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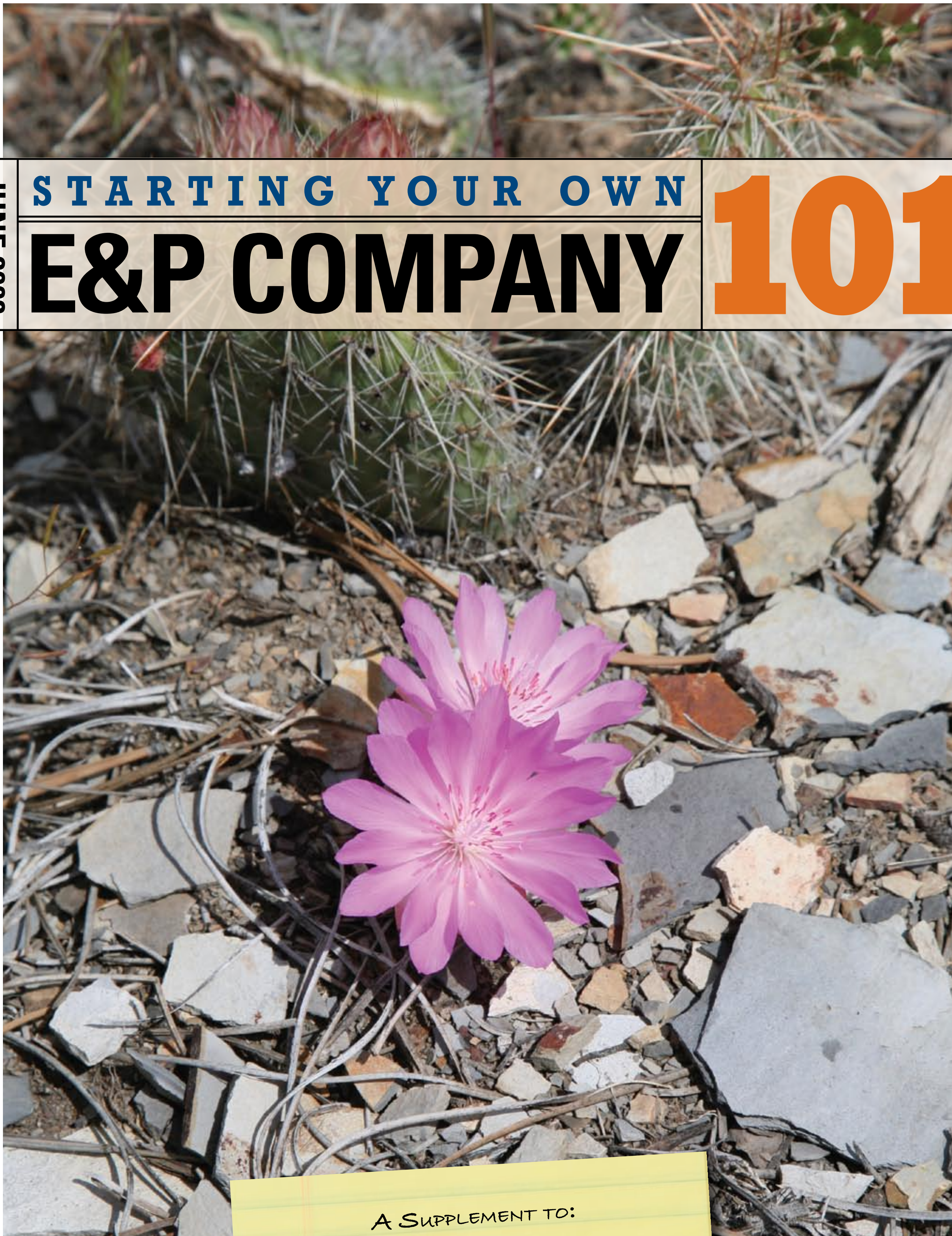
STARTING YOUR OWN E&P COMPANY 101



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1616 S. Voss, Suite 1000
Houston, Texas 77057-2627
713-993-9320
Fax: 713-840-8585
OilandGasInvestor.com

Editor-in-Chief
LESLIE HAINES
713-260-6428, *lhaines@hartenergy.com*
http://blogs.oilandgasinvestor.com/leslie

Executive Editor
NISSA DARBONNE
713-260-6429, *ndarbonne@hartenergy.com*
http://blogs.oilandgasinvestor.com/nissa

Contributing Editor
GARY CLOUSER

Art Director
MARC CONLY

Graphic Designer
JAMES GRANT

Production Director
JO POOL
713-260-6404, *jpool@hartenergy.com*

For additional copies of this publication, contact customer service at 713-260-6442.

Publisher
SHELLEY LAMB
713-260-6430, *slamb@hartenergy.com*

Regional Sales Manager
BOB McGARR
713-260-6426, *bmcgarr@hartenergy.com*

Regional Sales Manager
TOM CARRESE
713-260-6472, *tcarrese@hartenergy.com*

Regional Sales Manager
CHARLENE (CHARLIE) CHASE
713-260-6466, *cchase@hartenergy.com*

Hart Energy Publishing, LP

Vice President, Hart Publishing Group
BRION D. PALMER

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About the cover: A blossom in the Mowry shale. *(Photo by Lowell Georgia)*

INTRODUCTION

You've been thinking about it for a while, maybe for years, maybe since you chose an energy-industry career. This primer is designed to take you many step forwards in your goal of owning and operating your own E&P company. The experts who offer advice in these pages are seasoned professionals—in arranging capital, in providing capital, in helping to find key management partners, in structuring administrative function and in helping you establish your company as a leader with good relationships.

Expert advisors here include E&P start-up icons Randy Foutch, Jeff Voncannon, George Solich, Alan Smith, Maurice Storm, Wil VanLoh, Bill Weidner, Scott Kessey and Ben Stamets.

Don't get started without this.

A gentle warning: Some of the contents may seem overwhelming. You want to find oil and gas—and profit from it. But, you have little interest in running a back-office system, for example. No worries. Your entrepreneurial counterparts don't either. In these pages, you will learn how to best task this and other matters to experts in those fields—while you work at the business of turning hydrocarbon resources into dollars, and a large profit margin.

Energy investors are actively looking for talented, seasoned industry members in which to invest. Read this, and get started. It's time.

—*Nissa Darbonne,*
Executive Editor

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ILLUSTRATION BY STEVE KROPP

Financing the Start-Up

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

Article by T. Prescott Kessey and William E. Weidner

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

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

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

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

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

Yet, the oil and gas executive has a much greater challenge. He has to keep track of who's got capital and who doesn't; who's exiting the money business and who's coming into it; and most importantly, with whom he can get along, and of course, with whom he can't. Know thyself!

The various financing styles on the "stairway to harvest" are well known, as are many of their advantages and drawbacks. The key is knowing how to match the stages in the growth cycle of a company with these financing styles.

Only by assessing candidly your own merits as a candidate can you realistically determine which of the familiar financing styles in the life cycle of a growing oil and gas company you have a high probability of capturing.

FOUR BASIC STEPS

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

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

Capitalizing with equity allows a company to multiply the number of times that its special something can be repeated, thereby maximizing value by compressing time. For example, an exploration company would want to capitalize with equity to gain sufficient exposure to a number of prospects to ensure success within one or two industry cycles. Having achieved success, the company would have created real going-concern value as an organization.

A company like Newfield Exploration might be a good

FOUR BASIC STEPS

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

example of this. During the early 1990s, it first developed a strong management team with repeatable skills and then capitalized the company for certainty of success over a series of prospects.

