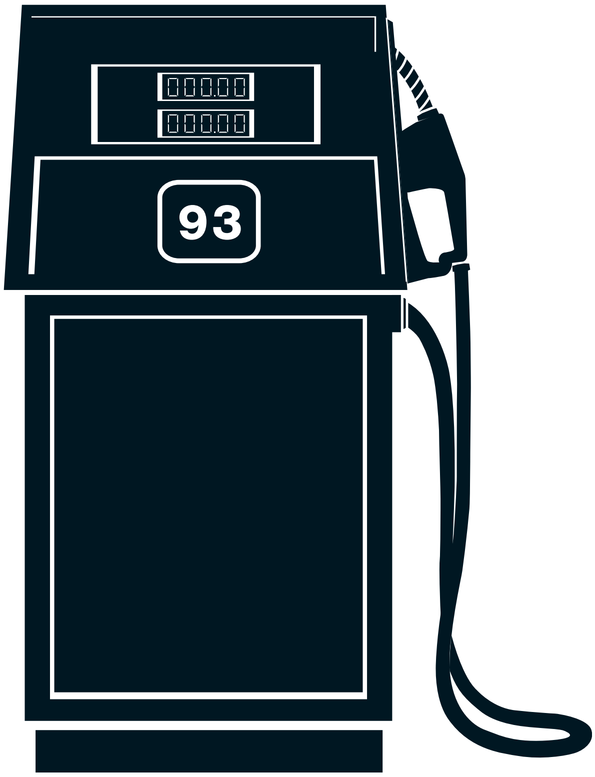
HERE'S THE MONEY: CAPITAL FORMATION 2005

ABOUT THE COVER:
A waterfall near the Citicorp building in New York. (Photo by Lowell Georgia)



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STRETCHING TO GROW

Capital markets for the oil and gas industry are hotter this year than popcorn exploding in your microwave. It appears there is no reason a solid business plan cannot obtain capital on favorable terms.

Dollars for start-ups and well-established producers are more plentiful now than at any time in the past 20 years, between their own robust cash flows and eager energy investors. What's more, that capital is more likely to be available on more generous and flexible terms than in the past.

In addition to being well-armed and poised to do deals, some banks and private capital providers are willing to stretch further than ever before to give collateral value to proved undeveloped (PUD) reserves. "Last year we heard people talking about PUD creep," says one private-equity and mezzanine provider, "but this year, we are starting to hear about 'possibles creep.'"

The flood of capital is fueling a surge in drilling, with the U.S. land-rig count at a 20-year high and greater utilization rates seen in the Gulf of Mexico. Although the acquisition and divestiture market is fast-paced, observers expect it to pick up even more this year, fueled by buyers with plenty of free cash flow or highly valued stocks to be used as currency, and institutional money.

For two or three years now, capital has been flooding into the sector, most recently boosted by the astonishing climb in oil and gas prices during the past six months.

It is not "funny money." Rather, it is smart capital from seasoned investors and capital aggregators who have been in business awhile. They are increasing their exposure to energy—or turning to it for the first time in several years.

In addition, plenty of new private-capital sources have rushed to join the party, such as Vulcan Capital, which is essentially a fund full of Silicon Valley profits started by Microsoft co-founder Paul Allen.

The public-capital markets are healthy too. Several energy-related initial public offerings have been made in the past six months. At press time, already public Chesapeake Energy Corp. announced two private placements with undisclosed investors to raise an aggregate $1 billion to fund its recent acquisitions.

Capital providers are doing more than stretching their deal terms; they are expanding their investment horizons. Long-time sources of private capital such as Warburg Pincus are making forays into smaller E&P names, the midstream, energy technology and international deals, sometimes even coal, in addition to traditional funding of public and private E&P companies.

The smart money is proceeding with caution. One executive, starting his third, private, E&P company since 1999, told us that this time, he intends to hold the company for a while and build it with annuity-type production, rather than "flipping" it in a year or two for a quick profit, as is common these days.

This special report will bring you up to date on what has changed since our Capital Formation report last year, and it contains many helpful points on the type of deals being done, the commercial debt outlook, mezzanine sources and much more.

—*Leslie Haines,*
Editor-In-Chief

To assist in your capital-formation efforts, these are some of the articles that have appeared in Oil and Gas Investor since last year's Capital Formation report.

- Dear Private Equity, Greetings from Hubbert's Peak. A discussion of trends fueling private-equity growth. January 2005
- Capital Clout. The 2005 outlook for public and private markets for debt and equity. December 2004
- From Across the Pond. A look at international banks BNP Paribas, Royal Bank of Scotland and Calyon. December 2004
- Public vs. Private Capital. The roles of public and private equity are complementary. December 2004
- Ladenburg Keeps an Eye on the Little Guy. New York investment-banking firm Ladenburg Thalman returns to energy with a focus on small-cap companies. November 2004.
- Small-Cap Capital. Providers and recipients of public and private capital discuss their recent deals. October 2004
- More Money. A look at some private capital sources' deals and criteria. July 2004
- Climbing the Capital Curve. Profiles of three start-ups backed by private capital. May 2004.

For copies of these issues, or of last year's report, Capital Formation 2004, please contact Jacquari Harris at jharris@hartenergy.com *or (713) 993-9325 x 126.*

PetroInvest

The Private Placement Drilling Partnership Exchange

Steven King, president of PetroInvest LLC

Who We Are

PetroInvest LLC is the innovator of the only Web based exchange that matches private placement drilling partnerships with general securities broker dealers.

Why We Exist—The O&G Company Viewpoint

The micro-cap oil and gas companies drill the majority of domestic wells each year but fly below Wall Street's radar screen. They aren't sharing in the increased availability of capital, which requires a proven reserve base on which to build an equity and debt package.

Many micro-cap O&G firms rely on internal cash flow plus family and friends for their capital needs. Increasing activity past your current financing strength means third party funding. Firms unwilling to live with the reserve-based loan covenants, or those without enough non-dedicated producing properties, have limited options.

These "Sub-Wall Street" firms usually sell all or part of their project to "the industry;" that small group of very knowledgeable drilling capital providers, ranging from individuals up to the larger O&G companies. These sources are willing to fund drilling exploratory projects—but at a stiff price (refer to the Case Studies next page).

Entertaining the idea of partnership funding, many firms found excessive barriers to entry: 1) their buddies don't use partnerships, 2) a fear of securities regulators, 3) the initial start-up costs and 4) becoming associated with a "boiler-room" broker/dealer. With a foundation in both the petroleum industry and the securities industry, PetroInvest is uniquely positioned to solve these problems.

PetroInvest can demystify partnerships—they are just a joint venture or farmout. We guide you to specialized legal and financial service providers. The Web site lowers the cost of marketing. Because we represent multiple partnerships, we penetrate the securities community deeper and with a broader appeal than a traditional wholesaler.

Why We Exist—Investor and Financial Advisor Viewpoint

Most of us with gray hair remember, with some uneasiness, when limited partnerships gave the petroleum industry a black eye during the 1980s. There is nothing wrong with the theory of investing in drilling partnerships. The investor and his registered advisor just need professional, petroleum knowledgeable help. They want the ability to compare multiple opportunities apples to apples.

This is what makes PetroInvest unique.

It isn't that drilling deals went away completely since the '80s. Already this year, the handful of organizers have raised record amounts of partnership capital. But still this is a drop in the bucket of total discretionary funds controlled by the accredited investors.

Many non-petroleum investors and their advisors are just plain afraid. The current marketing system relying on individual wholesalers gathering together a selling syndication is very inefficient and fails to instill confidence. Then there are still the "boiler-room" operations.

The investor wants to feel he is getting a fair deal. PetroInvest brings standardization and transparency to this funding marketplace for the first time. We are setting a high professional standard, especially by our requirement for rigorous independent technical due diligence, which is almost totally lacking out there today.

PetroInvest has developed a 21st century solution to these historical problems. Our compensation is heavily weighted towards production revenue, meaning our best interest is aligned with the investors'—making money from producing O&G, not from the selling of partnerships.

OTHER STRATEGIC REASONS PARTNERSHIPS WORK

Other funding options—After a few successful partnerships, you have a faithful following of brokers and investors receptive to other ideas, including private equity.

Project control—Your partner is an entity you manage vs. an industry player with an independent agenda.

Operating efficiencies—Managing 100% brings savings, operational efficiencies and reduces decision time delays.

Off balance sheet funding—This is normally project financing not a corporate obligation.

Exit strategy—When selling the assets or corporation, the partnership unit holders will normally join in; selling a 100% interest usually commands a higher per Mcf price.

Exit strategy—Before going public, roll up the partnership remaining reserves for company stock, increasing your PV10 value. This is probably the easiest paper acquisition you can make. After listing, these small shareholders will trade your stock—something Wall Street likes.

The Role of PetroInvest—Doing It the Right Way

The PetroInvest business plan is to be a conduit between that large group of micro-cap oil and gas companies and the very large group of registered investment advisors representing the accredited investors.

Using the power of the Internet, PetroInvest brings cost savings to the fund-raising process. This means more of the money raised goes into the ground—or another way to look at it, it means the same amount of money drills more wells, increasing the size of the potential production; thereby making everyone's percentage ownership more valuable.

The PetroInvest system for presentation relies on properly understanding the structure of the deal and its risks, inputting costs and cash flows, and then generating the most likely, risk-adjusted, economic projections. While these projections can not be considered promises, they do allow the opportunities to be compared side by side.

What PetroInvest Is Looking For

More than just the prospect generator, you have to be an O&G operator or be part of a group that can operate.

Multiple independent prospects (each being an initial well, with or without follow-up development wells) organized as a program, or a multiple well in-field program will sell faster. However, the stand-alone prospect can also sell, because the brokers are encouraged to take a portfolio approach when using the PetroInvest system.

The prospect has to be in hand with the pre-drill activity done. Blind pools will not be considered except:

- An exploratory program based on realistic expectations provided 1) it is based on a definable plan such as 3D being interpreted, 2) sufficient open acreage exists or you have lease options, and 3) the technical due diligence team reviews the prospect(s) before release of funds for drilling.
- Acquisition (either for the whole package or as the exploitation portion on top of debt) funds in escrow before an offer is made. Generic economics are used for fund raising but due diligence confirms that the acquisition meets or exceeds that hurtle before release of funds.

What You Get Out of It

A lower cost of money, while providing a real investment opportunity to the non-petroleum investor is the PetroInvest hallmark. Any deal priced above one equal to the NPV of the industry farmout but below one where the investor and the O&G company are have equal NPVs, will benefit you, while still giving the investor an outstanding opportunity.

In the Case Studies below, the O&G company could have more than doubled its NPV using a partnership vs. an industry deal.

How to Proceed

Each deal presentation is hand crafted; therefore, the earlier we get involved, the better. Check *www.petroinvest.com* and then contact Steven King, president of PetroInvest LLC at (713) 667-5692 or at *sking@petroinvest.com*.

CASE STUDIES: Demonstrate the attractiveness of partnerships as a lower cost, drilling capital source. The three deals in each case use the same O&G project, production/revenue and costs. The only difference is the deal.

Case One would be typical of a single, high production rate, multiple zone prospect. The initial risk of a dry hole is high, 25% POS (probability of success), but if successful, three 75% POS development locations exist. Case Two is a 80% POS program of eight in-field locations, which settles into relatively flat production decline after the initial decline.

Risk-adjusted, discounted (at 10%) cash flow analysis was performed. The before tax results shown are net to the capital providers and prospect organizer (after costs, broker commissions, PetroInvest's carried working interest, etc.). EPVI = present value of $1 invested, CoC = cash returned for $1 invested, NPV = net present value, and IRR = internal rate of return, all being risk-adjusted, expected values.

The first deal for each is a third for a quarter at casing point industry deal (0% cost until logging, then 25% working interest including development wells). The second deal analyzed (a flat carried interest in all operations and all wells) gives the O&G operator the same NPV as the industry deal. Third, we calculated the partnership terms (a smaller carried working interest converting to a larger working interest after the investor's payout) needed for equal NPVs for both the investor group and the partnership organizer.

	Deal		Unrisked Gross Project	Mcfe Reserves Risked	Investors or Farmin O&G ------Before Tax------ EPVI	COC	NPV	IRR	Mcfe Reserves Risked	Prospect Organizer ------Before Tax------ EPVI	COC	NPV	IRR
Case #1	1/3 for 1/4 @	bbl	0										
High	casing	Mcf	27,438,082	3,170,191	3.44	4.95	$8,584,759	101%	1,058,290	2.76	2.77	$1,945,162	39%
Risk	10.50%	bbl	0										
25% 75% POS	Carried WI	Mcf	27,438,082	3,433,073	2.83	4.49	$7,701,697	59%	511,860	4.97	45.41	$1,953,339	515%
High	5% BPO	bbl	0										
Reward	40% APO	Mcf	27,438,082	2,613,344	2.18	3.42	$4,952,514	57%	1,376,376	12.92	122.10	$4,782,967	402%
Case #2	1/3 for 1/4 @	bbl	118,775										
Low	casing	Mcf	1,737,982	922,155	3.03	4.53	$2,576,630	141%	308,944	2.53	2.67	$603,519	52%
Risk	9.60%	bbl	118,775										
80% POS	Carried WI	Mcf	1,737,982	1,009,308	2.56	3.98	$2,177,035	68%	150,904	4.68	22.27	$603,133	405%
Medium	5% BPO	bbl	118,775										
Reward	35% APO	Mcf	1,737,982	808,093	2.04	3.19	$1,447,464	64%	365,480	7.40	53.94	$1,352,917	396%

Middle-Market Money

Mezzanine financiers fill the space between public and private equity and bank debt.

ARTICLE BY DAVID WAGMAN

The list of mezzanine-finance providers might not be as long as it was during the raucous days in the 1990s when Enron, Aquila, Duke and Mirant were major players. But mezz money appears sufficient to satisfy demand.

"The market is strongly on the mend from having been decimated in the wake of the Enron bankruptcy (in late 2001)," says Scott Johnson, co-founder of Weisser, Johnson & Co., a Houston-based firm that advises energy companies on arranging capital.

The total value of mezzanine deals in 2001 was about $1.3 billion. Activity slipped to some $350 million in 2002 and remained there in 2003. Deal volume last year was up from 2003, "but not dramatically higher," he says.

Mezzanine finance typically backs two primary oil and gas activities: acquisitions and development drilling. Of the two, demand for acquisition-related financing is down, Johnson says. That's because fewer large producers are divesting their smaller, lower-margin properties while high commodity prices have made even lower-margin properties healthy earners.

"The market is strongly on the mend from having been decimated in the wake of the Enron bankruptcy (in late 2001)."

*—Scott Johnson,
Weisser, Johnson & Co.*

While larger producers typically feed the acquisition market with their cast-offs, the supply of acquirable properties is relatively thin right now.

"Demand is less than it otherwise would be, although there are significant development-drilling projects," he says. "Most mezzanine money is going there."

Mezzanine lenders provide development capital to convert non-cash-flow assets into cash-flow assets, beyond what banks are comfortable doing, says Rich Bernardy, chief financial officer and managing director of NGP Capital Resources Co., Houston, a mezzanine provider that recently went public.

He sees the acquisition market split into two camps: those companies that believe the high price environment can be sustained going forward, and those that believe "what goes up must come down."

Smaller producers' equity position is not strong enough to let them bet on where prices may go.

"They have to know their reserves would still provide cash flows if prices fall back to historical levels," Bernardy says.

A typical mezzanine borrower lacks a large production base and has little cash flow, if any, says Johnson. In most cases, the mezzanine loan is a first lien and is usually the only debt on the borrower's property. An overriding royalty also may be included. Typical returns have been between 15% and 20%, although recent competition is eroding that somewhat. Of that, between 9% and 11% comes from the coupon on the debt. The rest represents royalty payments.

"A couple of providers might consider an equity investment in the company if that is needed," Johnson notes.

Drillbit-focused transactions are up, says Paul Beck, division director for Macquarie Bank in Houston. In such a deal, the company seeking mezzanine financing may have minimal—even no—production, but does have proved reserve locations to drill like coalbed methane in Wyoming's Powder River Basin.

Macquarie recently closed on a $35-million Gulf of Mexico transaction. The E&P borrower had no production to speak of, but numerous "discrete" drilling opportunities, Beck says. The deal was structured into three tranches of debt and included an initial $15 million to drill selected proved undeveloped (PUD) prospects.

"Based on the success of that drilling, we'll free up the rest of the commitment," Beck says. The money carries an interest rate of about 10%, and the borrower came with just farm-out properties. "We couldn't even file mortgages," he says.

CHANGING PARAMETERS

Competition among lenders has led some to lower their expected-return thresholds. Deals with sub-10% cost-of-capital rates are being written today, compared with rates in the mid-teens a few years ago, says Petrobridge Investment's managing director Michael Keener.

Aside from lowering its overall return thresholds, Macquarie Bank is building a traditional commercial bank portfolio, "which was not our directive two and a half years ago," Beck says. The firm's strategy now is to build business through commercial banking in the hopes that this will create synergies that in turn will generate mezzanine-finance business.

Mezzanine lenders are perhaps slightly more aggressive in pursuing deals, says Johnson. Five years ago, lenders expected stronger collateral coverage from producing properties. "They wanted a strong return on capital" from day one, he says. Return on capital is still important, "but," Johnson says, "there has been a step toward requiring less capital and allowing more straight drilling risk, especially on properties with a history of success."

High commodity prices are leading to significant opportunities to drill and develop new oil and natural gas properties, making it attractive for new sources of capital to enter the market.

One such player is Prospect Energy Corp. Founded by a group of former Merrill Lynch executives, Prospect raised about $110 million in its first public offering last July and is now looking to put that money to work in the energy sector through mezzanine investments. To date, the company has made four relatively modest commitments, but sees its sweet spot as making $5- to $10-million deals for oil and gas properties.