Building a project is quite different. By identifying, designing and executing a project that may or may not be repeatable, but which, by itself, provides a fairly certain outcome, a good technical team can generate significant added value. With a project, value is created not by compressing time, but by compressing the amount of capital for which management is responsible.

> THE KEY IS KNOWING HOW TO MATCH THE STAGES IN THE GROWTH CYCLE OF A COMPANY WITH THESE (MANY) FINANCING STYLES.

The less equity that management must share in a predictable project, the more value creation it keeps for itself. For example, an acquisition-oriented company would want to capitalize primarily with debt if it could acquire reserves, enhance them, pay off the debt, and then live off the cash flow from the property.

Often a little introspection at the start of the capital-formation process provides important insight into the correct path. Moreover, the desire to build a company usually requires that one first prove oneself by successfully building a few projects. Before starting on the money-raising trail, think about this important distinction.

Building a company requires great management, a great track record and a repetitive business plan. Building a project requires a great project. Management has to be at least adequate, but it needn't yet have a track record.

Track record. Everyone has a "track record," but very few people have taken the time to document it. Compiling a track record represents possibly the most important step in raising money to finance an oil and gas business. Most people claim they cannot document their track records because it would require rooting through the files of former employers or taking credit for successes and failures for which the outcomes involved many others.

> ASPIRING ENTREPRENEURS SHOULD DEVELOP THE HABIT OF RECORDING THEIR ROLES IN COMPLETED TASKS AND THEIR FINANCIAL RESULTS....

Aspiring entrepreneurs should develop the habit of recording their roles in completed tasks and their financial results, thus becoming the owner of their own track records. This information becomes a key prerequisite when raising capital.

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

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

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

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

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

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

Second, issuers must assess how potential investors will behave under various circumstances and the degree to which the investor may become involved in running the business. Some issuers seek investor involvement, while others seek to avoid it. Private companies that obtain investment from family members, friends or groups of individuals sometimes find that the emotional interaction among disparate, nonmanagement

Financing Styles

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

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

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

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

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

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

This permits a company to realize a substantial compounding effect from repeated generation, leveraging and redeployment of field-level cash flows.

Mezzanine debt. Mezzanine debt is characterized by high advance rates, which are ideally suited for project financing, in exchange for strict repayment terms and restrictive covenants. Interest rates range from 350 to 1,000 basis points over comparable-term U.S. Treasury issues, and often are accompanied with equity participation rights. Notwithstanding, compared with joint ventures, mezzanine debt almost always costs less, a fact too often lost on independent producers stuck in traditional financing styles.

Used with discipline, mezzanine debt is a great means to jump-start from start-up, or even the early stage, to acceleration.

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

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

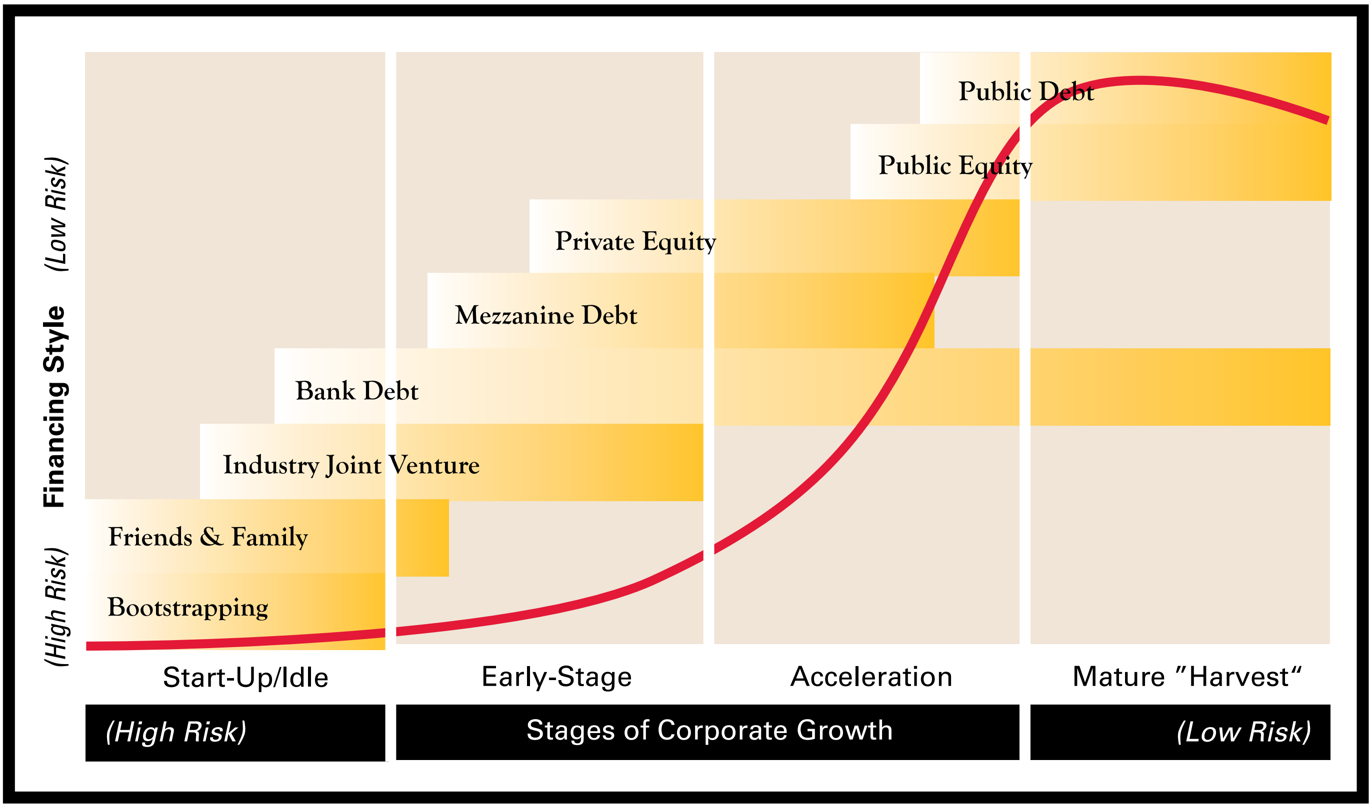
Public equity. Once a company has demonstrated consistent capacity to grow, assuming it has achieved a scale sufficient to attract institutional interest (now considered at least $400- to $500 million) then the public equity market is an option. In terms of financial cost, public equity is the least expensive style of equity, but it has its drawbacks in regulation, management of investors and analysts, and conflicting expectations of timing and success.

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

Public debt. Public debt, when the market is open, is the lowest cost of all capital styles. It can become a debilitating—even deadly—drug, however, as its ease and size can mesmerize its devotees, often hypnotizing away fear of covenants and repayment terms.

Public debt can be a marvelous financial option, but like all debt, it requires immense discipline. Like public equity, it is not an exit in itself, but it indirectly fuels the ability of others to pay more and more for seemingly endless growth (and the purchase of the company). It creates the harvest, but beware the sickle.

THE STAIRWAY TO HARVEST



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

owners can become an obstruction to the value-creation process of the company, or worse, force its liquidation.

Professional investors usually provide a much greater degree of consistency, so issuers must ensure that this consistency will wear well over time.

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

FEDERAL REGULATIONS REQUIRE (REGULAR COMMUNICATION) FROM PUBLIC COMPANIES, BUT PRIVATE COMPANIES IGNORE IT AT THEIR OWN PERIL.

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

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

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

T. Prescott Kessey and William E. Weidner are managing directors in the energy group of Rodman & Renshaw Capital Group Inc. (both formerly with COSCO Capital Management LLC, which was acquired by Rodman in May 2008). They work with E&P start-ups in arranging initial and secondary equity and mezzanine debt financings. Kessey is based in Houston; Weidner in Simsbury, Connecticut. They can be reached at 713-654-8080 (Kessey) and 860-658-6700 (Weidner).