John Barry, chairman and chief executive of Prospect, explains the preferred deal structure. It might include a 50% senior debt component at an interest rate of about 4%, a 30% subordinated debt component (provided by Prospect) at a rate between 12% and 15%, and a 20% equity component that pays a return between 20% and 30%. The mezzanine portion would be secured by collateral and cash flow.

"If the numbers work, we're happy," says Barry, who added that his fund is not interested in taking control of a borrower's company. "Our job is to pay a dividend to our common shareholders. We like to invest in companies that enable us to do that."

With large E&P companies throwing off relatively fewer properties to the acquisition market, Prospect Energy is targeting small and family-run E&P companies for prospects. Those companies may consider the high price environment a signal that it's a good time to sell for several reasons. First, they would likely pay capital gains rather than ordinary income tax on the sale. Second, they may feel that high commodity prices may be close to a reversal. And third, they prefer to drill in a high price environment rather than own producing properties.

Sellers can recover several years of cash flow as a capital gain in one sale, Barry says.

At NGP Capital Resources, which was formed in late 2004, a sweet-spot loan would be between $20- and $40-million, Bernardy says. The newly public mezzanine provider has only a few deals on its books.

Bernardy describes a hypothetical deal in which the company might participate: a borrower might have $40 million worth of proved developed producing (PDP) reserves and another $40 million in other proved assets. The borrower might qualify for $25- to $50 million of bank debt, given a bank's typical price deck on PDPs. NGP Capital could provide the additional $15- to $25 million to fully develop the borrower's pool of proved assets.

That money could be provided in one of two ways. NGP Capital could write a vertical loan in which it would provide $25- to $30 million of senior debt as well as $20 million in additional capital to bring in the other assets. Or, the borrower could arrange to have a senior bank provide a $25-million, first-lien loan and NGP could invest $20 million of sub-debt. Depending on a variety of factors, including management team and the assets themselves, NGP Capital might expect to earn a return in the mid-teens on its investment.

"I look at a situation where it's the difference between actual risk and perceived risk," Bernardy says. "We can really get hold of the assets and get a high level of confidence in our borrower's ability to execute the program."

Johnson expects the mezzanine-finance market to strengthen through the rest of this year. He's looking for a recovery in acquisition activity, but expects that will follow only a moderate step-down in prices.

"Certainly it will gear up volumes of activity in this market," he says.

Bernardy also says he feels positive about the market's potential through 2005. The firm's deal log has about 30 potential transactions currently under consideration. He also feels bullish that producers continue to be active with a "wealth of mature assets in North America not fully exploited."

However, he cautions, "this has aspects of a bubble market."

Investors are excited about energy. Having been through two bubble markets in 1980 and 1998, Bernardy is reserving judgment on what kind of year 2005 turns out to be. ■

Paul Beck, division director for Macquarie Bank, says the firm's strategy now is to build business through commercial banking in the hopes that this will create synergies that in turn will generate mezzanine-finance business.

Mezzanine lenders' capital allows companies to grow, says Rich Bernardy, managing director of NGP Capital Resources Co.

QUANTUM ENERGY PARTNERS

Quantum Energy Partners ("Quantum") is a leading provider of private equity to the energy industry. We primarily invest in oil and gas companies focused on building their reserve base through acquisitions, exploitation and exploration, but also consider opportunities in the mid-stream, gas storage and independent power sectors. Quantum currently has over $670 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 $50 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.

Since inception, Quantum has made 26 investments across three funds. To date 13 of those investments have been realized or partially realized.

S. Wil VanLoh, Jr.
Managing Partner

Toby R. Neugebauer
Managing Partner

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QUANTUM ENERGY PARTNERS

Quantum's active portfolio companies include:

Rockford Energy

$50,000,000

The undersigned has made an equity investment in Rockford Energy Partners II, LLC which will engage in acquisition and exploitation activities throughout the United States.

QUANTUM ENERGY PARTNERS III, LP

EQ EnergyQuest Resources, LP

$25,000,000

The undersigned has made an equity investment in EnergyQuest Resources, LP which will primarily engage in acquisition and exploitation activities along the Texas and Louisiana Gulf Coast and CBM activities in the Mid-Continent.

QUANTUM ENERGY PARTNERS III, LP

STRATAGEM ENERGY • CORP

CDN $14,600,000

The undersigned has made an equity investment in Stratagem Energy Corp. which will engage in acquisition, exploitation and development activities throughout Saskatchewan and Alberta, Canada.

QUANTUM ENERGY PARTNERS III, LP

MERITAGE ENERGY PARTNERS LLC

$19,312,500

The undersigned has made an equity investment in Meritage Energy Partners I & II LLC which will engage in acquisition and exploitation activities in the Rocky Mountain region and CBM activities in the Mid-Continent.

QUANTUM ENERGY PARTNERS I & II, LP

Tripoint Energy Ltd.

$11,400,000

The undersigned has made an equity investment in Tripoint Energy Ltd. which will engage in acquisition, exploration and development activities throughout British Columbia and Alberta, Canada.

QUANTUM ENERGY PARTNERS II, LP

CELERO ENERGY

$80,000,000

The undersigned has made an equity investment in Celero Energy, LP which will engage in acquisition and exploitation activities in the Permian Basin and legacy asset transactions with major oil companies.

QUANTUM ENERGY PARTNERS II & III, LP

CHALKER ENERGY PARTNERS, LP

$15,000,000

The undersigned has made an equity investment in Chalker Energy Partners, LP which will engage in acquisition and exploitation activities in East Texas and along the Texas Gulf Coast.

QUANTUM ENERGY PARTNERS II, LP

Northpoint Energy Ltd.

CDN $11,400,000

The undersigned has made an equity investment in Northpoint Energy Ltd. which will engage in acquisition, exploration and development activities throughout British Columbia and Alberta, Canada.

QUANTUM ENERGY PARTNERS II, LP

Denali

$37,500,000

The undersigned has made an equity investment in Denali Oil & Gas Partners, LP which will engage in exploration and development activities primarily in South Texas.

QUANTUM ENERGY PARTNERS II, LP

LINN Energy

$35,000,000

The undersigned has made an equity investment in Linn Energy, LLC which will engage in acquisition and exploitation activities in the Appalachian region.

QUANTUM ENERGY PARTNERS II, LP

TRI-C RESOURCES, INC.

$15,000,000

The undersigned has made an equity and mezzanine investment in Tri-C Resources, Inc. and certain affiliated entities, which such entitities engage in exploration and development activities along the Texas and Louisiana Gulf Coast.

QUANTUM ENERGY PARTNERS II, LP

EnSight Energy Partners, LP

$12,000,000

The undersigned has made an equity investment in EnSight Energy Partners, LP which will engage in acquisition and exploitation activities in the Ark-La-Tex region.

QUANTUM ENERGY PARTNERS I, LP

THE CREDIT CRAZE

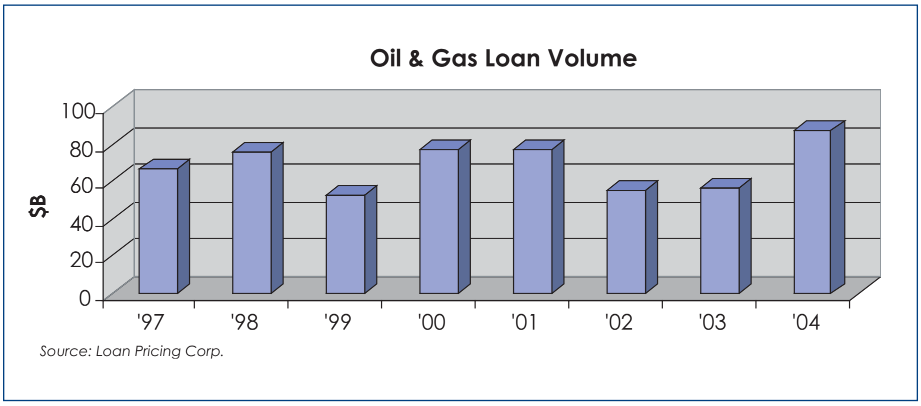
Bankers are aggressively giving credit where it's due to producers seeking to fund growth with attractively priced, longer-term debt.

ARTICLE BY BRIAN A. TOAL

Despite lofty commodity prices and ballooning cash flows in the oil and gas sector last year—events that usually dampen lending activity—the energy credit markets virtually sizzled.

Specifically, overall oil and gas loan volume in 2004 shot up to nearly $88 billion from a 2003 level of $56 billion and a 2002 mark of $55 billion. Indeed, the oil and gas sector last year experienced the highest loan volume seen during the past eight years.

The big driver: refinancings by investment-grade and non-investment-grade borrowers, which accounted for 83% of all energy-lending activity in 2004.



Oil and gas loan volume shot up to nearly $88 billion in 2004, the most in eight years.

"We witnessed a very borrower-friendly credit market, with banks actively looking to loan money and borrowers seeking longer maturities, higher commitments and lower spreads in a very attractive interest-rate environment," says Meredith Coffey, senior vice president and director of analytics 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 services, pipelines, refining and integrated oils.

Citing the improved lending terms in the energy credit market last year, Diana Diquez, market analyst for LPC, notes that the average tenor for investment-grade borrowers rose from slightly more than two years to three-and-a-half years as all-in drawn loan-pricing spreads lowered on average from 77.8 basis points to 67.

Examples of this trend: ConocoPhillips replaced several 364-day and multi-year credit facilities with a $5-billion credit, split equally between a four-year revolver and a five-year tranche, with a fully drawn pricing spread of London interbank offering rate (Libor) plus 40 basis points.

Similarly, Kerr-McGee went to a five-year tenor with an expanded and cheaper $1.5-billion credit that had an all-in loan-pricing spread of Libor plus 70 basis points—down from Libor plus 100 on an earlier facility.

Meanwhile, in the leveraged loan market—credits below a BBB- rating or with an interest rate of at least 1.5% over Libor—the tenor or maturity of credits in the upstream sector increased from 38 months to 42 as the spreads across all levels of the borrowing-base utilization grid declined 12%, on average.

Among those E&P companies that took advantage of better terms and pricing were Magnum Hunter Resources and Ultra Petroleum, Diquez says.

The analyst points out that the stepped-up pace of oil and gas credit transactions last year also was fueled by a rebound in M&A activity, 80% of which took place in second-half 2004.

"Commodity prices had already been high for a long time and many oil and gas companies thought this might signal a fundamental change, in terms of increased asset values," she explains. "They thus concluded there were more acquisition opportunities out there, some of which wound up being financed with loans."

In all, nearly $9.4 billion worth of M&A transactions were completed in the oil and gas sector last year—more than double a 2003 level of $4 billion but still well below the $22-billion pace of energy M&A deals done in 2001.

Will banks, so aggressive in courting oil and gas loans in 2004, be as open-armed toward the sector in 2005?

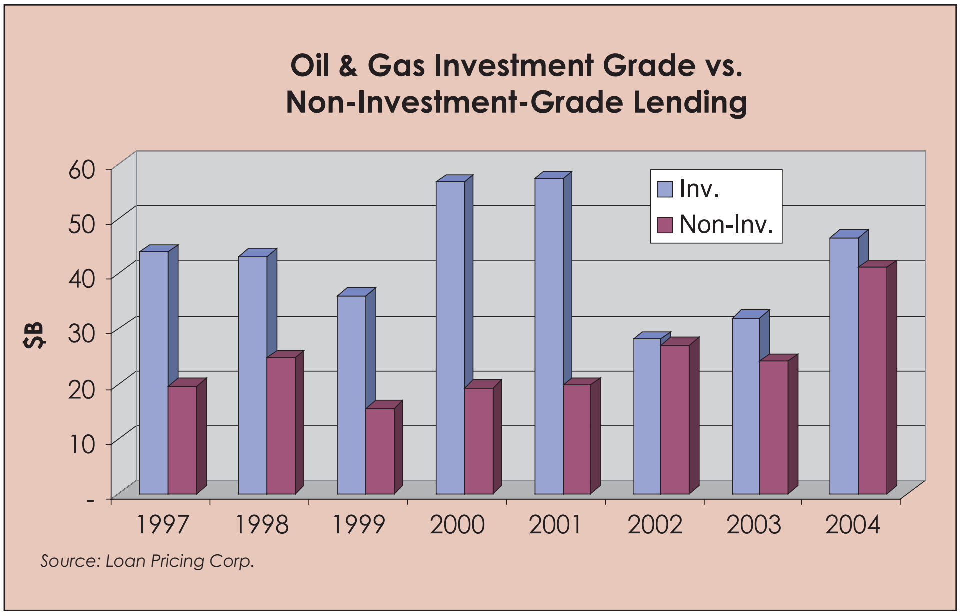
"The dynamics we observed in the energy-banking market at the end of 2003 and at the end of last year didn't change," Coffey says. "Banks want to lend money and need to be very solicitous of new business across almost all segments of the loan market.

"In short, this is still a borrower's market, and loan volume will be very much a function of how much borrowers need or want."

Diquez notes that right now, amid high commodity prices, oil and gas companies are sitting on a lot of cash, so they don't really need incremental debt to finance their operations.

However, she observes, M&A activity in 2005 has started at a slightly faster pace than was witnessed in first-quarter 2004—plus there is the expectation that consolidation in the service sector will increase throughout the balance of the year.

"The extent to which energy companies need loans to finance M&A deals or other major capital investments will greatly influence how much oil and gas loan volume we see in 2005," Diquez says. "As for the banks, they'll need to continue to be aggressive and flexible to get deals done."



Since 2002, both investment-grade and non-investment grade lending have increased.

AN EXPANDED PRESENCE

Leading the stepped-up burst of lending to the oil and gas sector in 2004 was JPMorgan Chase & Co. According to LPC, the bank lead-arranged in the sector 99 credit facilities totaling more than $29 billion. This was almost double a 2003 level of 58 lead-arranged energy loans worth nearly $15.7 billion.

Naturally, JPMorgan Chase's merger in July 2004 with Bank One Corp., which created a global financial services firm with $1.2 trillion in assets, ballooned the bank's presence in the non-investment-grade E&P credit space.

But that's only part of the reason for the lender's surge in lead-arranged, energy-loan volume last year, says Murphy Markham, managing director and group head of oil and gas corporate banking for JPMorgan Chase in Dallas.

"An increase in energy-related M&A activity, coupled with favorable market conditions—both in the public capital-markets sector and the syndicated loan market—caused a lot of oil and gas companies to redo their credit facilities on more favorable terms and to use bank borrowings to finance acquisitions."

Markham notes that last year, the pricing or spread on non-investment-grade E&P credits dropped an average 25 basis points from 2003 levels. Meanwhile, independent producers took the opportunity to lengthen their loan maturities to up to five years from prior-year tenors of up to four years.

In addition, he says, the financial covenants associated with oil and gas loans were pruned down to as few as two tests: a leverage test such as debt/EBITDAX (earnings before interest, taxes, depreciation, amortization and exploration expenses) and a liquidity test such as current ratio (of current assets to current liabilities).

"Since just about every operator's EBITDAX has risen so much due to improved commodity prices, this leverage covenant test became very easy to meet," he says.

Back to the M&A arena, Markham points out that such activity was a mixed blessing for the bank in 2004. On one hand, JPMorgan Chase benefited from being involved in most of the mega-deals in the E&P space last year. This includes advising Tom Brown on its $2.7-billion sale to EnCana; Pioneer Natural Resources, on its $2.1-billion acquisition of Evergreen Resources; Plains Exploration, on its $945-million purchase of Nuevo Energy; and Noble Energy, on its pending $3.4-billion acquisition of Patina Oil & Gas.

The downside to such transactions: the bank lost 12 of its oil and gas client relationships in 2004 as the result of upstream corporate combinations and asset sales.

Offsetting this, the lender added six new E&P relationships, including Delta Petroleum, Quicksilver Resources and Laramie Energy, a private Denver-based operator co-founded by former Forest Oil head Bob Boswell.

"Although a start-up company with an initial need for only a small borrowing base, Laramie is a good

COSCO Capital Management LLC

Corporate Background:

COSCO Capital Management LLC for over a decade has functioned as the preeminent agent for value creation within the private energy sector, fulfilling its mission to **"develop sound, sustainable, and profitable relationships between the financial and operational segments of the energy business."**

For energy companies, COSCO specializes in helping managements recognize and focus on their particular competitive advantages. Between March, 2005 and the beginning of 2000, alone, COSCO has advised over fifty such energy clients, defining market niches, assisting with investment strategies and execution, effecting mergers and acquisitions or sales, arranging secondary placements of their securities, and selectively providing investor relations services.

Through its affiliate, Private Energy Securities, Inc (member NASD, SIPC), COSCO has also proven its ability to arrange significant, tailored private capital for energy companies throughout North America and abroad. As distinct from other placement agents, however, COSCO's selection process is governed by its first principle: to invest in every equity mandate it sponsors. Again, over the past five plus years, COSCO has assisted energy companies to access approximately $540MM of private capital (see recent record below).

COSCO managing directors Cameron O. Smith, left, Lane W. McKay, middle, and William E. Weidner, right.

Finally, following its mandate, since its inception in January 1992, COSCO has regularly represented professional investors with existing or pending energy investments. Since just the beginning of 2000, as an example, it has assisted buy-side clients to purchase or sell approximately $360MM of portfolio companies.

Another distinguishing characteristic of COSCO is that the majority of its personnel and colleagues first enjoyed careers within the energy business before joining COSCO. Its founder, in fact, built, ran, and sold private and public E&P companies in the U.S. and Canada for over 15 years. Three of COSCO's senior personnel have advanced degrees in geology. COSCO's only non-industry managing director presided over 30+ M&A transactions in a 3 year period, on his way to building, taking public, and selling what is now the second largest property and casualty insurance company in Canada.

As a consequence of this background and the insight of its Colleagues, COSCO has extraordinary inside knowledge of the energy business and capacity world-wide to source investment opportunities, conduct primary due diligence on individuals,

2004-2005Q1: $175 Million in Energy Private Placements

Financings	Size	Financing Source/Security	Purpose
Potoco, LLC (Denver CO) April 2005	$20,000,000	Alder Wood Partners, L.P. Line of Equity (LLC Units)	CBM Exploration and Development (Arkoma)
Bunker Energy Inc. (Calgary AB) March 2005	C$24,000,000	Natural Gas Partners VII, L.P. Convertible Preferred Stock	Acquisition & Development (Alberta)
Action Energy Inc. (Calgary AB) February 2005	C$4,000,000	Toscana Capital Corporation Convertible Subordinated Debentures	Development Drilling & Facilities (Alberta/Saskatchewan)
SDG Resources (Montrose CO) October 2004	$35,000,000	Goldman Sachs E&P Capital Secured Notes	Development of Proved Reserves in Permian Basin
Ausam Energy Corporation (Calgary AB) August-November 2004	C$12,900,000	Lead Investor: Affiliates of Wellington Management Co. LLC Common Stock and Warrants	Underbalanced Drilling in Australia
JOG Capital (Calgary AB) September 2004	C$37,612,660	Undisclosed Partnership Units in JOG Limited Partnership No. 2	Private Corporate Equity Fund for Canadian Energy
Mid-Con Energy Corporation (Tulsa OK) July 2004	$33,900,000	Lead Investor: An Affiliate of Yorktown Partners LLC Common and Preferred Stock	Waterflood Development in Mid-Continent
Avalon Exploration, Inc. (Tulsa OK) June 2004	$10,000,000	Energy Trust Partners L.P. Common Stock	Development and Exploration in OK
Stratagem Energy Corp (Calgary AB) May 2004	C$15,000,000 C$742,000 C$274,083	Quantum Energy Partners Follow-On Placement Secondary Placement	Drilling in Central Alberta Initial Round Shareholder Liquidity
Karl Oil & Gas (Calgary AB) February 2004	C$1,300,000	Quest Capital Corp Senior Secured Bridge Financing	Short-Term Development Financing
Total Financings (10):	*$175MM (US)*	*12 Capital Sources*	*8 Equity; 1 Mezz; 2 Bridge; 1 Secondary*

companies, and specific projects, and initiate and manage M&A transactions, making it certainly one of, if not *the* leading energy investment specialist based in North America.

Standing, from left, are Sam Hammons, Lane McKay, Cameron Smith, Bill Weidner, and Scott Kessey. Seated, from left, are Jack Crissup, Reva White, Warren Shimmerlik, Sharon Younger, and Max Dillard.

COSCO Services:

Capital Formation. COSCO specializes in assisting energy companies to raise private capital, particularly corporate equity and project or mezzanine debt. Often this capital is sourced from those same professional investors to which COSCO provides advisory services. COSCO also invests in all equity financings it arranges. 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.

Advisory. COSCO provides financial, investment/divestiture, and investor relations services to both oil and gas companies and professional investors, alike. For investors, advice includes 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 private and public energy companies, COSCO provides sound financial and business advice designed to focus managements on their own competitive advantages, business opportunities, and financing potential. For the latter, COSCO also provides a full range of investor relations services. For family-owned companies, it is experienced in and provides generational succession planning. Advisory clients within the Industry have included Ausam Energy, Shell Canada, Arena Energy, Crutcher Tufts Resources, Novus Petroleum, and Momentum Energy, among many others.

Mergers & Acquisitions/Divestitures, Secondary Placements. Because its personnel and Colleagues are located in almost all of the principal energy centers of North America, as well as certain key international centers, COSCO is well positioned to match industry clients with acquisition, divestiture, or merger candidates. COSCO's experience in structuring deals and in raising capital is often crucial in completing successful transactions. Also, because COSCO has close working relationships with almost all of the Private Capital Funds and many of the public money managers and hedge funds in the U.S., Canada, and abroad, it is particularly adept in arranging secondary placements of public and private energy securities, as well as entire energy portfolios.

Principal Investing. Since the mid 1990's, COSCO has participated as an investor in virtually all of the equity financings it has arranged. On its five investments monetized to date, it has realized an aggregate IRR of 35% and an ROI of 2.5:1. In addition, it currently holds minority interests in an additional 16 private and corporate equity and direct property funds it has helped organize and capitalize.

Education. From the outset, COSCO has worked diligently to inform the energy industry and investors, alike, in the U.S. and Canada about the mores and virtues of Private Capital. COSCO personnel regularly contribute articles on private capital for *Oil and Gas Investor* and are interviewed by it and other industry and financial publications, most recently including *Business Week*, *Worth*, and *Private Equity International*. COSCO in 1997 founded the Private Capital for Energy Forum™, which it has hosted over fifteen times in New York, Calgary, and Houston, with over fifty Private Capital Sources and another forty or so Beneficiaries having made presentations on the demands and benefits of Private Capital.

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212-889-0206	860-677-6345	403-237-9462	403-263-9467	713-654-8080	212-247-5200
212-696-4343 (F)	860-677-6569 (F)	403-237-9464 (F)	403-237-9464 (F)	713-654-9090 (F)	508-374-1297 (F)
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COSCO Capital Management LLC
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Murphy Markham, Banc One Capital Markets Inc.

example of the type of operator we like to back—one that has seasoned management and the capacity to grow," Markham says. Notably, about half the bank's current 100 upstream credits are for private E&P companies.

Again with a focus on the smaller-cap end of the upstream, the bank last year was able to bring to bear on its existing credit relationships a broad range of investment-banking capabilities.

Case in point: in addition to lead arranging a $480-million revolver for Whiting Petroleum, the lender through its capital-markets arm co-managed for the Denver operator a $240-million, common-stock offering and a $150-million, high-yield debt offering.

Similarly, when Fort Worth, Texas-based Range Resources wanted to buy out the interest of a joint-venture partner in some Appalachian Basin properties, the bank and its investment-banking group acted as M&A advisor to Range and led for it a $500-million, senior credit facility; a $100-million, high-yield offering; and a $149-million, common-stock offering.

This ability to bring more than credit capabilities to bear on upstream financing needs also was of particular benefit last year to Gasco Energy Inc., a roughly $300-million-market-cap Englewood, Colorado-based producer.

"At the time, the company didn't have sufficient proved developed producing reserves in its Rockies asset base to support a bank credit facility," Markham explains. "So we came up with the solution of sole-leading for this producer a $65-million convertible-debt issue."

That gave the company enough capital to exploit its acreage position and drilling opportunities in Uinta Basin in Utah.

Looking ahead, the banker sees strong upstream M&A activity through the balance of 2005. The reason: acquirers now are willing to pay high prices because they're able to lock in those prices in the commodity-derivatives market by hedging their production forward.

On the other hand, Markham believes that the strong cash flows the E&P sector is now generating—and a strong capital-markets environment that allows operators to raise public equity or debt to pay down credit facilities—will serve to dampen loan volume.

The net result? "In a hot M&A market, acquiring companies will be taking on bank debt plus we'll continue to see a steady stream of new companies being formed by managements coming out of all the consolidations," the banker asserts. "However, when you balance everything out, we expect continued downward pressure on oil and gas loan volume this year. That said, we're well positioned to provide financing alternatives to the E&P sector beyond credit facilities."

UPSTREAM FOCUS

Also reflecting the aggressiveness of major money-center banks within the energy sector last year was Citigroup. According to LPC, the financial giant lead-

2004 U.S. Oil & Gas Lead Arrangers

Rank	Bank Holding Company	Lead Arranger Volume ($MM)	# of Deals	Market Share
1	JPMorgan	29,037	99	33%
2	Bank of America	15,685	58	18%
3	Citigroup	15,162	22	17%
4	Wachovia Securities	5,855	18	7%
5	Barclays Bank Plc	2,925	3	3%
6	Wells Fargo & Co.	2,788	31	3%
7	BNP Paribas	2,154	17	2%
8	Harris Nesbitt	1,750	6	2%
9	Royal Bank of Scotland Plc	1,478	5	2%
10	Deutsche Bank	1,455	5	2%
11	SunTrust Bank	1,290	5	1%
12	Goldman Sachs & Co.	1,230	4	1%
13	Credit Suisse First Boston	1,125	6	1%
14	Union Bank of California	1,087	8	1%
15	Scotia Capital	716	3	1%
16	UBS AG	665	3	1%
17	Calyon Corporate & Investment Bank	575	5	1%
18	RBC Capital Markets	515	3	1%
19	Bank of Tokyo-Mitsubishi	400	2	0%
20	Merrill Lynch & Co.	295	1	0%
21	Lehman Brothers	248	1	0%
22	Guaranty Bank	225	1	0%
23	Sumitomo Mitsui Banking Corp.	200	1	0%
24	Fortis Bank	185	2	0%
25	Bank of Oklahoma	150	1	0%
25	Nordea Bank	150	1	0%
27	KeyBank	107	2	0%
28	Hibernia Corp.	100	1	0%
29	Frost National Bank	47	1	0%
30	U.S. Bancorp	46	2	0%
31	Comerica	40	1	0%
32	First American Bank	36	1	0%
33	Bank of New York Co.	25	1	0%
34	PNC Bank	22	2	0%
35	Petrobridge Investment Management	18	1	0%
36	National Bank of Canada	16	1	0%

Source: Loan Pricing Corp.

arranged 22 credits in the sector totaling close to $15.2 billion. This was a quantum jump from a 2003 pace of 11 energy-related loans worth just under $4.2 billion.

"While many banks had pulled back from the oil and gas sector going into 2004—after spending most of their time doing workouts in the merchant energy space—we began taking an aggressive stance toward the sector," says David Hunt, managing director and head of Citigroup's mid-corporate energy banking group in Houston.

"Specifically, we spotted early on some positive trends in the credit markets, in terms of improved pricing and loan tenors, and advised our energy clients to take advantage of them," the banker explains. They did, and a slew of refinancings followed.

Meanwhile, the bank—which was heavily involved in leading multibillion-dollar restructuring financings for the likes of El Paso and The Williams Cos. in 2004—committed itself to expanding its lending presence within the E&P sector.

David Hunt points out that the recent loan facility for Energy Transfer Partners is a good example of how Citigroup was able to leverage an existing investment-banking relationship into a corporate-banking relationship.

"This is a fertile growth area where Citigroup, especially on the non-investment-grade credit side, hadn't focused all that much in the past," says Hunt who was brought on board last June to shore up the firm's E&P lending effort.

During second-half 2004, the bank participated in four upstream loan transactions for new clients, including a $750-million facility for Fort Worth-based Encore Acquisition and a $400-million credit for Celero Energy, a privately held producer with management in Dallas and Midland, Texas. In addition, Citigroup last year co-led a $185-million facility for Resolute Natural Resources, a private Denver-based start-up founded by Nick Sutton, the former chairman of HS Resources.

Currently, the bank is pursuing three more E&P credit opportunities with publicly traded operators whose market capitalizations range from $600 million to $3 billion.

"Typically, we're dealing with producers that initially may be looking to Citigroup for a $20-million commitment out of an overall $100-million credit facility," Hunt says. "This, however, doesn't mean we won't look at smaller loans. We have at least one credit where our original commitment was less than $10 million out of an overall $50-million facility."

Stresses the banker, "The important ingredient in a credit relationship is that a borrower has a growth trajectory that will eventually allow us to use our other financing capabilities—from providing M&A advisories to underwriting public equity and debt issues. That's the kind of operator that matches up well with us.

"The initial size of a credit isn't important to us—what is important is where a company is going and what its financial needs are going to be."

The bank, which has 105 energy clients globally—65 of those in North America—was also aggressive last year in its lending to integrated oils, larger-cap independents and midstream master limited partnerships, says Charles Bohn, Houston-based managing director and head of North American energy corporate banking for Citigroup.

Besides leading a $5-billion facility for ExxonMobil—Citigroup's biggest energy credit in 2004—it also led revolvers for Occidental ($1.5 billion), Unocal ($1 billion) and Apache ($750 million). In addition, in early 2005, it led a $2.4-billion credit for the general partner of midstream firm Enterprise Products, and added two others—Energy Transfer Partners and Crosstex Energy.

"Like the E&P space, where the risk-reward balance is good, the MLP arena affords us significant growth opportunities, in terms of being able to expand our credit and investment-banking relationships as we continue to move away from historical definitions of banking," Bohn explains.

Hunt points out that the recent loan facility for Energy Transfer Partners is a good example of how Citigroup was able to leverage an existing investment-banking relationship into a corporate-banking relationship.

"On the E&P side, we did the same thing with Pogo Producing. Conversely, our new lending relationship with Celero Energy is leading to opportunities on the investment-banking side," he says.

The bank's brisk 2004 energy-loan pace aside, Bohn is somewhat cautious in his outlook for oil and gas loan volume in 2005.

"With clients like ExxonMobil sitting on $23 billion of cash, and smaller independents using their strong cash flows to pay down debt, it's hard to see energy-lending opportunities growing this year," he observes. "About the only thing that would change this picture is a lot more M&A activity."

This scenario isn't entirely out of the question. Bohn believes there's a chance that some of the major integrated oils may go after select acquisition opportunities this year among U.S. independents in order to broaden their reserve base.

In the upstream last year, Citigroup represented Evergreen Resources in its $2.1-billion acquisition by Pioneer Natural Resources.

"Absent strong M&A activity this year, we would expect 2005 oil and gas loan volume to be flat to slightly down versus last year," Hunt concludes. ■

AT THE BANK

Energy lenders are carving out their low-cost loan niche with increasingly competitive asset valuations.

ARTICLE BY DAVID WAGMAN

Small to midsize E&P companies are having little trouble accessing capital for virtually any deal they want to do, say bankers who specialize in lending to the segment. Strong commodity prices that show no sign of weakening are attracting a steady stream of capital providers to the market.

R. Danny Campbell, Community National Bank

At the same time, sustained high cash flow among many producers is helping them pay down outstanding bank debt or use cash on hand for acquisitions.

"We see a lot of loans paying down," says R. Danny Campbell, executive vice president of Community National Bank, based in Midland, Texas. Revolving loans that used to be between 20% and 25% unfunded now may be as high as between 35% and 40% unfunded.

Oil and gas producers may have healthy balance sheets these days, he says, "but you don't make money as a banker." Increased competition among sources of capital and healthy cash flow among producers are making it difficult to push additional bank debt into the market, says Todd Berryman, senior vice president with American National Bank in Denver.

"People don't need money as much," he says.

That may be changing, however. Higher costs for drilling and other services are being passed on to producers, somewhat slowing the rate at which borrowers are paying down their loans. As the rate of paydown starts to stall, some bankers are seeing more customers tap bank credit facilities.

"With the recent run-up in contractor costs, we see a definite leveling off of payoffs and a slight increase in fundings," says Dorothy Marchand, senior vice president with Compass Bank in Houston. "We expect the trend in paydowns to slow or stop as service costs increase."

This appears a long way from signaling a bust for producers, however.

"This is not 1985, when prices peaked and took a nosedive," says Charles Spradlin, senior vice president of oil and gas for Kilgore, Texas-based Citizens Bank. Not only is there no gas bubble in 2005, but OPEC has little excess oil-production capacity.

Couple that with Asian demand for oil, and bankers like Spradlin see little cause to worry that commodity prices will fall any time soon. That gives banks extra confidence to bump up their loan-to-PDP (proved developed producing) reserves ratio and even to give extra credit for proved undeveloped (PUD) prospects.

"Everyone is comfortable with the higher price environment," says Mickey Coats, senior vice president and energy department manager at Tulsa-based Bank of Oklahoma. "We feel the prices are here to stay."

The story among banks about trying to move money into the market is almost like a broken record, says Mark Fuqua, senior vice president and manager of energy lending for Comerica Bank in Dallas. Comerica prefers deals in the $10- to $50-million range and sees more opportunities from midstream and service-sector borrowers these days than from upstream prospects.

"With the recent run-up in contractor costs, we see a definite leveling off of payoffs and a slight increase in fundings. We expect the trend in paydowns to slow or stop as service costs increase."

—Dorothy Marchand, Compass Bank

Demand for bank debt is stronger in midstream and service markets right now, Fuqua says. Upstream companies can't spend all their cash flow, and they still tend to be "careful and conservative," he adds. Those borrowers are all but pushing money back.

"They don't feel they can efficiently use all the money," he says.

OVERACTIVE

With a wide variety of capital sources actively seeking E&P deals, energy capital markets have become "overactive," says Steve Kennedy, senior vice president and manager of energy lending for Amegy Bank of Texas (formerly Southwest Bank), based in Houston. Amegy's sweet spot is for deals between $5- and $30 million, and it led a group of lenders who extended a $50-million line of credit last year to back a customer's acquisition program.

"We see margin decreases on corporate deals," Kennedy says. And customers that once looked highly leveraged now have paid down debt, he adds.

"Any good project has little problem with sourcing capital," agrees Arthur R. (Buzz) Gralla Jr., managing director of oil and gas banking for Houston-based Guaranty Bank, which holds more than $1 billion in loan commitments to the sector. "There is more money than deals today."

A major competitor to bank capital is the private-equity market, adds Dan Steele, senior vice president and manager of energy lending for Houston-based Sterling Bank. Some estimates suggest as much as $80 billion of private equity may be available for E&P companies to tap.

"When you get that type of liquidity in the market, the demand for and usage of bank debt is greatly diminished," he says.