Building the Management Team

Beginning with a winning chief executive, a strong start-up team possesses several additional key qualities.

ARTICLE BY S. WIL VANLOH JR. and BENJAMIN A. STAMETS

The ultimate goal of most E&P entrepreneurs when starting a new company is to create wealth for themselves, their team and their partners. Creating a successful E&P company requires operational excellence, scientific acumen, the ability to create quality assets and, occasionally, a bit of luck. But it all begins with building a team of E&P professionals with the requisite skills to form the backbone of a company.

Since its inception in 1998, Quantum Energy Partners has made or committed to make investments in nearly 50 oil and gas companies run by energy entrepreneurs. Over the years, we have identified a number of common traits shared by our most successful management teams.

The CEO. A successful company depends on the dedicated efforts of its employees at each level within the organization. This ability to succeed is reflective of the quality of its management team, beginning with its chief executive officer. As such, our first screen of a potential new management team focuses on its CEO and his or her demonstrated ability to analyze investment decisions, and identify and understand their underlying risks.

...Our first screen of a potential new management team focuses on its CEO....

A CEO must be a proven capital allocator with the ability not only to identify the value-creation opportunity associated with a potential investment, but also to analyze and categorize risk and develop a coherent strategy of how to mitigate such risk. A successful CEO is capable of demonstrating a consistent and disciplined record of risk analysis and capital allocation resulting in superior risk-adjusted returns.

A CEO must also have a philosophy or vision that guides the long-term strategy of the company, although a coherent strategy alone is not enough to achieve success. The CEO must also be able to articulate the process that he or she uses when making the critical investment decisions that will ultimately lead to the long-term value creation of the company.

This process begins with the risk analysis described above and should align with the company's strategy. The decision analytics may be very different for an unconventional-resource company acquiring unproven acreage, and an operations-intensive company acquiring long-lived production. But the thought processes through which successful CEOs weigh the risks and rewards of strategic decisions are typically very similar.

In addition, a CEO must be a leader who can build, guide and motivate his or her management team, while also maintaining balance within the organization. No CEO will ultimately be capable of making every decision within a company, but rather must serve as a principled example to keep the company's entire team, from the executives to the rig hands, moving the organization forward in a manner consistent with its strategy and tolerance for risk.

Complementary skills. As the oil and gas industry has grown more complex and the drivers of success have evolved over the years, it has become increasingly difficult for a single leader or entrepreneur to individually maximize return on investment. We believe strong CEOs are most effective when they are supported by an equally strong team that possesses all of the requisite skills necessary to build a best-in-class enterprise with critical mass.

The greatest ultimate value of any company is achieved when the management team, collectively, is skilled at executing each of the necessary steps of the investment process.

Technical expertise in petroleum engineering, geology, geophysics and land is essential to success in the oil and gas industry. These skills enable a team to identify and potentially access great assets; however, they are not enough, absent other complementary talents.

To consummate a transaction, they must first be augmented with strong commercial skills that can facilitate appropriate deal-making and optimize structuring of investments. Once control of targeted assets is achieved, a team must then be capable of operational excellence.

Depending on the strategy of the company, operations may

ILLUSTRATION BY STEVE KROPP

focus on driving greater recoveries, lowering operating costs or achieving optimal F&D costs through the drillbit. Additionally, as the industry has developed a greater reliance on resource plays as a source of new production, the strength of the drilling and completions personnel within the organization has never been more important.

And, noteworthy is that financial acumen and general managerial skill have become an increasingly critical component. As the capital requirements of the industry have risen, diligent financial reporting, accurate "score keeping" and the ability to implement a sound hedging strategy have become necessary for a company to access additional sources of capital from the debt and equity markets, whether public or private.

Track record. Given the strong market fundamentals of the energy industry since 2000, many management teams have experienced success simply as a result of increases in commodity prices and valuation multiples. The members of a successful management team are able to articulate the reasons for their past achievements and can clearly identify the actions they took, either individually or as a group, which caused such achievement.

We believe it is necessary to retroactively reconstruct and fully understand the track record of a management team to discern whether prior success was primarily attributable to a thoughtful strategy and superb execution or merely the result of the "rising tide" of commodity prices. In building a new team, each member should be able to demonstrate how they created value in their prior endeavors.

Working together. There is no greater indication of how a management team will perform in the future than past examples of that team's success. To have constructive debates within an organization that result in better investment decisions, a team must have good chemistry and a high level of mutual trust.

While it is possible to foster this in a new start-up with all new participants, it is most easily achieved in an organization in which at least some of the executives have previously worked together.

IN BUILDING A NEW TEAM, EACH MEMBER SHOULD...DEMONSTRATE HOW THEY CREATED VALUE IN THEIR PRIOR ENDEAVORS.

Competitive advantages. Very few companies can truly excel in pursuing multiple strategies, each of which entails different markets, challenges and opportunities. The energy industry in particular is characterized by highly competitive markets in which multiple players possess strategic advantages over their competitors, such as a lower cost of capital, superior products or services, greater market penetration, and recognition or access to legacy assets.

We have found that top-performing teams are typically those that apply strategies and operational execution capabilities in a manner consistent and congruent with their past success.

SUCCESSFUL TEAMS

Successful E&P management teams bring one or more of these attributes to the business model:

- A detailed knowledge of a geographic area or geologic province;
- Expertise in a specific strategy, e.g., relative to operating, drilling and completing, reservoir stimulation or gas transportation;
- A strategic asset position in a developing region; or
- A well-defined technological advantage.

The most successful teams have a clearly identifiable and sustainable competitive advantage, and they build an organization and asset base that best enables them to exploit that advantage. Examples of uniquely positioned, successful teams we have seen include those with a detailed knowledge base of a geographic area or geologic province, expertise in a specific strategy (e.g., relative to operating, drilling and completing, reservoir stimulation or gas transportation), a strategic asset position in a developing region or a well-defined technological advantage.

Deal-flow access. Access to acquisition opportunities is the lifeblood of a start-up oil and gas company initiating operations without an existing set of assets. As the marketplace becomes increasingly transparent and competitive, the ability to originate proprietary deal flow in this environment has become an important competitive advantage.

This characteristic typically stems from a management team possessing a network of close relationships that are either concentrated in a particular region or around a particular technical discipline. While not every member of a team needs to possess such a network, a successful organization must have one or two executives that can drive this origination process.

Once the desired deal flow is achieved, real value is created when a team, collectively, can quickly and accurately assess the merits and risks of an opportunity by applying a consistent and effective due-diligence screening process. A successful team can clearly articulate how it will implement such a process.

In our experience, for each acquisition that the most successful teams complete, they will initially screen approximately 50 deals, bringing roughly 25% of them to a phase of detailed due diligence and actually bidding on only a third of those.

Industry changes. During the past decade, the North American oil and gas industry has changed in many ways. Rig counts have almost doubled and total upstream spending has risen dramatically, yet overall production has actually decreased. Wells drilled today realize materially lower estimated ultimate recoveries on average and experience materially higher initial production decline.

> ...A TEAM MUST HAVE GOOD CHEMISTRY AND A HIGH LEVEL OF MUTUAL TRUST.

Perhaps nowhere is this more pronounced than in emerging unconventional-resource plays, where many of the wells drilled today experience first-year decline rates of 60% to 80% and second-year decline rates of 20% to 30%. Simply put, the industry today—again, primarily driven by unconventional-resource plays—requires significantly more resources of all types—capital, people, rigs, frac trucks, tanks, pipes, pumps, seismic, technology, etc. The result has been that successful methods 10 years ago are less likely to be effective today.