That's because corporate management can invest right along with their equity capital provider. This gives management incentive to build value and then to capitalize on what they have built. By contrast, bank debt typically uses economic assumptions that are "somewhat below market prices," Steele says.

Producers who use a bank lender's relatively conservative economic assumptions may find it harder to acquire additional reserves, for example. The gap between current market prices and a bank's willingness to lend may be closed by an equity contribution or hedging production. Equity providers may be more willing to aggressively structure deals.

Given the scrappy competition, banks are becoming more aggressive.

For example, while banks traditionally looked at loan values that ranged from between 55% and 65% of a property's valuation, that is changing. Hedging practices and higher commodity prices make banks more comfortable with the idea of lending closer to 70% of a property's valuation. Bankers look at factors such as property concentration, revenue-stream diversity and the economic life of the oil and gas reserves.

"But if you had a high-grade set of properties, a bank might be willing to exceed 65%," Steele says.

Demand for bank debt is stronger in midstream and service markets right now, says Mark Fuqua of Comerica Bank.

MORE CREATIVITY

The combination of increasing competition among capital providers and high cash flows among producers leaves banks "competitive, aggressive but selective at the same time," says Comerica Bank's Fuqua. He sees loan terms loosening, pricing getting thinner, borrowing bases becoming more aggressive, loan

Select Regional Bankers' Loan Guidlines

Bank	2005 Price Deck (Gas/Oil)	PDP%	PUD%	Loan Range
Amegy Bank, Houston	$5/$35	75%	25%	$5-$30MM
American National Bank, Denver	$5/$32	~60%	0%	$500,000-$30MM
Bank of Oklahoma	$5/$35	60%	0%	$25-$30MM
Citizens Bank, Kilgore, Texas	$5/$37.50	80%	varies	up to $5MM
Comerica Bank, Dallas	$5/$30	75%	20%-25%	$15-$35MM
Community National Bank, Midland, Texas	$4/$30	55%-65%	15%-20%	$500,000-$3.5MM
Compass Bank, Houston	$4.50/$30	75%-80%	20%-25%	up to $35MM
Coppermark Bank, Oklahoma City	$6.68/$46.97	Up to 100%	0%	$2-$3MM
First American Bank, Midland, Texas	$4.25/$28	50%-60%	25%	$40MM
Frost Bank, Houston	$5/$30	75%-80%	20%-25%	$1-$20MM
Guaranty Bank, Houston	$4.50/$30	65%	25% onshore, 35% offshore	$5-$60MM
Hibernia Bank, New Orleans	$4/$25	70%	up to 30%	$10-$20MM
Sterling Bank, Houston	$5/$35	75%	10%	$1-$25MM

maturities lengthening and more flexibility coming into covenant packages.

With more than $1.6 billion committed to upstream, midstream and service-company borrowers, Comerica has begun to see faster growth on the services side of the business within the past year. Service companies increasingly must spend aggressively to meet the strong increase in demand for E&P spending.

In this highly competitive banking atmosphere, many banks are getting more creative in their dealmaking and more aggressive in their lending practices. For example, American National Bank, based in Denver, will lend against a borrower's personal real estate and marketable securities.

"We hope these companies are deleveraging and creating dry powder for when stability returns and the acquisition market fuels up again."

Dan Steele, Sterling Bank

"We try to be creative to address the fact that our customers are drilling," says American National Bank's Berryman. The bank prefers loans that range from $500,000 to $30 million, and has an internal hold limit of $15 million. "A lot of borrowers don't need anybody's capital," he says. With producers generating so much cash "the flip side for lending institutions like ours is we're getting great deposits."

Fuqua says Comerica Bank has become more aggressive when it comes to lending against non-PDP reserves. The bank will normally lend between 25% and 40% on the value of non-PDP reserves, in part because of advances in technology that have improved drilling success rates. Robust cash flows and lower leverage among its customer base means Comerica can be more aggressive.

The bank was an agent last year on a $75-million loan to allow a West Texas E&P company to recapitalize itself and complete a shareholder payout. The company's management wasn't ready to sell out, so Comerica brought together a couple of other lenders to allow the recapitalization.

One of Compass Bank's largest deals in 2004 was a $25-million loan to a company with a market cap in the $700- to $800-million range and properties in the Permian Basin, Midcontinent and Gulf of Mexico.

"We have another $10-million loan to the CEO," Marchand says. The bank has a long-term relationship with the company and its chief executive.

Many E&P customers of Community National Bank in Midland are not currently drawing on their borrowing bases, Campbell says. That means the bank has "a lot of dry powder" available to finance acquisitions. The trouble is, affordable prospects are difficult to find. Acquisition prices are high and continuing to rise, and the supply of available properties on the market is down too, as even marginally productive properties are proving profitable.

One of Spradlin's customers in East Texas was bidding on a property in Oklahoma last year when a rival offered a 30% premium over the rest of the bids. Even though it's increasingly difficult to find new acquisitions at realistic prices, Spradlin says he continues to urge his customers to buy.

"There's probably a longer payout, but the downside risks are limited," he says.

Most 2005 bank price decks for natural gas are in the range of $4 to $5 per thousand cubic feet of gas, although lenders cautioned they regularly update their decks to reflect changing market conditions.

"We've always been bullish on gas," says Spradlin, whose bank is using a $5 deck. But at $37.50 a barrel, Citizens Bank is "running behind on oil." Until prices build a base above $40 a barrel, Spradlin is reluctant to change.

Oklahoma City-based Coppermark Bank will lend up to 100% of present value discounted 9% (PV9), but has a policy of giving no value to PUDs. Last year, it wrote a $15-million revolving facility for a client to use for acquisitions, says Bob Holmes, senior vice president of energy and community lending at the bank. The loan is less than 50% committed, but it more than doubled the total amount of money available to the company.

LOVIN' LIKE-KIND EXCHANGES

The bank also likes the business of financing tax-free property exchanges under Section 1.1031 of the Internal Revenue Code, which deals with deferred exchanges. Since the IRS rule came out in 1990, owners of certain types of like-kind property may sell one piece of property and buy another without paying the capital gains tax.

The provision encourages sellers to buy replacement property without a tax consequence. A bank such as Coppermark finances the deal, meaning it doesn't lose the loan business. "We love that," Holmes says.

Spencer Gagnet, energy department manager at Hibernia Bank in New Orleans, will lend to about 70% of PDPs and up to 30% of PUDs. Although the bank prefers to lend between $10- and $20 million, it took a $33-million stake as an agent in a $240-million transaction last year. The loan was repaid when the borrower was sold.

Frank Stowers, executive vice president with First American Bank in Midland, lends on between 50% and 60% of PDPs and up to 25% of PUDs.

"We have found our flexibility on our advance rate coupled with credit for non-PDP, which allows us to compete," he says. "We like deal flow," and so the bank will originate loans up to $40 million in value. The bank originated a $92.5-million loan last year for a publicly held company that wanted to acquire and develop producing and nonproducing assets in the Permian Basin.

Amegy Bank prefers to see at least 75% producing and generally no more than 25% nonproducing, and then will loan 60% against the PDP portion. The bank allows, however, up to 15% of a borrower's collateral pool to be undeveloped. Kennedy at Amegy Bank says that was an increase from the previously allowed 10%. The change reflects the greater certainty that PUDs will be developed, given higher commodity prices.

"There's absolutely no reason to delay drilling," Kennedy says. "PUDs are more likely to be drilled today." Kennedy sees a similar shift in opportunity to in the oil-services business. Even so, the bank's outstanding debt to E&P companies was up 20% over 2003.

"We grew our outstanding debt even though only 42% of our $1 billion in commitments were funded."

Steele at Sterling Bank sees a similar pinch because of rising costs and waiting times for drilling rigs and reduced availability of tubular goods. "All of that impacts an independent's business strategy," he says. So although producers' high cash flow has "greatly diminished the pipeline" for new business, Steele says there may yet be a silver lining.

"We hope these companies are deleveraging and creating dry powder for when stability returns and the acquisition market fuels up again," he says. ■

SERVICE SECTOR DRAWS INCREASED ATTENTION

With too much money chasing too few borrowers in the upstream and midstream E&P sector, lenders are looking to service-sector companies for new growth. At a time when E&P companies are paying off debt and leaving bank lines of credit unused, service companies are increasingly in the market for money.

"The fastest growth we saw in 2004 was on the services side," says Mark Fuqua, senior vice president and manager of energy lending at Dallas-based Comerica Bank. The bank started as an upstream lender, but plans to market more to service providers in the future.

Demand for everything from drilling rigs to steel to seismic analysis is being lifted by robust prices for natural gas and crude oil. To win a commitment for equipment, a producer increasingly must show a high-grade exploration program, a long-term commitment and also a multiwell program, says Dan Steele, senior vice president and manager of energy lending for Houston-based Sterling Bank.

One emerging-finance vehicle is the use of nonamortizing, Term B loans, says Carmen Jordan, senior vice president of energy-service lending at Amegy Bank of Texas, based in Houston. That this product exists at all is a reflection of the willingness of institutional investors and banks to extend credit on better terms given the increasing cash flow and health of the market, she says.

Two years ago, these structures weren't even available to most service companies. Now, they are being embraced by many lenders, and currently make up 15% of Amegy's outstanding energy-service loans.

Making term loans to service companies is riskier than working capital revolvers because of the extended maturity and collateral volatility.

Typically, lenders prefer rapid loan amortization in case of a market downturn. The flip side is that lenders like to keep their funds deployed as long as possible. Term B loans allow bankers to keep funds deployed for an extended period while presenting what they consider to be a marginal increase in risk.

In most instances, the Term B portion of a loan is relatively small. It pays back slowly during time and therefore is the last money a borrower pays back. That's an advantage for lenders who want to keep their funds deployed during a five- to seven-year period, a typical Term B maturity. Lenders look for about a 50-basis-point spread between a standard-amortizing loan and a Term B loan.

A strong driver for the Term B market is the lower debt-to-cash-flow ratios that many companies are posting, compared with two years ago, Jordan explains. Where earnings before income tax, depreciation and amortization leverage was a multiple of 3.5 two years ago, today it's typically in the 2.5 range, with covenants restricting its expansion. That improvement has "built some headroom" and is one reason the Term B market is viewed as more acceptable by lenders.

It's also another indication of how robust prices and solid demand are leading lenders to do deals in the services sector. ■

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FULL STEAM AHEAD

The private capital market for oil and gas is chugging along as more investors, including new hedge funds, stoke up their energy portfolios.

ARTICLE BY LESLIE HAINES

In the past year, most private funds devoted to energy have stoked their engines with new dollars. Couple that with new fund entrants and the arrival of hedge funds on the energy scene, and the amount of debt or equity looking to invest in the upstream energy business is estimated to be well north of $8 billion.

Add to this total the additional bulk of heavyweights like Goldman Sachs, Citigroup, Lehman Brothers, JPMorgan and other Wall Street bankers.

Most fund commitments are made in $50- to $250-million increments, sometimes smaller, so one could easily predict at least 50 possible financings during the next 12 to 24 months if all the capital is invested. That is a big if.

Restocking the Shelves

Company/Fund	$ Millions	Date	Type of Fund
Energy Trust LLC	$200	March 2005	Equity
Energy Spectrum Partners IV LP	353.5	Dec. 2004	Equity
NGP Capital Resources Co.	261	Nov. 2004	Mezzanine
Lime Rock Partners III LP	425	Nov. 2004	Equity
Kayne Anderson Energy Fund III	550	Nov. 2004	Equity
Prospect Energy Corp.	105	July 2004	Mezzanine
EnCap Energy Capital Fund V	825	July 2004	Equity
ARC Energy Venture Fund 4*	403	July 2004	Equity
Quantum Energy Partners	345	June 2004	Equity

* *Canadian dollars.*

These companies or funds are just some that have raised fresh capital recently, to be invested in upstream and midstream clients.

"The latest change we've seen is the emergence of the hedge funds ready to make significant energy investments," says Mike Bock, principal with investment-banker Petrie Parkman & Co. in Denver. "That's an imponderable amount of capital."

We have to thank the tight supply-demand balance for oil and gas in North America. Commodity price swings in 2002 calmed the A&D market and financial players, but in 2003 and 2004, all facets of the energy industry came roaring back.

FRESH CAPITAL

Capital inflows and deal-making continue unabated. At press time, Bovaro Partners LLC, a three-year-old firm based in New York, had begun raising its first energy fund after hiring energy specialist Michael Humphries to gear up the firm's energy practice.

In Houston, Eschelon Energy Partners was in the process of raising a $100-million private equity fund to focus on small-cap opportunities in North America in the upstream and midstream. The fund "continues to originate and execute on interesting private-equity opportunities that may be finalized before the first closing of the fund and are funded by its core investor group," says Tom Glanville, managing partner.

Dallas-based Energy Spectrum Partners' affiliate, Energy Trust Partners, has just closed a $200-million upstream fund and is planning to add another $100 million in a second closing this summer. This is on the heels of its $353.5-million midstream fund that closed in December.

Some E&P companies raise their own capital directly with the institutional community with whom their management team has deep, long-standing relationships. An active buyer and operator of producing assets, EnerVest Management Partners in Houston raised $550 million this spring. This is the firm's largest fund yet.

In Dallas, Merit Energy recently closed a $1.5-billion fund, after raising $1 billion in 2004, which was deployed to buy a major group of producing assets from Anadarko Petroleum. Again, Merit manages this capital for its own account and for its investors, rather than making the capital available to other oil and gas companies

Todd A. Dittmann joined D.B. Zwirn & Co. to open its new Houston office last fall. The $2.7-billion, New York-based hedge fund makes senior, senior stretch and mezzanine loans to, and structured equity investments in, all industries, but with a growing focus on energy. It acquired the energy portfolio of Mirant Energy in 2003.

"A lot of what we do are deals a bank probably wouldn't do," he says. "In a risk-rating, world banks might loan on 65% of the value of PUDs [proved undeveloped reserves] but we can outstretch that. For example, if a bank would loan $50 million, we'd do $70 million."

Because Zwirn places more value on proved developed, PUD and behind-pipe reserves than a bank does, it can come in after the bank to lend the final amount. It does so at a more expensive cost, but it is very valuable capital, Dittmann says, because when an

E&P firm needs that last piece of money to complete a deal, it grows in importance.

In addition, several equity and debt providers such as Zwirn specialize in refinancing E&P companies that are in distress or in some other special situation. Examples of recent deals in which Zwirn was involved include a $90-million first- and second-lien financing secured by reserves for KCS Energy before the latter did bond and equity offerings during its major restructuring of the past two years. Zwirn participated in the recapitalizations of Mission Resources and Abraxas Petroleum. Zwirn also invests through other intermediaries such as those that provide mezzanine funds.

Yet another new entrant is Laminar Direct Capital GP, which began in 2004 with several former employees of Duke Capital Partners, which was disbanded. Offering debt and equity, Laminar is affiliated with D.E. Shaw & Co., a $14-billion New York hedge fund.

It has already funded more than $200 million in equity and mezzanine deals. Laminar provided $10 million of subordinated debt to Stallion Oilfield Services Ltd., a Houston oilfield-service firm, says Todd Overbergen, a Laminar director. This was part of a larger financing completed by Carlyle/Riverstone Global Energy and Power Fund II.

As new capital flows to the energy industry, seasoned E&P companies and financial providers now think the brakes may be applied—all participants must become more selective and disciplined. One backstop is hedging.

Although traditional private capital providers seem busiest now—the EnCaps and NGPs of the world—public capital providers such as investment banks are also actively closing on private deals. Lehman Brothers raised $260 million in convertible preferred stock for start-up Antero Resources in February 2003. Denver-based Antero, which focused on the hot Barnett Shale play in North Texas, was just sold to XTO Energy for $658 million, providing a quick turnaround.

During the past five years, roughly half of investment-banker Petrie Parkman's deals have been public underwritings and half private placements, many for start-up companies, says principal Mike Bock. At press time he was about to go out on the road with Steve Mikel's Houston E&P firm, Chroma Energy, to do another private placement.

NEW CAPITAL USERS

Private capital is a catalyst for start-ups needing to grow quickly. Some 90% of the time, E&P companies use pri-

vate capital to buy oil and gas properties with existing production and undrilled potential. Exploitation through development drilling is the main use of these dollars, and perhaps, some exploratory work.

Oil and Gas Investor has counted more than 70 start-ups in the past three years funded primarily by private capital sources.

Medicine Bow Energy Corp. in Denver is an example. It was funded in 2002 with $214 million from a group including CSFB Private Equity, EnCap Investments and Kayne Anderson, among others. It has since made three key acquisitions totaling $248 million.

Petrie Parkman helped former El Paso and Coastal Corp. E&P president Rodney Erskine's new company, Erskine Energy, access $126.3 million of common equity in August 2004. The providers were Yorktown Partners and Wellington Management.

Recent Private Capital Investments

Start-Up E&P	Recent Deal/Goal	Source
Escondido Resources	Acquired $45MM of South TX production	EnCap Fund V
Goldking Energy Holdings	$30MM to acquire and exploit	Natural Gas Partners
Kosmos Energy LLC	Up to $300 MM for offshore Africa exploration	Warburg Pincus & Blackstone Capital
LMP Exploration Operating LLC	$35MM to acquire and exploit in S TX	Greenhill Capital Partners & Lime Rock Partners
Merit Energy	Acquired $680MM of assets from Anadarko	Various
Orion Energy Partners	$50MM to acquire in several basins	State Farm & Wellington Management
Resolute Natural Resources Co.	Acquired Utah assets from ChevronTexaco	Natural Gas Partners
Rockford Energy Partners II	$50MM Midcontinent acquire and exploit	Quantum Energy Partners
Voyager Gas Corp.	Acquire and exploit in South & East TX	Natural Gas Partners

Erskine is focusing on gas plays in South Texas and the upper Texas coast. Unlike most start-ups, however, it favors drilling wildcats in addition to the acquire-and-exploit model.

Another new company created by executives who left El Paso is Denali Oil & Gas Partners LP. It was formed with $50 million of private-equity commitments from Quantum Energy Partners in the lead, joined by Energy Trust Partners and a private Houston independent, Walter Oil & Gas Corp. Chief executive Rich Louden and president Greg Hutson were previously with El Paso Production and Coastal Oil & Gas.

They started with a focus on the Gulf Coast by pursuing tight-gas plays. Denali first acquired properties in Hidalgo County, South Texas.

Privately held Concho Resources in Midland, another start-up, committed up to $100 million to participate in drilling with Denali on a 50-50 basis, with the latter operating.

Many of the companies that receive private capital will sell to public companies rather than go public, then they go back to the well for fresh capital, often from the same sources, and start to build a new E&P again. Among the more than 70 start-ups of the past few years, some have started twice—they amassed assets, sold and began again.

Houston-based Laredo Energy is an example. Laredo II, which focuses on gas plays in South Texas, was at press time acquired by Chesapeake Energy after just 16 months of deploying capital from EnCap Investment LC. EnCap had also funded Laredo I, which was sold to Chesapeake and has assets near where Laredo was restarted.

It is not uncommon for a fund such as Yorktown Partners or Warburg Pincus to commit hundreds of millions of dollars in a year's time, to seed two, three or four start-ups. Lately, in a testament to the market's high hopes and the number of seasoned management teams looking for seed money, the amount of capital a start-up can access has risen, if management's track record is sound.

Several E&P start-ups are formed with people from the E&P and financial communities, marrying the best of both worlds. Peak Energy Resources was created in 2003 in this way. Principals include William E. Pritchard, formerly a manager of oil partnerships for GE Capital, and Jack Vaughn, former vice president for the Rockies division of EnerVest Management. Yorktown Energy Partners V LP, a New York private fund, committed $55 million.

Rockford Energy Partners LLC began in May 2002 with $15 million from Quantum Energy Partners and its own management team. The Tulsa company grew through an acquire-and-exploit model and was sold in several packages to different buyers in July 2004 for a total of $68 million.

"I didn't expect to sell so fast," says CEO Chuck Perrin. "We took eight months off and now we're back."

This past March, he established Rockford Energy Partners II LLC, this time with a $50-million commitment from Quantum Energy Partners III LP. This is Perrin's third start-up, having founded Sapient Energy in 1998 and selling it to Chesapeake in 2001 for $135 million.

Perrin and his team will focus on acquiring long-life reserves in Oklahoma and Texas. At press time, he had five term sheets on his desk for an additional $200 million if bank debt, so he believes he could make a deal of up to $250 million.

No doubt this cycle will continue if commodity prices remain high, above $5 for gas and $40 for oil. And if the stock market continues to move essentially sideways as it has in the past six months, oil and gas companies—public and private—will remain viable investment alternatives for the big funds. ■

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Follow-On Offering
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JULY 14, 2004
$73,000,000
atlas pipeline partners
Follow-On Offering
CO-MANAGER

JUNE 9, 2004
$149,300,000
RANGE RESOURCES
Follow-On Offering
CO-BOOK-RUNNING MANAGER

MAY 11, 2004
$41,000,000
Atlas America, Inc.
Initial Public Offering
SOLE BOOK-RUNNING MANAGER

APRIL 8, 2004
$27,000,000
atlas pipeline partners
Follow-On Offering
SOLE BOOK-RUNNING MANAGER

SEPTEMBER 23, 2003
OCTOBER 9, 2003
FEBRUARY 19, 2004
$1,308,500,000
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2	Goldman Sachs	36	4,309.5
3	Merrill Lynch	38	4,162.3
4	UBS	51	3,808.8
5	Morgan Stanley	30	3,630.6
6	JP Morgan	47	3,592.9
7	Citigroup	30	3,443.4
8	Lehman Brothers	37	3,371.5
9	Credit Suisse First Boston	36	3,065.7
10	Banc of America Securities	27	1,671.0

Source: Dealogic. Relates to total dollar amount, with over-allotment, of all common equity issues for U.S. companies with market capitalizations of $1 billion or less; priced between 1/1/04 and 12/31/04, with apportioned credit to all book runners, excluded closed-end funds; dollars in millions.

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I-BANKING SMALL-AND MIDCAPS

Smaller E&P companies are finding eager investment bankers to arrange public capital to grow their profiles.

ARTICLE BY BERTIE TAYLOR

For years, many of the heavyweight investment banks of New York monopolized the financial markets. These investment-banking institutions routinely have taken aim at larger, more lucrative deals because bigger companies can afford not to blink at larger fees. The opportunity to have a hand in taking a high-growth company public is another reason for the mammoth investment banks to aim high.

But the 1980s and 1990s gave birth to a new breed of regional investment banks, all eager to meet the financing needs of small- and midcap producers. The string of positive deals that marked 2004 for many of the large New York investment banks also gave many smaller, regional firms a boost that same year, and executives at Friedman Billings Ramsey (FBR), First Albany Capital, Morgan Keegan and Pritchard Capital are expecting even more investment opportunities and positive trends in the future for energy markets.

While the larger New York City bulge-bracket firms certainly have well-known names, they cannot claim all of the limelight during 2004. Arlington, Virginia-based FBR is a young investment bank that has had no trouble holding its own in the competitive capital markets. FBR focuses on small- and midcap companies that have strong management teams, and assets that can leverage FBR's knowledge and access to the capital markets.

"FBR is only 16 years old," says George Hutchinson, managing director and head of FBR's Houston energy investment-banking office. "In that short time-span we've grown to become a top-10 national investment bank with book capital of over $1.8 billion, and nearly $3-billion-plus market capitalization."

The principals, Eric Billings and Emanuel Friedman, are involved in reviewing every transaction and often help in deal execution.

"Few realize that FBR ranks No. 1 among all U.S. investment banks for equity raised for companies with market capitalization, pre-raise, of $1 billion or less."

Last year the company raised $6.4 billion through 37 deals for this market segment.

Kevin Andrews, senior vice president at investment banker Morgan Keegan & Co. in Houston, says investors continue to seek opportunities in energy.

"A significant amount of new funds has been raised by private-equity groups seeking energy investments," he says. "In addition, the growth of hedge funds and their continuing interest in the energy sector has increased resources available for publicly traded oil and gas companies. The availability of funds to small- and microcap E&P and oil-service companies has increased significantly during the last year, and U.S. investors are increasingly interested in international oil and gas opportunities."

Andrews adds that investor interest in unconventional resource plays seems to be growing with many new plays emerging from the development of reservoir stimulation technology.

Tommy Pritchard, managing director of Mandeville, Louisiana-based Pritchard Capital Partners, adds that once-overpassed, secondary areas like the Barnett Shale and tertiary-recovery projects are seeing a renewed wave of interest.

"It will be interesting to watch an area like the Barnett Shale take on a life of its own and manifest itself in companies' equities," Pritchard says. "It's been so picked over in the past, but now it's economically feasible to revisit it.

"The availability of funds to small- and microcap E&P and oil-service companies has increased significantly during the last year, and U.S. investors are increasingly interested in international oil and gas opportunities."

—Kevin Andrews, Morgan Keegan & Co.

"There's also going to be more interest in secondary- and tertiary-recovery options." He also expects news from alternative energy sources and projects that involve coal—"right now coal is really hot."

James Hansen, managing director at First Albany Capital Inc., says the energy sector is benefiting from the strength of upward pricing trends.

"Long-term commodity-price expectations are in a period of sustained upward adjustments, as maturing basins and the associated rise in finding, development and acquisition costs set a higher floor for commodity prices," Hansen says. "Also traditional valuation metrics don't measure or value upside potential. Given the maturing nature of the hydrocarbon asset base, growth visibility is critical. Consequently, investors are beginning to value equities giving partial risked value to probable, and sometimes possible, reserves."

Another trend Hansen sees is in the way small-cap names with acreage positions are being valued for the meaningful impact exploratory and developmental success would have on a relative basis.

"Gasco Energy and Carrizo Oil & Gas are examples of small-caps with great upside based on development of existing acreage. Both have prospects of creating repeatable, low-risk, long-lived drilling inventories from current acreage positions," he says.

Value in the independent energy sector during the 1990s was associated more closely with assets rather than in the equity of those companies. Hutchinson says the reversal of this relationship is another emerging trend.

"What we've experienced in the last 24 months has been a fundamental reversal in valuations between public companies vs. upstream oil and gas assets," Hutchinson says. "Today public-company valuations are approaching \$3 per thousand cubic feet equivalent (Mcfe) for proved reserves among many small- to midcap independents while the average valuation for oil and gas properties bought and sold on the A&D market is around \$2 per Mcfe.

"In the mid-'90s, the common sentiment among many institutional and endowment investors was better returns could be realized by direct ownership of the oil and gas assets versus holding the equity of a public independent E&P company," he adds. "In a sense, the view was assets were superior to equity but that belief is reversed today. Many investors believe we've seen a real shift away from \$2.50 to \$3 gas to perhaps \$4 to \$6, and public companies today generate much more free cash flow. Management becomes far more important in a world of higher free cash flow as management must make the key investment and operating decisions on where and how the free cash flow will be reinvested."

IPOS AND THE 144(A)

Initial public offerings also are reappearing in the energy sector, giving large and small investment banks an opportunity to broaden their industry footprint and show true capital-raising talent.

FBR is leading the upstream energy sector in dollars raised and number of deals done when aggregating traditional IPOs and 144(a) equity raises or institutional IPOs, says FBR energy head Patrick Keeley. Between January 2004 and mid-March this year, the firm has done three of the six E&P transactions for more than \$650 million of new equity capital raised.

"Assuming the financials, audit and reserve reports are in good shape, we can start the process and have capital raised within eight to 10 weeks."

—Patrick Keeley,
Friedman Billings Ramsey

"We recently raised over \$400 million on a sole-managed basis for an institutional IPO of a Texas-based E&P company," Keeley says. "The proceeds enabled a large private investor to receive a major return of its invested capital."

Speed and certainty of the capital-raising tool has caused an increase in 144(a) private-equity placements.

"Assuming the financials, audit and reserve reports are in good shape, we can start the process and have capital raised within eight to 10 weeks," he says. "This comparatively fast execution helps mitigate market risk where external events in the capital markets can sometimes overtake an individual company's capital plans."

Pritchard doesn't believe energy IPOs have hit the market with full force yet.

"You have the W&T Offshores and the Bill Barretts, but I just don't think the IPOs have really cranked up yet," he says. "There's always been capital available to entrepreneurs with good track records, so the only thing I can see happening is that Sarbanes-Oxley is causing more headaches and costing public energy companies a lot more money."

Private-equity funding from entities such as EnCap Investments, Quantum Energy Partners and Yorktown Partners continues to flow toward private E&P companies. Meanwhile, institutional money managers—such as of mutual and hedge funds, which traditionally only buy public equities—are now funding more and more private transactions.

"Money managers are more and more willing to take their funds into the private market in the hopes that the company sells out or that there will be a successful IPO."

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$475 Million
sale of
its Propane Business to
Inergy, L.P.
Advisor to
the Special Committee of the
Board of Directors of Star Gas, LLC
December 2004

Warren Resources, Inc.
$82 Million
Initial Public Offering
Common Stock
Sole Book-Running Manager
December 2004

Copano Energy, L.L.C.
$115 Million
Initial Public Offering
Common Units
Co-Manager
November 2004

WHITING
$250 Million
Follow-On Offering
Common Stock
Co-Manager
November 2004

WHITING
$150 Million
Senior Subordinated
Notes Offering
Co-Manager
May 2004

Buckeye Partners, LP
$234 Million
Follow-On Offering
Common Units
Co-Manager
October 2004

Buckeye Partners, LP
$275 Million
Senior Notes Offering
Co-Manager
October 2004

U.S. Shipping Partners, L.P.
$154 Million
Initial Public Offering
Common Units
Co-Manager
October 2004

MARKWEST Energy Partners, L.P.
$108 Million
Follow-On Offering
Common Units
Co-Manager
September 2004

MARKWEST Energy Partners, L.P.
$49 Million
Follow-On Offering
Common Units
Co-Manager
January 2004

Enterprise Products Partners L.P.
$348 Million
Follow-On Offering
Common Units
Co-Manager
August 2004

Enterprise Products Partners L.P.
$362 Million
Follow-On Offering
Common Units
Co-Manager
April 2004

Aka Energy Group, LLC
has acquired
LumenEnergy
Advisor to Aka Energy, LLC
June 2004

The Houston Exploration Company
$327 Million
Follow-On Offering
Common Units
Co-Manager
May 2004

XTO ENERGY
$600 Million
Follow-On Offering
Common Units
Co-Manager
May 2004

RANGE RESOURCES
$108 Million
Follow-On Offering
Common Stock
Co-Manager
December 2004

RANGE RESOURCES
$100 Million
Senior Subordinated
Notes Offering
Co-Manager
June 2004

RANGE RESOURCES
$149 Million
Follow-On Offering
Common Stock
Co-Manager
June 2004

FirstEnergy
has sold its 50% interest in
Great Lakes Energy Partners, LLC
to
RANGE RESOURCES
$290 Million
Advisor to FirstEnergy Corp.
June 2004

Atlas America, Inc.
$41 Million
Initial Public Offering
Common Stock
Co-Lead Manager
May 2004

TRANSFORMATION

"Relationship investing" is becoming more en vogue, Pritchard adds.

"It's not the same role as your average arranger," he says. "We know company XYZ is looking to do an oil deal and hedge fund ABC is looking to do something similar. We then bring them together and let them hammer out the details. It's about dealing with a much more targeted, personal process versus the shotgun approach to arranging a deal."

Another stellar year for energy M&A and capital markets may be under way.

"Energy is in a new place today, and we're definitely out of our comfort area."

—Tommy Pritchard, Pritchard Capital Partners

"The robust energy prices we've experienced in the last 18 months spurred a large amount of M&A activity last year," Hutchinson says. "A fair amount of it came from private-equity funds monetizing assets and investments. My impression is that most of the private-equity sponsors are nearly done with that monetization so we expect to see less activity in larger M&A deals."

It will take some time for the new capital being invested by the private-equity sponsors to be harvested. Meanwhile, he expects continued investment activity in the midstream area as those companies continue to grow by acquisition.

"M&A will be strong as the lack of organic growth prospects steers many midcaps and large-caps toward an 'acquire to grow' strategy," Hansen says.

Hutchinson adds that institutional investors are seeking companies with top management and clear drillbit growth potential.

"Investors are willing to pay a premium for that combination of good management and line-of-sight growth," he says.

Andrews expects very strong public- and private-equity markets for energy companies in 2005, strong growth in international oil and gas markets and continued growth in development of unconventional oil and gas reservoirs in the United States.

FBR has a 2005 commodity-price forecast of $42 for oil and $6 for gas. First Albany: $44.75 and $6.05. Pritchard Capital Partners: $44 and $6.30.

"There are a couple of dark clouds on the horizon," Pritchard says.

Producers' tax bills are large and many deferred tax payments are now coming due on top of everyday taxes. Meanwhile, producers have an ongoing need for more capital no matter that some are flush with cash right now.

"We are in uncharted waters and to opine on the direction would only be a wild guess," Pritchard says. "OPEC clearly is trying to bring near-term prices down by leaking production, but if you look at oil prices longer-term, through 2010, the prices continue to strengthen. I think that right now you actually have the market in one of the steepest contango ever.

"Energy is in a new place today, and we're definitely out of our comfort area." ■

SOME RECENT DEALS

FRIEDMAN BILLINGS RAMSEY

- Co-book-running manager, Range Resources, $107.8MM follow-on offering, December 2004
- Sole manager, Petrohawk Energy Corp., $200MM convertible preferred share placement, November 2004
- Co-lead manager, NGP Capital Resources Co., $261MM IPO, November 2004
- Sole book-running manager, Meridian Resource Corp., $100MM follow-on offering, July 2004

FIRST ALBANY CAPITAL INC.

- Co-manager, Bill Barrett Corp., $373.8MM IPO, December 2004
- Sole placement agent, Carrizo Oil & Gas, $28MM private placement of senior subordinated notes, November 2004
- Co-manager, Gasco Energy, $65MM private placement of convertible notes, October 2004
- Financial advisor to Inland Resources, $575MM corporate sale to Newfield Exploration, August 2004

PRITCHARD CAPITAL

- Lead manager, 1818 Fund LP, sale of $35.9MM Vaalco Energy shares, March 2005
- Co-manager, Cheniere Energy, $5MM-share offering, raising $300MM, December 2004
- Co-manager, Gastar Exploration Ltd., $30MM convertible senior secured debentures, November 2004
- Co-manager, Energy Partners LLP, $3.4MM-share offering of Energy Income Fund stock, November 2004
- Advisor, Gastar Exploration Ltd., placement of $10MM of 15% senior notes, October 2004

1+1 = Much More

Investment bankers are teaming with asset-brokering firms to offer above- and below-ground technical and financial transaction services.

ARTICLE BY NISSA DARBONNE

Investment bankers long have been advisors on upstream corporate mergers and acquisitions. Meanwhile, asset-only advisories—firms that mostly handle upstream property divestments—appeared in the late 1980s and have since grown in number and market support.

While the face of how producing assets change hands during the years has been chameleon in response to market needs, yet another transformation is under way. Investment-banking firms are cozying up with asset-dealers, and rather than doubling their business, they see many-fold revenue opportunities.

And each expects its combinations to result in smarter deal-making for the traditional clients—oil and gas producers looking to buy or sell.