> ...THE MOST SUCCESSFUL TEAMS EMBRACE CONTINUOUS EVOLUTION, NOT REVOLUTION.

In our experience, the most successful management teams are acutely aware of the changes occurring in their sector or niche and are willing to adapt their acquisition or operational strategy appropriately. We often look for entrepreneurs who have a track record of proactively addressing problems they have encountered in their past and who developed creative and effective solutions to overcome them.

A fine line should be drawn, however, between a team that is continually looking for ways to appropriately adjust its strategy and one that abandons its prior experience altogether in favor of the next "new thing." In short, we believe the most successful teams embrace continuous evolution, not revolution.

> ...THE MOST SUCCESSFUL...ARE THOSE WITH DEEP INTEGRITY AND THAT DISPLAY AN UNWAVERING MORAL CHARACTER IN THEIR BUSINESS DEALINGS.

The ultimate objective. The goal of most oil and gas investors is to eventually generate a return on their investment through the sale or monetization of their assets or through an initial public offering. Management teams seeking capital from a financial sponsor, therefore, must keep in mind the importance of the ultimate exit in achieving superior investment returns.

CEOs creating a new company should seek to build a management team that will have the greatest chance of developing assets, products or services that will be an attractive acquisition target for a strategic or financial acquirer, or will serve as a growth platform suitable to take public. Meaningful enhancements to value can then be achieved upon an exit to a strategic buyer who will benefit the most from owning—or, perhaps more importantly, lose the most by not owning—the company or its assets or by successfully completing an IPO.

Interests, expectations. Just as the members of a team must have a high level of mutual trust and a set of complementary skills, the most successful management teams in the industry also align well with the organizations or individuals providing their financial support.

Capital providers can range from passive investors to truly value-added partners, and a team should seek out the approach that best fits its objectives. Additionally, a management team and its financial sponsor must share a common understanding of the company strategy and tolerance for risk. An exploration company, for example, may not align well with a mezzanine lender seeking a more stable source of returns.

Character. Last, but certainly not least in importance, the most successful management teams are those with deep integrity and that display an unwavering moral character in their business dealings. These are traits that cannot be achieved by simply adding complementary personnel to the team, but rather must be earned or established over time. As in all businesses, there is no substitute for strong ethics and principles when building a management team that will achieve long-term success in the oil and gas industry. •

S. Wil VanLoh Jr. is a co-founder and managing partner of Quantum Energy Partners, a Houston-based energy private-equity firm that has been involved in initial capitalization of 35 E&P companies, involving more than $3.2 billion in investments. Benjamin A. Stamets is a principal of Quantum involved in due diligence, transaction structuring and execution, portfolio-company monitoring and transaction exits. They can be reached at 713-225-4800 and swl@quantumep.com *or* bas@quantumep.com.

Recruiting the Talent

You've formed the business model and won capitalization. Now, build out the rest of the team. Here's how to convince winning talent that your start-up is right for them.

ARTICLE BY CHERYL BYRAN and TOM ZAY

Human-resources executive Bruce Levine had not heard of Ivanhoe Energy when he was contacted about the start-up in 2007. At the time, Ivanhoe, which offers a proprietary, heavy-oil upgrading process, was nothing more than a technology with a visionary chief executive.

For more than two decades, Levine built his career with some of the world's most seasoned and trusted brands—Frito Lay, Dial Corp., Aetna and Pennzoil. Yet the day-in and day-out frustrations associated with corporate bureaucracies were beginning to take their toll. So when Levine was contacted by the executive-search firm charged with helping Ivanhoe fill out its management team, Levine listened.

"The company's business model made sense, its technology was solid and the capital was there," Levine recalls. "I saw an opportunity to join an entrepreneurial culture—and that was incredibly appealing." Levine had that spark. He had that entrepreneurial spirit. He embraced the opportunity to have ownership and accountability for the organization's future. Ivanhoe found their man.

At the same time Levine was taking the leap to a start-up, Henrique Tono was on the other side of the desk trying to sell experienced executives on his new venture, Ingrain, which uses a patented numerical method to compute physical properties of reservoir rocks from core samples and drill cuttings.

"By the time we started approaching experienced talent, we knew exactly the kind of person we wanted and the job we wanted them to do," says Tono. "Along with our other founders, we established, in concrete terms, the excitement we had for the company. Once we had that, our team fell right into place, starting with a chief financial officer and a chief marketing officer."

The perspectives of Levine and Tono may have been different, but they underscore the same conclusions. Seasoned executives, even those in very secure positions, are willing to consider a new venture and take the risk associated with a start-up, provided the business model is attractive, the idea behind the business model looks like a game-changing kind of idea, and if you can convince candidates they will become an integral part of the organization's strategic decision process and exit strategy.

New ventures, by their very nature, are about uncertainty. With a start-up, there is no track record, no history to refer-

THE PITCH

Seasoned executives, even those in very secure positions, are willing to consider a new venture and take the risk associated with a start-up, provided:

- The business model is attractive,
- The idea behind the business model looks like a game-changing kind of idea, and
- If you can convince candidates they will become an integral part of the organization's strategic decision process and exit strategy.

ence and no way to evaluate the opportunity based on past situations. A business doesn't have to be new to be considered a start-up. In the eyes of a prospective executive, even an established business with new ownership, a new strategy or one focusing on a new technology can be considered "start-up" in nature.

The good news for start-up ventures is there is plenty of seasoned talent available, particularly among those in the energy sector who are inherently ambitious, confident and naturally entrepreneurial, looking for their "piece of the pie" in this dynamic market environment. There is a ready opportunity for those who have accepted early retirement packages and perhaps can take on a bit more risk.

Even with the talent available, however, building your executive team and attracting the right talent to a new venture takes considerable, careful planning.

Candor. Start by adopting a philosophy of complete candor and openness when it comes to communicating the pluses and minuses of your venture. What are your growth and exit strategies, your ownership structure and the owners' expectations?

Describe the involvement of the board and, above all, don't leave any skeletons in the closet. If your chairman is difficult to work with, then say so. The more you share, the more comfortable you'll make the executive, and the more aware they will be of what the real uncertainties are. That's part of the sale: quantifying the uncertainty. Instead of leaving it unknown, define it. The right candidate will look at the uncertainties as opportunities and challenges.

> THE VISIONARY LEADER MUST…GET INVOLVED IN RECRUITING PEOPLE WITH AN ENTHUSIASM THAT IS PALPABLE AND CONTAGIOUS.

Define the financial stability of the company. Be prepared to disclose past financial performance, if there are any pro formas in terms of the company performance and the availability of additional capital. Proprietary technologies also should be discussed once non-disclosure agreements are signed.

Equity participation. Present an attractive risk/reward rationale. Keep in mind you are talking to executives who can put more of their compensation at risk. If you are presenting an equity opportunity, then make sure it is attractive and treat the candidate as a true partner. Don't try and squeeze somebody down in their equity participation for the wrong reasons. Remember, you get what you pay for. In a start-up venture, everyone is focused on the end game.

Make sure your compensation is well thought out, well documented and clear. Compensation should never be an afterthought. If you want your venture to be taken seriously, ensure that the candidate clearly understands how they will be compensated in the face of all the other uncertainties that could drive someone away.

A start-up's vision and leadership team is its most valuable asset. A leader who can articulate and sell an organization's vision and a management team that is willing to engage in the recruitment process is the key to attracting senior-level executive talent to a start-up. The visionary leader must step in and get involved in recruiting people with an enthusiasm that is palpable and contagious.

Spinning it. Any new venture is bound to have its share of challenges. How you describe these challenges can make the difference in whether or not you can attract executives to your organization. The right person will be attracted to challenges such as building a team, or developing a joint venture or alliance relationships, provided there is an entrepreneurial culture that allows someone to take these challenges head on. A problem solver will see opportunities rather than challenges.

Make sure the candidate understands that by joining your organization, he or she will have authority as well as accountability. In larger companies, executives may be more insulated from ultimate accountability. Those who gravitate to a situation where there is minimal bureaucracy, faster decision-making and a certain nimbleness will want to be accountable for those decisions.

Personal qualities. As you meet with prospective candidates, consider personal qualities equally with technical capabilities. Rather than focus on what a candidate has or has not done, take a close look at the softer skills. Is the candidate flexible? Does the candidate present an adaptable, can-do, natural optimism when it comes to finding a solution?

Finding the right level of intelligence and personal leadership ultimately will bring you a better candidate than if a person has simply "checked a box" in a certain area of expertise. Passion and enthusiasm can often make up for a lack of technical depth.

Tapping retirees. Finally, when recruiting top talent for your new venture, consider more seasoned executives. In some cases, tapping a retiree who may still have the energy, passion and entrepreneurial spirit may provide the right solution.

Because start-ups inherently lack the bureaucracy and structure of more established companies, you have the advantage of being able to focus on an individual's capabilities and can hire people who are ideally suited to take on a challenge without worrying about how that person will fit into a defined structure.

Start-ups and new ventures are about uncertainty. Define the uncertainty as well as the opportunity for impact, and you will attract the right talent for your organization. •

Cheryl Smith Bryan and Tom Zay are managing directors of the Houston office of Boyden, a global executive-search firm. They can be reached at csmithbryan@boyden.com *and* tzay@boyden.com.

Building the Back Office

A great deal can be invested in business-function systems—and not just capital but valuable effort. Here are the essential features of a system that performs.

ARTICLE BY HELEN LEEKE

When building your E&P company, you want technology that not only supports your infrastructure but helps drive your business. Today's back-office software helps companies of virtually all sizes in every industry achieve greater efficiencies and improve business performance. Those companies that choose best-in-class solutions enjoy a new threshold in open, integrated business productivity—giving them a clear advantage over less-equipped competitors.

The same rule applies to E&P start-ups. E&P companies are forward-facing—their success is defined largely by field performance. For these companies, focusing on the front office to find ways to achieve lower costs and improve efficiency is foremost.

The operational aspects of the front office determine your influence with customers, suppliers, partners, investors and competitors. Equally critical, however, are back-office resources that in today's market drive key improvements in integrated business performance.

For E&P companies, today's back-office management solutions allow for improved access to and management of accounting, land and production data in an integrated, flexible environment that enables better decision-making and ultimately, improved business performance.

An open, integrated back office eliminates the "silo mentality" in which different teams or functions within a company operate quasi-independently, periodically force-fitting data and resources to meet the needs of other teams that use disparate software and databases.

A large majority of productivity loss, miscommunication and unnecessary expense can be attributed to disconnects caused by isolated individuals or teams working in silos, ultimately leading to inaccuracies in data. For example, many E&P companies struggle to merge accounting data with up-to-date production and reserve data. These teams live in different worlds, using different tools and protocols.

Achieving synergy is an expensive, time-consuming process. With an efficient back office solution, everyone in the company works with a common set of tools within a single system, drawing from the same data pool with full transparency and better decision-making across the board. Cost-efficient synergies are built in and the back office becomes, in effect, a comprehensive, strategic management platform. It forms a newer, stronger backbone for the organization.

It is imperative that E&P start-ups acquire the right solution. The back office powers the business; if it fails, you can lose your competitive edge.

Conversely, if you select the right solution, you can achieve integrated efficiencies that optimize performance and minimize costs from day one. This can be particularly attractive to potential investors and partners.

Best-in-class back-office solutions share a series of common traits, including full integration; intuitive ease of use; system scalability; transparent access to information; business compliance; automated business processes; and outstanding customer service and support. Here's what to look for.

Integration. Core back-office applications for the oil and gas industry must address the complexity of the business, the high volume of transactional data and the unique business outcomes that new acquisitions and leasehold can bring to your company. These applications must be deeply integrated yet flexible and sophisticated enough to meet all your business requirements.

Sometimes a company will implement a system that is strong in one area, whether that is land, accounting or production. While the individual department is happy, the other two suffer with inadequacies and often poor integration.

Shared data within a single platform enables better decision-making, and eliminates the wasteful silo effect that costs many companies millions of dollars each year in lost opportunities. For example: with a fully integrated system, lease ownership and production volumes can be compared with actual revenue receipts in real time, with all departments or work teams pulling data from a shared database, thus eliminating troubling data inconsistencies.

Think of a non-integrated software solution as two or three silos speaking different languages. While there can be an effective translator, one or two words inevitably will be misunderstood, lost or even modified, possibly transforming the entire meaning of the exchange.

Scalability. If a company doesn't anticipate growing, scalability isn't important; their needs today may be the same as their needs tomorrow. The business plan of a company should affect its software decisions. If a company plans to grow, its software solution must deliver system-wide flexibility and scalability to meet growth demands—otherwise you will be forced into an expensive midstream switch to another solution.

Access to information. To make the best possible business decisions, you need easily accessible, up-to-speed data at your fingertips—data that delivers fast, system-wide visibility into every facet of the business. Your back-office solution should enable leading-edge analysis tools that offer high-level dynamic reports with the ability to drill down to detail, allowing you to examine or project business outcomes in different ways.

In an ever more global environment, it is important that your data can be accessed worldwide.

> YOUR BACK-OFFICE SOLUTION SHOULD... OFFER HIGH-LEVEL DYNAMIC REPORTS WITH THE ABILITY TO DRILL DOWN TO DETAIL, ALLOWING YOU TO EXAMINE OR PROJECT BUSINESS OUTCOMES IN DIFFERENT WAYS.

Automation. Many routine business processes can be automated with back-office solutions, saving hundreds or thousands of man-hours each year. Some of these labor-intensive processes that are essential to the oil and gas industry, such as production allocations, revenue distribution and ownership adjustments, can be shifted into autopilot with an automated system.

This frees valuable time to focus on managing the business instead of managing spreadsheets.

Ease of use. The functions of back-office systems are inherently complex, yet must mask that complexity with a simple, intuitive interface that makes it easy to use. If the system is cumbersome and confusing, users will quickly become discouraged, which in turn negatively affects productivity and performance.

The system should also be easy to configure to the way you run your business—with customizable options. It must also in-

HOW LEGEND DID IT: *A CASE SUDY*

Private E&P company: Houston-based producer Legend Natural Gas II LP, formed in 2004 to drill and acquire onshore the Gulf Coast.

Funding: Private equity from Carlyle/Riverstone Energy and Power Funds, a venture of The Carlyle Group (Washington) and Riverstone Holdings LLC (New York).

The challenge: Find a back-office system that adds value, rather than costs.

As a company that thrives on maximizing the value of its acquisitions, Legend was acutely aware of the need to lower costs while increasing efficiency throughout the entire acquisition process. For Legend, the overall challenge was to deploy a back-office system that would help manage those costs and enable the back office to add value to the company, rather than being considered overhead.

"We are always competing with other companies for oil and gas merger and acquisition opportunities," says Gary DeGrange, Legend vice president and controller.

"Because of the cyclical nature of the oil and gas industry, it is extremely important to keep costs low and staffing lean; we can do that with automation. We needed an integrated system that is fully featured, scalable and able to deliver the right information into the hands of those who need it—a solution that is efficient in both recording and managing our back office while keeping expenses down."