Long-time oil-service investment banker Simmons & Co. International, Houston, made its foray into arranging capital for upstream companies several years ago, and recently has added an alliance with upstream A&D firm Griffis & Associates LLC to its fold.

In less than a year with Griffis at its side, the pair has closed four of four divestment assignments—a 100% closure rate. Their tombstones include arranging the $425-million acquisition of Greystone Petroleum LLC in June 2004 by Chesapeake Energy Corp.—a deal that set tongues to wagging in the U.S. upstream property-divestment business.

"It was essential to identify those corporate buyers that could mitigate the present value of the assumed tax liability in the transaction. In the end, it was a project that required the expertise of both firms to execute."

—Gerald Carman, Simmons & Co. International

In a preemptive bid, Chesapeake paid $2 per thousand cubic feet equivalent of proved reserves for Greystone. Yet more noteworthy: many of the reserves were proved undeveloped (PUD). Simmons and Griffis represented Greystone.

Gerald Carman, Simmons & Co. International

The pair also led the $179-million sale of GMT Energy to El Paso Corp. in February. "One of the GMT management team's objectives was to have an option to sell all or only part of their company," says Joseph Small, Griffis chief operating officer.

Because Simmons and Griffis have both skill sets—investment banking for a corporate transaction and property brokering for an asset sale—the pair was able to run two marketing efforts simultaneously.

Gerald Carman, a Simmons managing director, says the bifurcated process for GMT involved one group of prospective buyers that was interested in a portion of the assets and one group that was interested in all of the assets in a stock transaction.

"It was essential to identify those corporate buyers that could mitigate the present value of the assumed tax liability in the transaction," Carman says. "In the end, it was a project that required the expertise of both firms to execute."

Griffis operates as an independent entity in its alliance with Simmons.

"The reason we keep the business separate is that we clearly recognize the benefit of allowing two different corporate cultures to exist to optimally develop and foster specific expertise," Small says.

To date, the arrangement has been win-win for Simmons and Griffis. Carman says, "From a marketing perspective, our industry knowledge, coupled with our relationships, not only at the CEO and CFO levels, but also with the evaluation teams, allows us to focus on the most likely buyers."

George Gosbee, chairman and chief executive of Tristone Capital Inc., has been familiar with the combination of investment banking and asset-brokering for some time. The firm, which has offices in Calgary and Houston, has done both since inception several years ago.

Today, a great expansion is under way—Tristone is merging with Denver-based Petroleum Place Inc., which owns negotiated asset-sales firm Petroleum Place Energy Advisors, asset-auction firm The Oil & Gas Asset Clearinghouse and software firm Petroleum Place Energy Solutions.

The result will exponentially grow Tristone's asset-brokering capabilities, and take Petroleum Place into Canada and investment banking.

"Investment bankers have focused on a top-down approach to mergers and acquisitions, while A&D firms have been bottom-up when marketing a property," Gosbee says. "By combining the two, we have been able to have both a bottom-up and top-down approach."

The bottom is below the ground—the E&P company's assets. At the top is the company's fiscal make-up.

"We understand both the assets and the financials. We know what happens above the ground, and we

"Investment bankers have focused on a top-down approach to mergers and acquisitions, while A&D firms have been bottom-up when marketing a property," George Gosbee of Tristone Capital Inc. says.

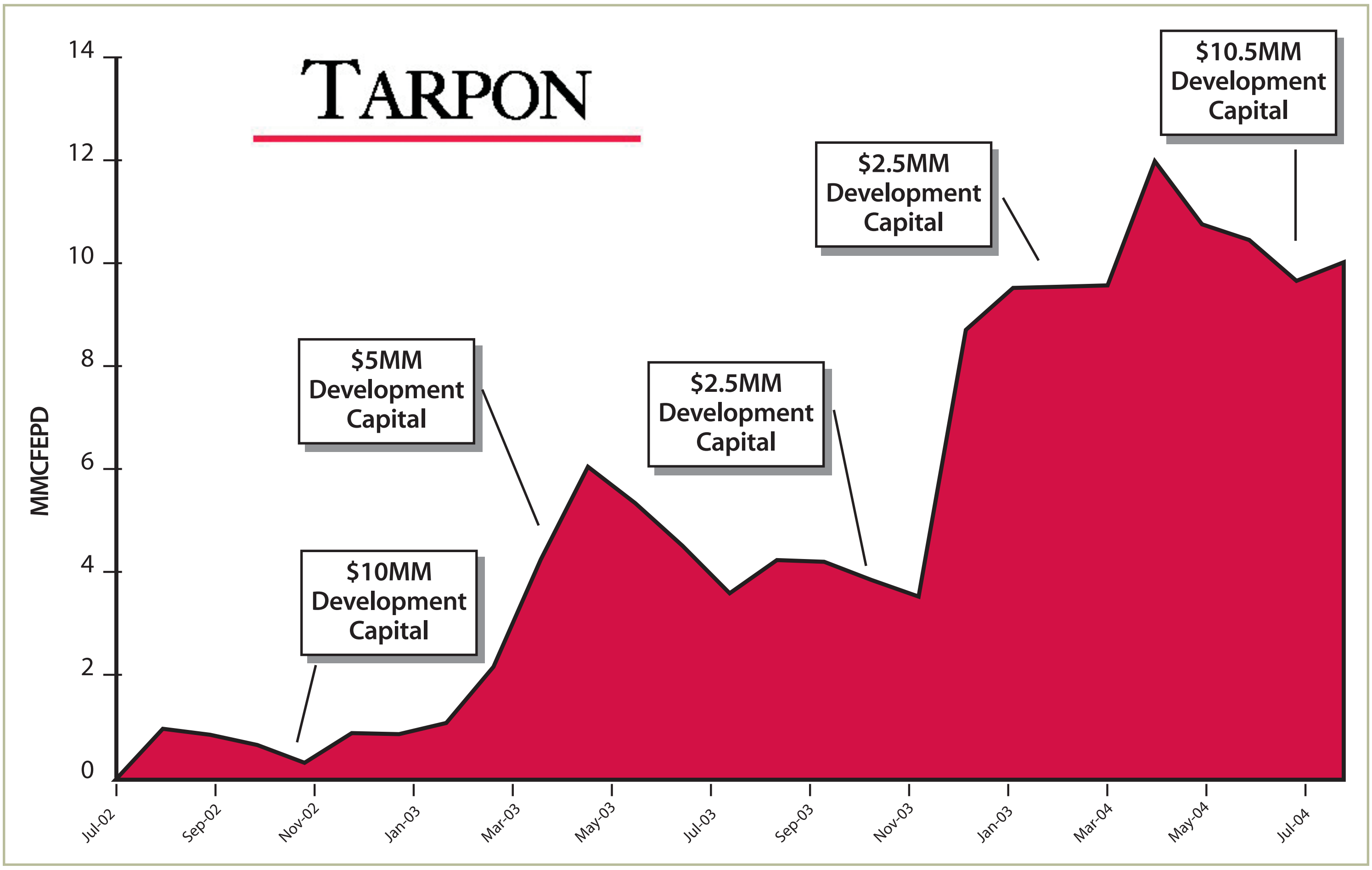
marry that with what is happening below the ground," he says.

Gosbee is convinced that M&A advisory will continue to trend across all industries toward truer

Wells Fargo Energy Capital

WELLS FARGO

Mezzanine Capital for the Oil & Gas Industry



"Wells Fargo Energy Capital has been instrumental in our growth from a start-up to a successful independent and continues to provide the resources we need to expand our Gulf of Mexico development program."

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understandings of clients' top and bottom profiles—and that of buyer and seller.

"In the 1990s, investment banking became all about execution. More and more, people are realizing that many investment bankers didn't know anything about their clients' businesses and there is less confidence in investment banking today because of this," Gosbee says.

On the flip side, an asset-broker can be disadvantaged by not being familiar enough with today's financial instruments and fiscal pitfalls.

"If you're not familiar with the capital markets, how can you give the best advice on which company a client should sell his assets to? Not always are we selling property to the highest bidder," he says.

Other factors include the type of currency that will be used, such as cash, stock, debt and assumption, and the ability to close. Overall, he sees a "huge sea change" coming to the capital markets in how oil and gas producers access capital, at what cost and from whom. Combining investment banking with property brokering will play an important role.

Gary Vickers, founder, chairman, president and chief executive of Petroleum Place Inc., says, "One of the key trends in the upstream-asset industry is that there isn't much of a border left between the U.S. and Canada."

For many years, U.S. companies have bought Canadian companies and assets. Increasingly, traditional Canadian E&Ps and royalty trusts are buying U.S. companies and assets.

"There is a perception among U.S. A&D departments, particularly among midcap companies, that Canadians may be the ideal buyers for many U.S. assets," Vickers says.

Petroleum Place and Tristone expect that, as E&P companies move toward portfolios that blend U.S. and Canadian assets, institutional investors will demand equity research on E&P companies integrate analysis of U.S. and Canadian assets.

Vickers and Gosbee plan to use Petroleum Place's historical transaction data on U.S. assets and Tristone's Canadian research to create a unique North American equity research product to meet this market need. In addition, the combined company will be able to provide fully integrated financial advisory services, including capital-raising, to cross-border E&P companies.

Investment-banking firm Jefferies Group Inc., a long-time arranger of capital to energy companies, has brought Houston-based A&D advisory Randall & Dewey Inc. into its fold.

"Randall & Dewey had been approached several times over the years by investment-banking firms, and Jefferies was among them," says chief executive officer Claire Farley. "Jefferies understood and valued our high-substance, deep-in-the-weeds approach to advising clients on M&A. They also understood our strategy to expand internationally."

During the past year, Randall & Dewey had added a management consultancy and corporate-finance services—unstructured problem-solving that wasn't going to lead to a transaction—to its cadre of offerings.

"As we did that, our business grew very nicely," Farley says.

The firm also was expanding outside North America, opening practices in Calgary and London.

"We were going to win the work and add a team member. It is a conservative way to go about it," she says.

That process could be rather slow, however, and a combination with Jefferies offered faster expansion opportunities as well as other opportunities.

Randall & Dewey, today a division of Jefferies & Co. Inc., the principal operating subsidiary of Jefferies Group, can now assist its existing customers with raising capital. Jefferies customers also now have access to the technical staff—numbering some 60 people—at Randall & Dewey as well as the A&D firm's extensive knowledge of asset values. The firm has marketed hundreds of property packages in its 17 years as well as gathered extensive additional intelligence on the asset marketplace.

"It is really important in offerings to tell the company's story in a way that helps investors understand the assets—the competitiveness of the play and the technical nature of the assets' value," Farley says. "The buyer of a security is asking to understand if a security is priced appropriately relative to the risk profile. We can credibly answer that because we have seen so much."

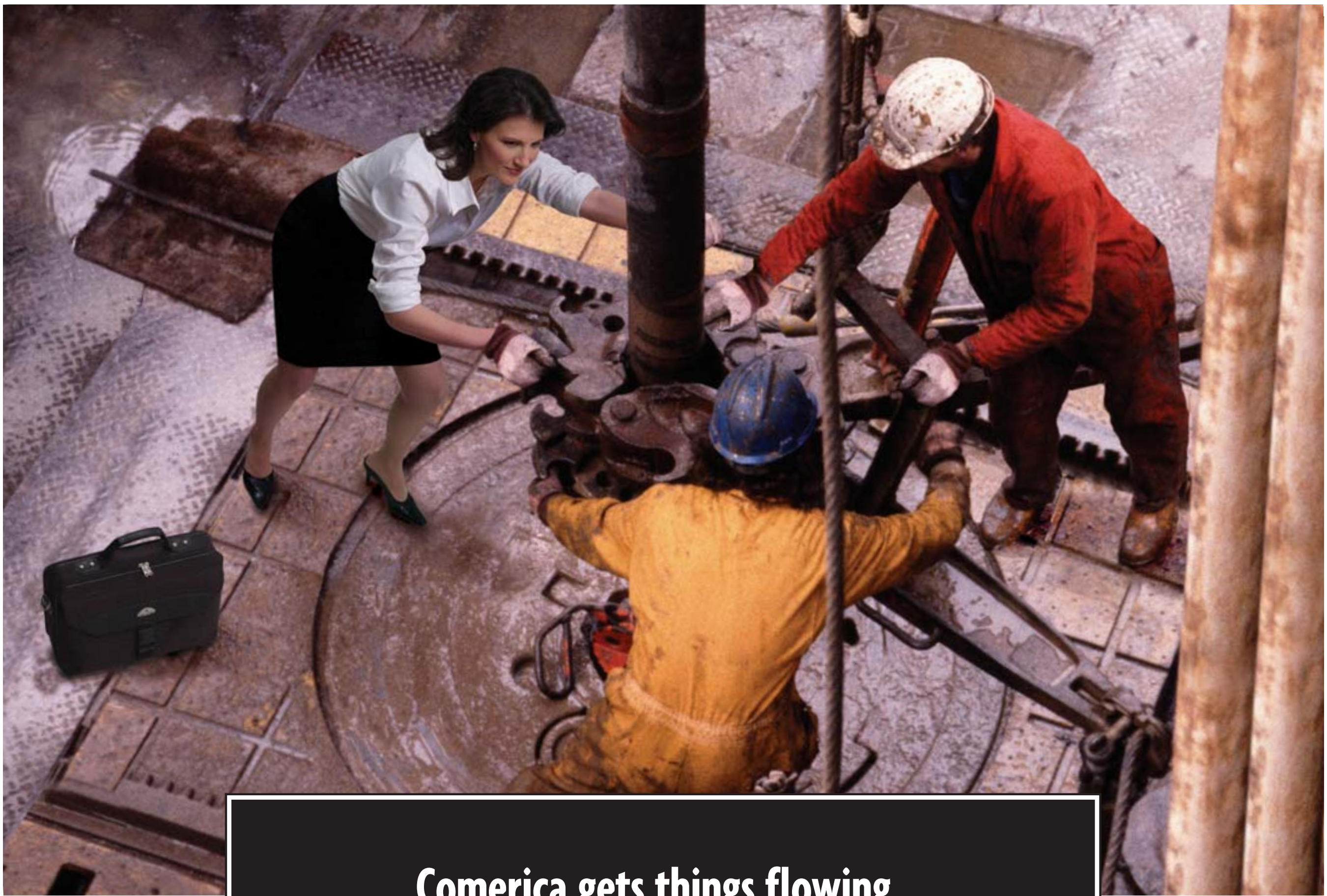
The partnership is accretive to the quality of services Jefferies and Randall & Dewey each offered.

"We've put great financial minds that are always trying to invent the best way to package risk and combined this with what we at Randall & Dewey know about the underlying asset risk," she says.

David Rockecharlie, a managing director of corporate finance for Randall & Dewey, sees near-term, capital-access activity by producers to mostly be driven by acquisitions, and he expects a continued strong amount of demand for commodity-price, risk-mitigation instruments in the forms

"It is really important in offerings to tell the company's story in a way that helps investors understand the assets," says Claire Farley of Randall & Dewey.

"The net share settlement feature minimizes equity dilution relative to other more traditional convertible financing," David Rockecharlie of Randall & Dewey says.



of hedging, volumetric production payments and other structures.

All of investment-banking firm Jefferies & Co.'s oil and gas practice is now represented through the Randall & Dewey business unit, except for separate Jefferies practices on oil services and shipping.

NEW DEBT STRUCTURES

Rockecharlie and his colleagues are working on bringing two new financial products to the upstream oil and gas space. One of these is debt that combines the lighter covenant package and greater capacity of high-yield bonds with the refinancing flexibility of credit facilities.

Borrowers are attracted to bank debt because of the cheap cost of capital and refinancing flexibility. However, bank-debt capacity is limited because of the focus by lenders on producing reserves and conservative commodity-price forecasts. Moreover, repayments can be required frequently, because of the right of the lender to redetermine the borrowing base.

Ultimately, this limits the ability of the borrower to reinvest capital. With the limited leverage offered by the banks, many companies are forced to look to public or private equity, which is a higher cost of capital. To reduce the amount of equity issued, larger companies have embraced the high-yield market, which allows long-term reinvestment of cash flow and more aggressive lending against the assets.

However, the typical high-yield offering is in excess of $100 million and also raises concerns about potential prepayment penalties. The mezzanine-debt market has traditionally filled the hole between bank and high-yield debt, but it can typically be very restrictive financing and carry an equity component.

"One of the key trends in the upstream-asset industry is that there isn't much of a border left between the U.S. and Canada."

—Gary Vickers, Petroleum Place Inc.

"We still see significant demand by borrowers for an alternative to bank, high-yield and mezzanine debt," Rockecharlie says.

The answer? Covenant-light bank debt. Jefferies has arranged such capital for companies in other industries. In its combination with Randall & Dewey, it aims to roll it out for oil and gas producers.

The other capital-raising tool Randall & Dewey is offering is convertible financing based on a net-share-settlement feature. With this structure, the company raises proceeds at a premium to the current stock price without any near-term dilution.

"The net share settlement feature minimizes equity dilution relative to other more traditional convertible financing," Rockecharlie says.

At Simmons and Griffis, Small and Carman say upstream property and corporate transactions today are trending toward increasing complexity that can more readily be handled by experienced investment bankers.

"As a result of more private-equity deals as well as the arbitrage between capital gains and ordinary tax rates, there has been a higher number of corporate stock versus asset transactions in the marketplace," Carman says. "A stock transaction adds an additional level of complexity associated with financial and legal due diligence."

Joseph Small of Simmons and Griffis adds, "The expectations of services to be provided by A&D advisors continue to escalate."

Small adds, "The expectations of services to be provided by A&D advisors continue to escalate. This is being driven by competition in the advisory segment and the increasing recognition that the right advisor can successfully maximize the transaction value. The advisors need to provide strong technical, financial and marketing skills."

The types of assets that are on the market are also increasingly complex, Small says. "Many of the emerging-resource plays have been technology-driven and a significant part of their success has been due to the application of advanced drilling and completion technologies. With these types of assets, as well as traditional development plays, technical expertise is required to further evaluate, document and clearly communicate the upside potential," he says.

The firm representing the seller should have personnel that has worked with these technologies, Small adds.

"We have a veteran team of engineering and geoscientists who have spent most of their career on the other side of the table—making acquisitions, drilling wells, setting budgets and booking reserves. They understand what is credible," he says.

Both see continued ebullience in investor interest in upstream assets.

"Public companies are being rewarded in the marketplace for their ability to grow through acquisitions as well as the drillbit—premium valuations are attributable to those companies with identified projects and inventory," Carman says. ■

VPPs

The VPP structure is an attractive way to assure forward prices without hedging.

ARTICLE BY TARYN MAXWELL

For producers who want to lock in these better-than-ever commodity prices, the volumetric production payment (VPP) is quickly growing in popularity, and market conditions have never been friendlier for this type of financing.

"The VPP has been around since the 1970s," says Dennis Millet, vice president and chief financial officer for Dominion Exploration and Production Inc., based in Houston. "It was done by some companies, but prices were falling, and you just didn't have the marriage of low interest rates and high prices that you have today. That's a recent phenomenon that has really brought the transaction en vogue."

"We think there's a lot of strategic value associated with a VPP," says Dennis Millet, vice president and chief financial officer of Dominion E&P Inc.

Dominion is the most recent major producer to take advantage of VPP financing. In March, the company announced it would receive $424.4 million in cash for the sale of 76.4 billion cubic feet of gas during the next four years to UBS Investment Bank. The production comes from 2,900 wells in Utah, New Mexico, Alabama, West Virginia and Michigan. Dominion will retain control of the properties and rights to future development drilling, as well as production above the promised VPP volumes.

"We're just selling a slice of the production, we're keeping ownership of the properties and we're able to continue our drilling plans," Millet says. "If we sold the property, we would be selling all of the future potential, which would involve completely different negotiations. In this transaction, we are able to receive all the cash up front. We think there's a lot of strategic value associated with a VPP. Yes, commodity prices could go up, but we feel very comfortable at this price strip. There are also no margin calls attributable to this type of structure."

David Rockecharlie, managing director of corporate finance, at Houston-based Randall & Dewey, a division of Jefferies Inc., which has arranged several VPP transactions, sees VPP deals becoming more of a standard product in today's market.

"There are more buyers for it and there's more transparency in how the deals get done," he says. "Over the past few years, financial investors have found the oil and gas asset class more attractive because there is a hard asset in the ground that can be owned directly. There's no corporate structure to deal with. In the supply and demand equation in the global economy, oil and gas is an asset with upside, born of the last few years of high commodity prices."

The buyer of the production in a VPP arrangement has in the past been a firm that needs a bookable supply of oil or gas more than it needs it at market prices. Corporate accounting scandals have been catalysts that have drawn investors to hard assets, rather than intangible or paper securities, he adds.

"These scandals have lead people directly to assets, and it's not just oil and gas that's in demand, it's all assets that are cash-flow generating," Rockecharlie says. "VPPs are much more viewed as oil and gas bonds…It's the least risky portion of an oil and gas asset because it's already producing."

Another phenomenon in today's market that has made VPPs increasingly popular is the commodity-price arbitrage between the futures market and stock market, Rockecharlie says.

"People buying stocks and bonds are assuming lower commodity prices than the company could actually realize in today's market," he says. "Investors are undervaluing companies. Something investors sometimes miss is that the futures market is real, it's not just a forecast. You can actually buy and sell based on those numbers."

Randall & Dewey was the transaction and financial advisor to CDX Gas LLC in a recent acquisition when the latter bought a portion of BP America Production Co.'s eastern San Juan Basin assets. A VPP was used as part of the financing.

"CDX was looking to do a VPP for acquisition financing; they locked in a solid rate of return on their acquisition," Rockecharlie says. "We've also advised private companies who view the current market as a good time to realize a portion of the gains on their investments. They drilled wells three years ago and prices have run up significantly, but they haven't exploited all the upside yet, so they're willing to sell forward in a VPP to lock in commodity prices that exist today, while retaining their upside."

Morgan Stanley found itself on the VPP scene in July 2003 by being involved with Apache Corp. in its total $500-million acquisition of Shell Exploration &

Production Co.'s 26 shallow-water Gulf of Mexico fields. The assets cover 50 blocks and interests in two onshore gas plants. Morgan Stanley put up $300 million for a VPP involving some of the lower-risk reserves, from which Apache is to deliver 68.4 billion cubic feet of gas equivalent to Morgan Stanley for the next four years.

In another joint venture with Apache, Morgan Stanley agreed to pay $775 million for an overriding royalty interest in Gulf of Mexico shelf assets bought from Anadarko Petroleum Corp. last summer. The VPP gave Morgan Stanley an interest in 24 million barrels equivalent of lower-risk reserves expected to be produced during the next four years.

When a VPP is not done to finance an acquisition, Randall & Dewey often advises companies to use the financing to buy back stock, because many are undervalued relative to prevailing futures prices.

Pioneer Natural Resources did just that with its gains from one of the largest VPPs done to date. In January, the company sold production representing 2% of its total proved reserves, or 20.5 million barrels of oil equivalent of proved reserves, in a VPP for total proceeds of $593 million, with Wachovia Securities as arranger.

Paul Riddle, managing director for Wachovia Securities energy and power investment-banking group, says the biggest risk involved with a very large VPP is reservoir performance.

"Most properties with predictable production, diversification of wellbores and the ability to hedge the regional basis, are good candidates for a VPP," he says.

Size is not a significant concern for Wachovia from a provider standpoint. Size is an important consideration for a VPP issuer, however, since a certain amount of future cash flow is exchanged for cash today.

"The determining factor for the VPP issuer ultimately is the use of proceeds, such as financing a property acquisition, organic growth capital, share repurchases or debt refinancing," Riddle says. "For a large VPP, it is also very important for the VPP purchaser and seller to work together to avoid moving the market when placing in the hedges. The VPP seller's execution risk is dramatically lowered when the hedges can be layered in over time."

HEDGING OR VPP?

Historically, hedging is the closest alternative to a VPP for producers. Both types of financings allow a company to collect now for future production, but hedging

involves a margin, which poses the biggest threat to companies hoping to avoid losing money.

"The great thing about a VPP is it doesn't have all the risks associated with hedging," Rockecharlie says. "The margin is typically the worst outcome of a hedge. In a VPP, the asset itself is the security; there's no margin required. Additionally, if properly structured, the VPP transfers significant production risk, giving it many of the benefits of an asset sale."

Riddle says a VPP is a good alternative to hedging because a VPP allows a company to hedge larger volumes for longer periods of time.

"The company does not use up credit availability, does not face counterparty risk of performance (as the capital is received up front), and there is no potential for future margin calls," he says. "There is no FAS 133 mark-to-market exposure to fluctuating commodity prices related to the VPP volumes. As a result, the VPP provides a very predictable oil and gas sales revenue stream over the life of the VPP." (Editor's note: FAS is a financial accounting standard the Financial Accounting Standard Board developed.)

Producers may sell the property, but that can result in tax consequences, Riddle says.

"By valuing the VPP volumes using current high commodity prices and selling only a term royalty, the producer is able to monetize the asset—not trigger a taxable gain on the sale—and maintain ownership of the upside and the remaining reserves, which would normally be heavily discounted in a sale," he says.

The details of arranging a VPP are as important as for a property sale, however.

"Due diligence is very similar to our normal reserve-based lending activities or that of a company purchasing properties," Riddle says. "It involves financial, marketing, engineering and title evaluations."

Price tends to be the primary focus, though length also is a major factor.

"First, producers worry about the potential effect on operations of the company. Once the decision has been made, it's all about the value received. Value comes first, the nominal price received per unit of production, and second, the amount of reserve risk and price-risk you're able to hedge," Rockecharlie says.

Most companies hedge production over one to three years.

"That's what the market typically allows," he says. "With a longer hedge, you risk margin exposure and credit exposure. With a VPP, there's no margin to worry about, and no credit exposure because the assets serve as collateral. We have done a seven-year and a 12-year transaction. Most companies aren't willing to do that at the corporate level, but on particular assets, they feel comfortable."

Dominion has done a VPP every year for the past three years, and each has been for a period of four years.

"Beyond four years, we have less comfort with the price," Millet says. "Four years seems to be the real sweet spot for us. Many parties have wanted longer terms, but we made the decision that four years is the right length."

The company has tweaked its negotiation process with each VPP, and Millet believes this has helped it achieve even more favorable results.

"Our first VPP was a negotiated deal, and with our second, we did a bidding process, but it was very limited," he says. "With our recent VPP, we had a number of parties bid on the transaction and it was a very valuable exercise for us."

A number of bids were made, and UBS was the winner. The process was quick.

"We did our last deal in about 45 days and that was quite remarkable," Millet says. "We were successful because we got the best value, as you would in almost any negotiated process."

Riddle also has had experience with closing VPP transactions quickly.

"Wachovia has not syndicated its VPPs, and this has proved to be an advantage in closing VPP transactions in a timely manner," he says.

"VPPs will increase in popularity with public companies if equity investors continue to undervalue mature reserves relative to VPP valuation."

—David Rockecharlie,
Randall & Dewey

As commodity prices continue to rise, Riddle predicts VPPs will continue to become more prevalent in the marketplace.

"A VPP purchaser can be the most aggressive bidder on predictable PDP reserves in this current high commodity price/low interest rate environment," he says. "VPPs will increase in popularity with public companies if equity investors continue to undervalue mature reserves relative to VPP valuation."

VPPs could allow investments in production.

"I think VPPs could serve as the starting point to create publicly traded oil and gas asset-backed bonds," Rockecharlie says. "Investors in VPPs have been institutions. With the current level of investment demand, the financial community will provide a way for the individual to invest in the product."

The concept would be similar to the Canadian royalty trust.

"It's not the same thing, but it's the closest thing," Rockecharlie says.

He also sees potential for an oil and gas master limited partnership. "The only thing you can own now is a stock or a bond in an oil company," he says. "Wouldn't it be nice to be able to own production?" ■

Drilling Abroad

Many financing options are available today to the internationally focused E&P firm.

ARTICLE BY KELLY GILLELAND

Ask any independent producer to name the hottest play in the exploration sector today, and chances are the answer will involve "at least one unpronounceable locale that couldn't even be found on the map 10 years ago." This sentiment, expressed by a Texas-based service contractor, is the key not only to survival, but to the lion's share of profits for some service companies today, he says.

"Used to be we'd put together a crew of really good men and head out to West Texas or the Rocky Mountains," he says. "Now my men have passports with multi-entry work visas for some of the most remote places on the face of the earth. Used to be you needed a degree in geology to find oil—these days you also need a geography degree and a really big pile of money."

Finding that pile of money is the job of his customer, the E&P company. It's becoming easier, in part because of the innovative nature of the modern oil entrepreneur and myriad financing options that continue to evolve to meet global investment needs.

"Small companies have a lot more options today than they did 20 or 30 years ago," says Florida-based Albion Resources president David Clark. "At the time of the North Sea fourth licensing round in 1972, the norm was for smaller companies to do the initial leg work (geologic studies, seismic, early negotiations with the government) and then put together consortia of larger companies to do the actual exploration. In return, the smaller company would get a carried interest through the first two or three exploration wells.

"The expectation was that a discovery would be made and the small company would be able to participate in the development or production phase by riding along with the group's anticipated project financing."

Today, it often is possible for small companies to finance their own share of development costs in foreign countries by using a local bank, Clark adds.

"Banks are much more sophisticated at this type of arrangement now," he says.

DEBT OPTIONS AVAILABLE

Debt is still one of the cheapest and most common forms of financing. Generally tied to a specific project, loans can be used to catapult a small player into the bigger playing fields, at least for an initial "proving" period. The key is the debt's structure. Savvy companies can help design the debt to mitigate certain types of risks such as currency exchange rates, commodity-price fluctuations and even the risk of nationalization of the assets by a host government.

Some companies opt for nonrecourse financing, which, unlike project financing, is not paid out of a specific oilfield-development project or tied to any specific asset that could be used as collateral in the event of default. Loans may be straight interest-bearing, or convertible debt, or a mixture of such terms with share warrants added as a kicker.

The lender will look at the financial strength of a company, its management and profitability record, and the likelihood that the company will remain a "going concern" during the life of the loan. Nonrecourse financing typically requires the borrower to pledge its "full faith and credit" to obtain the loan.

"Small companies have a lot more options today than they did 20 or 30 years ago."

—David Clark, Albion Resources

It usually has "negative pledges" included in the loan documents, that is, a series of "do nots" that could include such covenants as prohibiting the borrower from obtaining additional loans without consent of the nonrecourse financing lender, or issuing new shares without permission or filing bankruptcy without the lender's agreement.

PUBLIC AND PRIVATE EQUITY

Private-equity funding for small international projects, once a rarity, is now more commonplace as the larger private-equity funds come to grips with the risks of doing business in politically unstable areas.

"Unfortunately, most of the world's hydrocarbons seem to be located right in the middle of the so-called

Third World," one explorationist says. "We all wish there was oil in Hawaii or the Virgin Islands, but there's not. So, we get our cholera jabs and take our malaria meds and head out to places with questionable governments, hoping to make a fair deal and not get shot.

"To fund these ventures, we all use good, old-fashioned salesmanship, be it with the bank, private investors or on the street."

Many small E&P ventures begin their international lives—and raise capital—by going public on one of Canada's stock exchanges, which are viewed as less stringent than U.S. or European trading venues.

One example is InterOil Corp., first listed as IOL on the Toronto Venture Exchange. The firm graduated to the Toronto Stock Exchange in July 2004 with the same trading symbol, then joined Amex (as IOC) that September. It also trades on the Australian and Port Moresby exchanges as IOC.

Today, it often is possible for small companies to finance their own share of development costs in foreign countries by using a local bank, David Clark of Albion Resources adds.

The Canada-based company owns assets through the entire value chain, from wellhead to refinery to service stations, almost exclusively in Papua New Guinea, says Gary Duvall, Houston-based vice president of corporate development.

Its assets comprise a 32,500-barrel-a-day oil refinery, 8 million acres of onshore petroleum exploration licenses, and retail and commercial distribution assets. The majority of the products from the refinery are sold under contracts with Shell and InterOil's wholly owned subsidiary, InterOil Products Ltd. BP Singapore supplies crude to the refinery.

In an unusual deal recently, InterOil raised another US$125 million from institutional and accredited investors for an exploration program in exchange for an aggregate 25% indirect participation interest in that program. Six of the eight wells slated to be drilled in Papua New Guinea will be sited at locations chosen solely by InterOil, but the remaining two will be drilled at locations approved by the new investors. If the exploration program results in discoveries of oil or gas in commercial quantities, the investors have the right to prorated participation in any field development.

To raise the required capital, InterOil requested—and received—waivers from the Australian and Port Moresby stock exchanges, allowing US$33 million of indirect participation interest issued to be closed.

"We are pleased the (Port Moresby) recognized the conflict that can arise from being listed on numerous exchanges, and has allowed us to remain listed on…under our primary stock exchange listing requirements," says InterOil chairman and chief executive Phil Mulacek. "This will allow for continued investment support within Papua New Guinea."

Obtaining these types of permissions is nearly always aided by fostering good relationships with host-country governments, which are much more cognizant of the long-term investment implications today.

"Papua New Guinea, with all of our vast resources, welcomes the investment by InterOil in the largest exploration program in PNG history," says Moi Avei, petroleum and energy minister. "This investment…confirms that our fiscal policy reforms have made PNG globally competitive."

RULE 144A

Some companies take advantage of the U.S. Securities Act of 1933's "Rule 144a," a safe-harbor exemption from the SEC registration requirements. This rule allows for resale of certain restricted securities to qualified institutional buyers by persons other than issuers. The goal of Rule 144a is to make the private-placement market more liquid and efficient by giving institutional investors more freedom to trade securities, and to induce foreign companies to sell securities in the U.S. capital markets.

One example of a Rule 144a financing is that of Canadian Oil Sands Trust, which issued US$250 million in 4.8% senior unsecured notes last year. The notes mature in 2009 and were priced at $99.912 to yield 4.82%. Proceeds will be used to pay bank-facility borrowings and fund Canadian Oil Sands' share of the Syncrude Stage 3 heavy-oil project in northern Alberta.

THE WORLD BANK

Government agencies such as the World Bank are sometimes prepared to finance small operations, if the project meets the latest politically motivated criteria, like the currently popular development of gas reserves in the Third World. The bank offers an array of instruments including loans and grants to finance poverty reduction and economic development efforts globally, using two main lending instruments: investment loans and development-policy loans.

Investment loans typically run for five to 10 years and finance goods, works and services that support economic and social development projects in a broad range of sectors. Originally concentrated on financing hard goods and engineering services, investment lending has come to focus more on institution building, social development and developing the public policy infrastructure needed to facilitate private-sector activity.

Development-policy loans provide "quick-disbursing external financing to support policy and institutional reforms," according to the bank. These loans typically run for up to three years. They were designed to support macroeconomic policy reforms, including trade policy, but today they focus more on structural, financial-sector and social-policy reform, and on improving public-sector resource management.

According to the World Bank, a limited number of grants also are available, either funded directly or managed through partnerships. Most are designed to encourage innovation, collaboration with other organizations, and participation by stakeholders at national and local levels. Donors entrust the bank to operate some 850 active trust funds, which are accounted separately from the bank's own resources. These financial and administrative arrangements with external donors lead to grant funding of high-priority development needs, including technical assistance and advisory services, debt relief and post-conflict transition.