With an automated, intuitive and efficient back-office software system, Legend would be able to quickly and easily track leaseholds, record expenses and revenue, fulfill operator distribution and reporting requirements and provide analysis tools for managing the business.

Doing this enables Legend to become a more nimble competitor. In addition, the right back-office system would make assets easier to sell: Companies vetting potential deals can easily get the information they need for accurate analysis.

"The ability to quickly produce accurate records is critical when you are negotiating a land, lease or well deal," DeGrange says. "If you are unable to produce the information on demand, buyers lose confidence."

The solution: A fully integrated, easy-to-use back-office software system.

After reviewing competing products and vendors, Legend chose Bolo Systems as a strategic partner for its back office. Critical information gets into the right hands, faster, including field engineers, potential buyers, compliance officers, executives and others throughout the organization.

"It was an easy choice," DeGrange says. "It gave us the integration, efficiency, ease of use and lower cost of ownership we needed. Integration and automation—those are key to lowering costs and managing the business leaner, faster, better."

clude simple yet effective training walk-throughs to ensure all employees understand key features and functionality.

SOX compliance. Sarbanes-Oxley compliance is often mandatory and always expensive. A back-office solution that addresses these compliance needs and ensures that all regulatory conditions are met, saves valuable time and money that would otherwise be spent on internal and external audits.

While SOX compliance is not fully a concern of a private E&P company, a public-company buyer of it or its assets will more easily integrate the acquisition into its own compliance requirements. Also, privately held companies must still report to their investor group and do annual reports.

MANY ROUTINE BUSINESS PROCESSES CAN BE AUTOMATED…(SO MANAGEMENT CAN) FOCUS ON MANAGING THE BUSINESS INSTEAD OF MANAGING SPREADSHEETS.

Service and support. Outstanding service is essential. Your solution provider should be a partner who walks with you every step of the way. Although they are intuitive and easy to use, back-office applications are complex and require the dedicated efforts of numerous professionals during the install-and-deployment phase.

This relationship should extend throughout the life cycle in the form of first-rate support and service. Leading back-office solutions vendors will offer dedicated service teams for customer care, delivery and implementation to allow for specialized service at specific stages in the solution life cycle.

The results: More efficient acquisitions, lower costs and a competitive advantage.

"The technology adds value throughout the organization. In the business of M&A, you want people and systems that make the company worth more today than it was worth yesterday, and that's what Bolo does for us."

Efficiency. While the number of accounts-payable invoices has risen from 900 a month to 1,200, Legend continues to hold the line on staffing, because of back-office automation. Additionally, DeGrange notes that his former company (which used a competing system) needed twice as many people to manage a similar number of assets.

Time saved. Processes that took hours using other products in his previous company now take minutes. For example, the revenue-distribution process, which generates disbursements to approximately 800 owners, used to consume six full hours. Legend's back-office system handles it in less than one hour.

It also reduced the time it takes to generate joint-interest billings from five hours to one. Creating a lease-operating statement takes less than five minutes, down from 30.

Compliance. Though it is privately held, Legend still must report to its investor group, do annual reports and keep up on compliance filings. The back-office system helps by proactively delivering the right information to the right people, instantly.

Scale. Unlike many of its competitors for assets, Legend is now able to efficiently manage and distribute constantly changing data. This fits perfectly with Legend's goal of quickly fitting acquired properties into a system and taking advantage of the automation that is available.

DeGrange says he is confident that whatever acquisition challenges arrive, Legend can handle them with five people in the accounting division. Being able to grow the business using automation gives Legend a competitive advantage.

Reporting. DeGrange and others at Legend have found the system's reporting capabilities to be flexible, powerful and intuitive. With another product, DeGrange says he might be forced to design new reports nearly every day due to the variety of questions that arose—but he now has the flexibility to change existing reports, use dynamic reporting tools that run summary-level reports and drill down to lower levels of detail or query tools to obtain a quick answer to questions.

Ease. The system is also intuitive, adding efficiency throughout the organization, DeGrange says, noting that software people find hard to learn is destined to sit on the shelf.

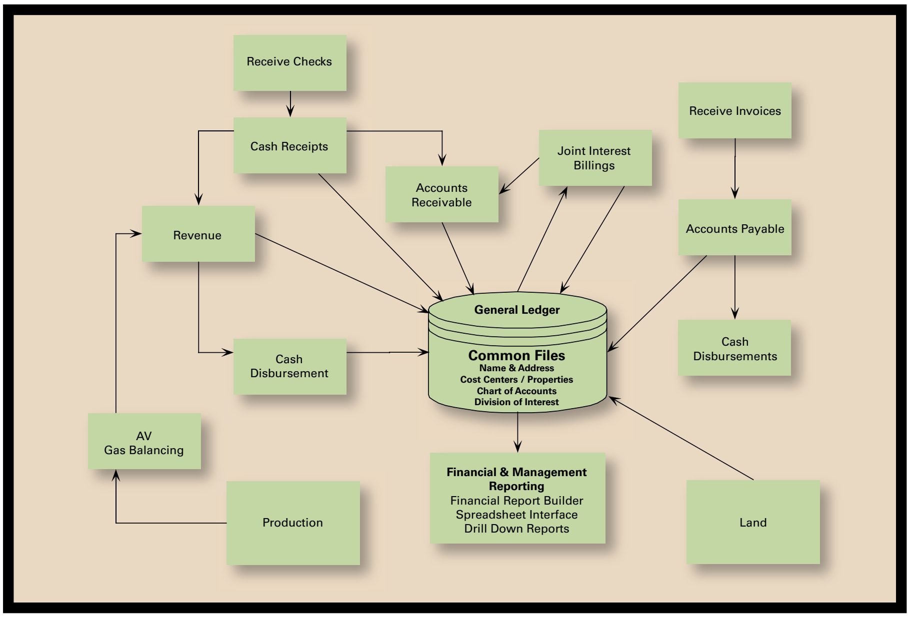
The bottom line: Legend's back-office system adds value to the company's results while saving money and providing a competitive edge.

"It's a tough business environment out there, and getting more competitive by the minute, so we really needed a system that would provide quality information for faster, better decisions while adding extreme efficiency," DeGrange says.

"Having software where the data is readily accessible—whether in reports or extracts—allows us to manage the business better and gives us an edge over our competitors. It also adds a level of value when you are selling a property.

"The better the information, the better the chance of closing the transaction faster because it provides a level of comfort to the potential buyer."

WHAT'S IN THE "BACK OFFICE"



Good data in a well-performing system produces instant snapshots of business performance, and helps get deals closed efficiently and with confidence.

Some vendors have the depth of industry expertise to assemble customized oil and gas teams that focus exclusively on a select customer's unique needs or interests. For example, a customized team with oil and gas expertise can help you quickly integrate acquisition data into the system and provide reporting recommendations, system configuration decisions or even advise you on your chart of accounts.

IN-HOUSE OR OUTSOURCE?

The final piece of the puzzle is to decide how you want to deploy your back-office solution. There are three primary choices: outsource your solution to a vendor that provides collocated hosting; license the software to bring it in-house where the core system runs on your servers; or subscribe to the software using an ASP interface wherein the solution resides securely on the Internet, allowing you full access and availability without any infrastructure burdens.

WHAT IS THE VENDOR'S RECORD OF TURNOVER? HOW MANY CUSTOMERS HAVE MIGRATED AWAY FROM THEIR SOLUTION? WHAT WAS THE REASON?