The bank also offers several types of guarantee and risk-management tools to protect commercial lenders from risks associated with investing in developing countries. One example is the Petroleum Sector Management Capacity building project in Chad, Africa. The project was designed to strengthen the country's petroleum-resources management capacity, within environmentally and socially sound practices, and establish a framework for private-sector investments in Chad's petroleum sector. Interested parties take note: the closing date for award of funding on this project is December 31.

IADB

Another important lender is the InterAmerican Development Bank. Its capital-markets division includes three sections. The funding section raises funds in the international capital markets to support the IADB's lending activities and conducts its liability management operations.

The investments section invests the liquid asset portfolio of the IADB in a broad range of high-quality assets in the fixed-income markets of all major currencies, including U.S. dollars, euros and Japanese yen. The operations section settles and services all of the IADB's funding and investment transactions.

On January 10, the IADB announced US$1.2 million in new financing to attract investment in oil and gas exploration in Paraguay. Only a small portion of land in the country has been explored to date. In Paraguay's entire history, only 49 wells during a 50-year period have been drilled, all with negligible results.

Its population growing, Paraguay is looking for a new electricity-generation source. The country is extremely close to passing new laws that will update its legal framework and entice further exploration efforts by international companies. The IADB will fund consulting services and other groundwork activities in hopes that new information will stimulate such exploration investment.

COUNTRY ECONOMICS

To benchmark offshore drilling costs across geographical regions, the same generic well needs to be considered, according to energy information-services firm IHS Energy. In this comparison, a 2,000-foot-water-depth, 7,500-foot reservoir is to be drilled with a fourth-generation semisubmersible rig. It is benchmarked against the January cost database found in QUE$TOR, operated by IHS Energy.

Using a Gulf of Mexico baseline cost of US$10.7 million, the typical variances seen are:

- Nigeria, 8% higher;
- Indonesia, 4% higher;
- Brazil, 10% higher; and
- U.K. North Sea, 62% higher (primarily due to exchange rates).

Traditionally, the prime cost drivers in the various regions have been rig availability and regional variations in dayrates. This continues to be the case, but major variations are now seen based on the location from which the rig is sourced.

This provides more significant differences in costs because of the dollar conversion, primarily due to the variability of exchange rates. Cost comparisons in the North Sea have traditionally been tracked in the local currency (Norwegian kroner or U.K. pounds).

Looking back from July 2004 to January, the variation in regional well costs have been as follows, according to IHS Energy:

- Gulf of Mexico, 3.1%;
- Africa, 6%;
- U.K. North Sea, 14.3%;
- South America, 2.3%; and
- Southeast Asia, 0.5%.

OPIC

The Overseas Private Investment Corp. (OPIC) is another source of funding for international energy projects. This self-sustaining federal agency aims to create a level playing field for U.S. businesses and support development in emerging economies. Its investment runs the gamut from providing insurance to high-risk pipelines in West Africa to funding E&P activity in obscure locations.

The agency provided the underlying US$85-million project financing for InterOil's Papua New Guinea refinery.

In 2002, OPIC offered up to US$350 million to Unocal for financing two offshore oil and gas projects in the Makassar Straits off East Kalimantan, Indonesia. OPIC's financing nearly single-handedly fulfilled a 2001 joint initiative of OPIC, the U.S. Export-Import Bank and the U.S. Trade and Development Agency to provide $400 million in loans and guarantees to finance U.S. investments in Indonesia.

Unocal and Pertamina, the Indonesian state oil company, worked to develop the offshore fields, with production slated to be sold in Indonesia and the general Asian petroleum market.

OPIC's political-risk insurance and financing have helped U.S. businesses of all sizes invest in 140 emerging markets and developing nations worldwide during the past 30 years. It has supported $138 billion worth of investments.

Sometimes a host government will assist in funding smaller exploration ventures in exchange for a larger portion of production than it would normally be entitled to under local law.

"In a very remote area, even the richest state oil companies may not be willing to assume 100% of the risk of exploration," comments a senior executive with a U.K.-based upstream operation. "Sometimes the motivation is simply the fear that if the state company drills and fails, it will be perceived as inept, so they enlist the assistance of a small foreign oil company who is eager to get a foot in the door, and let that company assume the 'face risk' of the drilling venture. If a small company is politically savvy, it can sometimes spot these special circumstances and use them to advantage."

Worldwide currency fluctuations and the decrease in the value of the dollar have sent many hopeful U.S. explorationists to foreign venture-capital organizations, and reciprocally, more foreign financiers are considering U.S. companies as potential value-added investments.

Sometimes a small exploration company will settle for an override percentage or a small net-profits interest, just to get initial deal financing off the ground, a common practice in U.S. exploration. However, this type of arrangement is often frowned upon by foreign governments that cannot or will not recognize such deals as recordable on the actual exploration license. This can be a frustrating experience for a U.S.-based company when entering into the alien world of international exploration and production.

TOREADOR'S FINANCING

Some companies have found the foreign game so enticing that they sell their domestic assets to finance their overseas plays. Dallas-based Toreador Resources in early 2004 sold all of its U.S. mineral and royalty assets to position itself as an international explorer and developer. Today the company's portfolio primarily consists of developed and undeveloped oil and gas properties in France, Turkey and Romania.

The company kept its nonoperated working interests in five states, but stresses its goal is to "take advantage of higher potential exploration opportunities overseas that create greater long-term value for investors."

Toreador entered the foreign marketplace by purchasing another small E&P company, Madison Oil, in late 2001, because it held rights to properties in France and Turkey. The purchase gave Toreador a U.S./international balance.

"The international arena offers sizable oil and gas provinces and the most prospective exploration opportunities, especially for a small-cap independent like Toreador," the company reports.

VENDOR PARTICIPATION

Some companies have become partners with their contractors to get a foreign prospect drilled.

"There are many other considerations other than the cost of drilling a well in a remote location," says one contractor. "You have to factor in political risk, different environmental rules and regulations, infrastructure investment, development costs and the ever-present 'open hand' of the host government. They always seem to want a new school or some other community enhancement that, while admirable, is a drain on a small explorer.

"That is why some companies choose to partner with their contractors. We may shoot the seismic or perform other front-end functions in exchange for an equity working interest in the project, and the explorer is grateful for the help because they've got their hands full keeping their cash flow under control."

In the not-too-distant past, the perception was that international oil deals were mostly scams, says a European-based project manager.

"Common belief was that small promoters would 'buy' a geologist to get a good possible reserves estimate, then put the concession on the stock market in Canada.

"Private parties would buy in, and two years later the concession would turn out to be worth nothing. In the meantime, the promoter has filled its pockets, and everyone else would be left holding an empty bag," he said.

While this scenario isn't always true, one needs only to search the SEC's enforcement notices to find examples of much the same situation happening time and time again. A cursory search of Ebay even turns up the occasional oil and gas leasehold or mineral rights available for sale. In the international oil sector as in every business deal, the buyer must always beware.

In today's market, Australia, New Zealand, Papua New Guinea, Colombia, India, Pakistan, former Soviet Union states, Tunisia, Egypt and several West African nations seem to head the popularity list for small oil investors.

"The world has shrunk in terms of communication, transparency of oil and gas regulations, markets for small projects—stranded gas for example—and willingness of governments to recognize that small companies can often do more, and do it more rapidly than the majors, who are only looking for the multibillion-barrel project."

"International exploration and development provides the investor with 'sizzle' in a portfolio and the chance to be involved in a big discovery," Clark says. ■

CAPITAL CHECKLIST

Even the smallest of E&P companies has access to virtually all types of capital in today's financial marketplace. Here are pointers on what type of capital to use.

ARTICLE BY JOHN BARRY

Long-term oil and gas supply and demand dynamics indicate a period of sustained higher pricing is likely, making it easy to recognize that significant opportunities for value creation now exist for the energy entrepreneur. However, many junior E&P companies are restricted in their ability to capture these opportunities because of the limiting nature of their existing capital base.

The junior E&P company that needs capital—to make an acquisition; to complete an attractive rework, debottleneck or enhancement; conduct new drilling; or perhaps pursue other opportunities—should seek to raise an optimal mix of capital to fund that venture. What makes an optimal mix?

As discussed here, junior E&P companies should consider three key criteria when considering mixes of debt and equity, and their sources: availability and challenges to closing; loss of ownership and control; and up-front and ongoing costs of capital.

Here's a quick look at the pros and cons of various financing options.

Although much capital comes from Manhattan and other money centers, friends and family, industry partners and local banks also play a big role. (Photo by Lowell Georgia)

OPERATING CASH FLOW

Generally, rolling operating cash flow into the next opportunity is the easiest choice for a small E&P company. Typically, shareholders are happy to "let it ride" rather than demand a dividend or distribution, as long as the company has been reasonably successful to date and has a solid business plan.

However, even with the rich oil and gas prices we see today, operating cash flow alone is often inadequate to execute a company's more meaningful growth plans.

FRIENDS, FAMILY, EXISTING SHAREHOLDERS

Often, junior companies look first to friends and family or existing shareholders for incremental capital. This type of equity is the easiest capital to raise, given the pre-existing relationships involved. Too, many business owners prefer managing shareholders they know, rather than answering to outsiders. That said, this pool of available capital is by definition limited, even to the most gregarious of E&P promoters.

These non-institutional sources of capital generally offer little in the way of managerial expertise, strategic relationships or publicity. They may fall short if the company needs more capital than expected, especially on short notice. Finally, as with any source of equity, any new equity dilutes the ownership and control of existing shareholders.

COMMERCIAL BANKS

Junior E&P companies that have outgrown friends, family and existing shareholders often turn to commercial banks, but it must be recognized that banks do not view their business as involving complex risk analysis or calculated risk-taking. They tend not to loan to early-stage companies or those that, for whatever reason, are not producing substantial positive cash flow.

In making their credit determinations, commercial banks will look for significant historical production and cash flow plus fully engineered collateral coverage,

audited financials, scheduled amortization and often compensating balances or personal guarantees.

If a junior E&P company can provide these high levels of credit quality and security, it may be able to borrow at single-digit interest rates. However, significant operating experience and advance planning is required, as it can take six to nine months to close a commercial bank loan in some cases. Finally, commercial banks demand a first lien against a borrower's assets, and they will foreclose on those assets in the case of a downturn.

PRIVATE EQUITY

Junior E&P companies that cannot satisfy the strict criteria of commercial banks, or those that need to move quickly, often turn to private-equity firms as a source of capital. These firms are generally unregulated private partnerships, including certain hedge funds, that are willing to analyze and accept risks that commercial banks will not accept.

As compensation for accepting additional risks, they require: higher interest rates on any loans they make; significant equity in the borrowing company, frequently in the form of "penny" warrants or convertible features on their capital; and various types of "control" over the borrowing company.

Control may mean new members on the borrower's board of directors loyal to the private-equity firm, tight financial covenants, a revolving credit available only if the private-equity firm is satisfied with the borrowing company's financial affairs, operations and other matters at each draw, or other restrictions.

More commonly, control means the private-equity firm takes a majority share of the common stock, and as a result can control the board, the management and all decisions. Controlling shareholders prior to a financing with a private-equity firm may become minority shareholder employees thereafter, subject to termination by the private-equity firm. Because of this loss of control and ownership, many junior E&P management teams are loath to take on expensive institutional equity.

PUBLIC EQUITY

Another option is for a junior E&P company to issue public equity, but a public offering can be very time-consuming and expensive. More important, there is no guarantee of success. Public market "windows" can close without notice, sometimes after the company has started or even completed its road show. Even a small offering can take months and cost millions of dollars in fees and expenses.

After closing a public offering, a public company will be saddled with the burdensome reporting obligations of being public, made all the more challenging with recent Sarbanes-Oxley legislation. As with private equity, owners will have to share future earnings with new shareholders. On the other hand, public shareholders tend not to ask too many questions or try to get involved in managing the company.

MEZZANINE CAPITAL

Some junior E&P companies and management teams are looking for the best of all worlds, if they can find it. While they cannot meet the strict, low-risk credit standards of a commercial bank, or cannot wait to see whether a commercial bank's credit committee will approve a loan, they still are seeking primarily debt capital.

They seek capital without too many strings attached, which will allow them to remain independent. They may not want to give up control of their company and its future to financial outsiders, but rather, keep control in the corporate or other family. They may want to keep their business and finances private. Finally, they may not want to share the bulk of their equity upside.

At the same time, small E&P companies may want a reliable financial partner that will be there for them as opportunities arise, providing the capital they need to grow their business according to their plan, not someone else's plan. Mezzanine capital has characteristics that fall between equity and bank debt.

Mezzanine capital providers generally structure their investments as high-coupon debt issued in combination with some type of equity participation. Mezzanine funds will generally look for a higher-coupon interest payment plus a "sweetener" in the form of equity options or warrants or a conversion feature that will enable the mezzanine fund to share in some equity upside.

...small E&P companies may want a reliable financial partner that will be there for them as opportunities arise, providing the capital they need to grow their business according to their plan, not someone else's plan.

In general, mezzanine funds can move very quickly to wire funds to a borrower—in as short as two or three weeks. In addition, mezzanine funds rarely look for control or a meaningful role in the management of the borrower. In short, mezzanine capital allows management teams to get their funds quickly without sharing too much upside or losing control of their business. ■

John Barry is chairman and chief executive officer of Prospect Energy Corp., a newly public provider of mezzanine capital to the E&P industry. David Belzer and Bart J. de Bie of Prospect Energy assisted in preparing this article.

FINANCE: A DIRECTORY

Although not exhaustive, the firms noted here are among known providers and/or arrangers of capital to the upstream energy industry. They include commercial banks, investment banks, capital intermediaries and advisors, and private-capital sources. Firms are listed once although they provide multiple types of capital. The codes that follow describe services each firm provides: *I = Investment Banking; C = Commercial Banking; M = Mezzanine; P = Private Equity/Debt; and A = Arranger/Advisor.*

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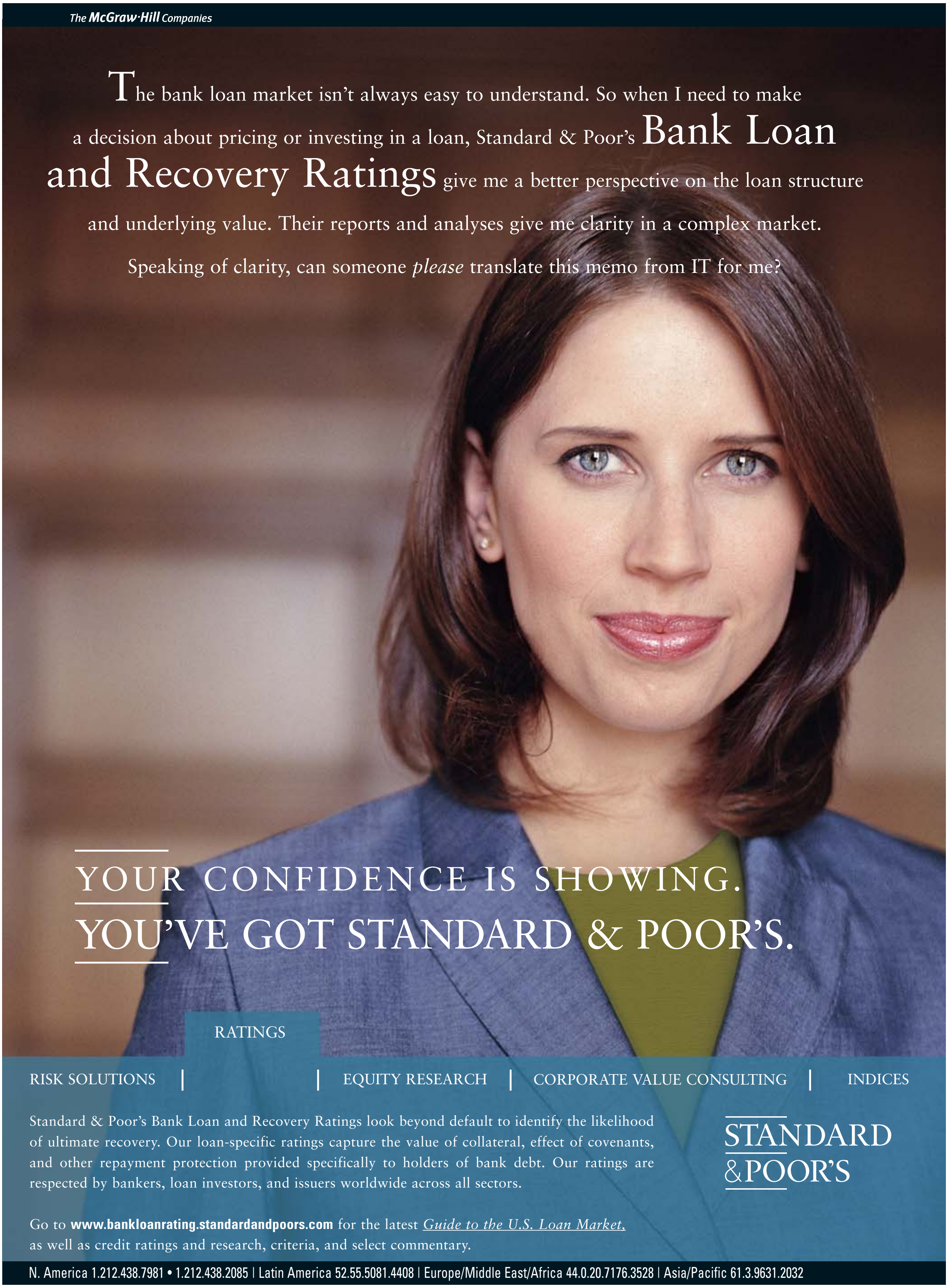
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