For start-up companies, outsourcing may be an option because it doesn't require an investment in staffing. When considering an outsourced approach, however, it is essential to address each of the following questions:

- Does the vendor have deep industry experience, with a record of timely response and service?
- Can the vendor accommodate the needs of private and public companies of various sizes?
- What is the vendor's record of turnover? How many customers have migrated away from their solution? What was the reason?
- Will you have full, transparent access to data?
- Can you manage and execute dynamic reports?
- Can they provide a seamless deployment transition should you choose to bring the solution in-house?
- Does the vendor use software you would want to use in-house?

If you are considering an in-house solution, choose a product that is easily supported within your organization, so you won't have to increase your IT staff. Additionally you must verify that the vendor can provide real-time support from remote locations.

Even though the system resides on your network, most vendors will have remote access protocols to deliver fast service and upgrades. Ask for customer references to gauge how effectively this works for existing customers. A related option is to license the software in-house, but have the vendor provide data hosting and storage.

Start-ups may choose an ASP option since it doesn't require an investment in software licenses or the staff to support the solution. ASPs also eliminate software troubleshooting and places the burden of system upgrades on the vendor. If you opt for an ASP model, it is essential to verify that the vendor's security protocols are up to date to provide maximum security and availability.

Regardless of the solution you select, it is important to understand that an E&P company's success is defined not only by its field performance, but also its back-office platform. In today's world of technology-driven business, a strong back office makes the front office better, which in turn makes your company more attractive to customers and the investment community.

This is a huge advantage in an industry where agility, performance and cost-efficiency are critical to success. •

Helen Leeke is vice president, market development, for Bolo by WellPoint Systems, and was previously with Marathon Oil Co. and Central Resources Inc. in acquisition integration, system implementation, business-process reengineering, corporate reporting and internal decision-support strategy. She can be reached at helen.leeke@wellpointsystems.com *or (713) 850-1812.*

Building the Brand

THERE ARE METHODS OF GETTING YOUR START-UP IN FRONT OF ASSET BUYERS AND SELLERS, AND BUILDING A GOOD REPUTATION WITH LANDOWNERS, REGULATORS AND CAPITAL SOURCES. HERE'S HOW.

ARTICLE BY BEVERLY SCIPPA JERNIGAN

Why should you use public relations as part of your management strategy and how should you use it? These are valid questions, especially since many executives don't fully understand what public relations is, or how it works. Ask 10 executives to define it and you're likely to get 10 different answers.

The Encyclopedia of Public Relations defines PR as "a set of management, supervisory and technical functions that foster an organization's ability to strategically listen to, appreciate and respond to those persons whose mutually beneficial relationships with the organization are necessary if it is to achieve its missions and values."

Obviously, public relations is difficult to define in a theoretical sense but, in practice, it is relatively easy to grasp the value and benefits and understand how it works. When employed properly, PR is an affordable, high-value communications platform that enables your company to achieve several important goals:

- Elevate market visibility by taking control of your company's identity and brand;
- Identify and communicate with all stakeholders, both internal and external; and
- Effectively respond to crisis or market events.

Unfortunately, many companies do not fully understand or effectively utilize public-relations strategies and as a result, their messages become lost in the marketplace. Controlling your company's identity and managing its presence in the market is critical to business success.

Perception drives behavior—how your targets (i.e., stakeholders and outside influencers) view you will determine how confident they are in understanding and transacting with you.

Companies that are proactive and have strong, elevated market visibility are almost always more successful than those that do not. By using objective, non-self-promotional PR strategies and tactics, these companies gain valuable footholds in the market that advertising and channel marketing can't provide.

In the digital realm, for example, PR-driven content ranks higher with search-engine crawlers than advertising or sales collateral because it is considered objective, evidence-based information. Yet many companies do not use these tactics to take ownership of who they are, instead allowing competitors to outpace them with a stronger command-level presence in the market.

When failing to communicate your brand to the market, your stakeholders will likely form a view of your company based on third-party information, which may not be your message.

We've seen companies that have innovative products or solutions that benefit the market, or operate extremely well, but never get anywhere. These companies never got their message out or in the right way. Their competitors had stronger voices, and gained more attention.

BEST PRACTICES

Like most management functions, a public-relations team or group operates within a strategic framework, with clearly defined goals and tactics. These tactics are translated into outputs, or deliverables, that drive communications.

These deliverables can take many forms, including press releases, media advisories, case studies, white papers, dedicated websites, blogs, speaking opportunities, newsletters, analyst tours, investor open houses, hosted events and more. The effectiveness of deliverables is measured in terms of outcomes or return on investment.

Outcomes, both qualitative and quantitative, determine the success of a public-relations campaign or initiative. For example, if a business-to-business PR campaign leads to a spike in sales of an existing product or service, the outcome is easily identifiable as a quantitative increase.

MESSAGE-DELIVERY TOOLBOX

- Press releases
- Media advisories
- White papers
- Case studies
- External newsletters
- Internal newsletters
- Investor memos
- Image advertising
- Analyst tours
- Investor open houses
- Speaking opportunities
- Blogs
- Trade-show participation

CREATING THE BUZZ

One example of effective communications is the work of Houston-based, privately held Leor Energy LP, which issued press releases on its Deep Bossier well results in East Texas at its website and through news services. It also used the website to explain its mission and its capitalization. Leor Energy was started four years ago and sold for some $2.5 billion this past fall to EnCana Corp.

Putting your assets in front of potential buyers, and creating a buzz about them, can be key to getting the attention the portfolio you've worked hard on deserves. *Oil and Gas Investor* can contribute. Getting started? Tell us about it. We'll help draft your announcement-news brief. Write to ndarbonne@hartenergy.com or call 713-260-6429.

Received important new financing? Adding new, key management? Make an important acquisition? Tell us about it. We'll draft that news report too.

Have expert experience or research to share? *Oil and Gas Investor* also hosts several conferences, on topics including A&D strategies, capitalization, recruiting and retention and developing unconventional-gas resources. And the new OilandGasInvestor.com offers start-up resources, with databases of Who's Who in the business and how to contact them. Use it online, 24/7.

—Nissa Darbonne

If a campaign leads to increased traffic to your website, the outcome can be both qualitative and quantitative—a larger number of stakeholders and potential E&P project partners are exposed to your brand and message (qualitative), which will almost certainly lead to an increase in sales or investor activity (quantitative).

Historically, successful strategies and tactics become best practices—that is, they become standard procedure when building a PR program or campaign. Best practices include the following:

Branding/core messaging. This is the essential first step, the "deep dive" that defines who you are and how you communicate. Your brand is not your logo or ad slogan—your brand is who you are, who you represent, how you serve the market and how you deliver value to your stakeholders and your company.

Effective branding and message development defines your presence in the market, enables you to present best-in-class deliverables and serves as a foundation for all PR, marketing and communication strategies.

Stakeholder analysis. You need to understand everyone who has an interest in your company. Stakeholders can include investors, landowners, project partners, employees and the media. Identify your stakeholders, and then take each group and analyze their needs and interests, establishing a framework for customizing and delivering core messages to each about your company.

This is not a one-size-fits-all approach. For example, messages that resonate with landowners might not resonate with partners or investors and vice versa. Similarly, if your objective is to target media and fund managers, you will need to develop distinct messages and use communications tools that are tailored for those audiences.

Media relations. Many professionals maintain that media relations is the heart and soul of PR and to a certain extent this is true. The vast majority of PR campaigns include media relations and in many cases it is the principal driver.

The media provides an invaluable resource called "third-party validation." When an editor or reporter writes about your company based on information you provide, or includes a bylined article guest-authored by one of your executives, you achieve a de facto endorsement or value-add that marketing alone cannot provide.

Third-party validation has been proven as one of the best ways to communicate thought leadership (innovation) and market leadership (performance), knowing that many, if not most, investors actively read trade periodicals and the business sections of daily newspapers.

What they read about your company in those publications will have a strong and lasting impact. Proactive media relations ensure that these messages will be positive and beneficial.

GETTING STARTED

PR can work for virtually any company. When employed properly, PR is scalable, extremely cost effective, especially in comparison with marketing, and delivers proven return on investment.

Companies that rely on public relations have two choices: contracting with an agency to provide PR, or building an in-house PR team, typically as an extension of marketing.

Both have their advantages. In-house PR is more expensive but draws from easily available in-house resources and deep industry expertise, and affords face-to-face contact on a daily basis. Agency PR is less expensive and can provide an invaluable outside perspective—most agency practitioners are well-versed in PR strategies and tactics ranging across multiple markets and industries, and can draw from successes in a wide range of areas.

Whatever path you choose, PR helps organizations grow and connect with their stakeholders, and achieve greater results in the market. •

Beverly Scippa Jernigan is an independent public-relations professional with global experience in creating and executing internal- and external-communications strategy for start-ups and multi-national corporations, including Halliburton. She can be reached at beverly@beverlypr.com *or 713-861-3851.*

Learn From the Masters

THESE VETERAN E&P START-UP EXECUTIVES SHARE THEIR SUCCESS STORIES, OFFER TIPS AND WARN ON TRAPS. DON'T GET STARTED WITHOUT THIS INSIDER INSIGHT.

ARTICLE BY GARY CLOUSER

A growing group of entrepreneurs has established a niche for themselves for their abilities to start, build and sell E&P companies, and then restart.

It's an oft-repeated cycle in the oil and gas industry: Small E&P companies are founded, quickly grow large enough to pop up on larger companies' radars. The maturing start-up is bought out and, in a relatively short period of time, members of the management team get back into the business.

Bankers and private-equity providers concede that capitalization terms vary greatly depending on the quality of the management team—its reputation, familiarity and track record. Here is advice and insight from the pros—five start-up veterans who've done it before, sometimes twice and even four times.

RANDY FOUTCH

It is much easier to re-load than to start from scratch. Because when starting from scratch, you have to convince potential investors or lenders of your potential, merits and competence, while it is easier to show what you have done and promise you'll do it again, says Randy Foutch, chief executive officer of Tulsa-based private producer Laredo Petroleum.

Randy Foutch, Laredo Petroleum

Formed in June 2007, Laredo is Foutch's latest venture. Previous start-up companies headed by Foutch were Colt Resources (1991), Lariat Petroleum (1997) and Latigo Petroleum (2002). Lariat was sold in 2001 to Newfield Exploration Co. for approximately $333 million, and Latigo was sold in 2006 to Pogo Producing Co. for approximately $750 million.

Given the reputation and track record Foutch enjoys in starting and developing E&P companies, Laredo had no trouble finding willing financial institutions to provide initial support. Foutch turned to Bank of America and Bank of Oklahoma as part of the team for a $300-million revolving credit facility.

Bank of Oklahoma had been the sole lender to Foutch's first company, Colt Resources, in 1991 when Foutch left his job as senior vice president of production at Dyco Petroleum. It and Bank of America also participated in lending to Lariat and Latigo. Foutch says his team has always managed commodity risk via hedging, using futures contracts that banks help provide.

In addition to the bank debt, global private-equity firm Warburg Pincus provided an equity commitment of $300- to $500 million to Laredo, and had backed Lariat and Latigo.

When Foutch founded Colt Resources, there were few start-up E&Ps, he recalls. Now, there are a large and growing number of start-ups—both first-time managers and repeat teams such as his own. He attributes the growth in prospective start-up E&P companies to rising commodity prices, and an aging industry demographic in which technical experts are now 50-plus and sense that they have the knowledge and skills to go out on their own.

And, there are numerous private-equity companies willing to invest. "There has been such an explosion of other sources of capital. While banks are still important, there are lots of start-ups that are doing deals based upon the availability of equity as opposed to the availability of debt," Foutch says.

Funding. Still, it is important for the start-up E&P to make certain that its business plan matches that of the equity provider with a commonality in investment characteristics—both in terms of duration and risks. For example, if there is a waterflood project, or something that will take years to become profitable, you better have a financing plan that matches. Regarding risks, if investors are looking for a safe investment, it will be very difficult to drill exploration wells with their money, Foutch notes.

Costs. He also cautions start-ups to consider that, while commodity prices have dramatically risen, so too have costs for just about everything, including land acquisition, drilling, service-company contracts, completions, materials and wages. Those costs are fourfold what they were when Foutch started his first company.

Finding costs then might have totaled 60 to 70 cents per thousand cubic feet of natural gas; now they are more likely in the $2.50 range. That has made the cost of entry much greater, he says.

Technical team. "But, the biggest challenge to a start-up E&P company, with plans to grow rapidly isn't land or rigs or opportunities. It isn't capital. It is assembling technically competent people."

Retention of good people has been an integral factor in the success of his companies, he says, noting that of the 52 employees at Laredo, about 60% have worked at one or more of his previous companies.

Laredo anticipates spending about $140 million in 2008 in drilling to add to production that is currently about 14 million cubic feet of gas equivalent per day. Foutch insists that, although he has built three successful companies before, he doesn't know how the story of Laredo will unfold, nor does he know its timetable.

Exit. There are three options: Continue to grow it as a privately owned company, sell it or take it public. Foutch insists that going public is an option and notes that, before Lariat was sold, documents were being written for an IPO when a buyout offer was made.

The determining factor will always be the action that is in the best interest of the stakeholders, he notes, and market conditions will dictate that. Yet, by being privately held and not having to provide quarterly earnings guidance and meet short-term goals, his management teams have been able to make decisions that have had long-term, positive outcomes.

"BUT, THE BIGGEST CHALLENGE TO A START-UP E&P COMPANY, WITH PLANS TO GROW RAPIDLY ISN'T LAND OR RIGS OR OPPORTUNITIES. IT ISN'T CAPITAL. IT IS ASSEMBLING TECHNICALLY COMPETENT PEOPLE."

RANDY FOUTCH,
LAREDO PETROLEUM

JEFF VONCANNON

In 1992, at the age of 30, Jeff Voncannon started Houston-based Redman Energy I, an E&P company with $1,000, a card table, phone, fax machine that sat on a cardboard box, and a folding chair. Ten years later, he sold the company for more than $20 million.

He then reloaded and built another company, Redman Energy Holdings LP, selling it in 2007 in a deal valued at about $180 million. Already, he is making plans to launch another E&P, as well as investing in other start-ups as the chief executive of Redman Resources LLC.

Jeff Voncannon,
Redman Resources

Voncannon began his energy career at Prairie Producing Co. as an engineer and held various management positions. When Prairie was sold to Unocal, he worked as an operations manager and helped run Prairie for about a year. Within Unocal he wanted a corporate-planning position and, through persistence, was offered a post even though he didn't have the typically required MBA and 15 years of experience.

While helping to write business plans for Unocal, he learned everything he could. By 1992, he was ready to own an E&P company.

He knew he had to start small. He managed to build the company without debt or private equity. He didn't want to assume large amounts of debt—a different approach than that used by many in the industry.

He began by acquiring a small asset from his former employer, and focused on one or two wells at a time. He would put a deal together, form a partnership, then buy and operate the wells.

Competence. "I had a portfolio of niche plays—sour gas, low-resistivity tight gas, and deep, overpressured water-drive reservoirs in Louisiana and East Texas. That's what I learned as an intern—stick with what you know. Prairie and Unocal were developing those kinds of fields," Voncannon notes.

Exposure. He showed his first drilling venture 104 times. "It had two prospects. The first well was in Freestone County in the Smackover, and it ended up producing 13 million cubic feet per day. The next well came in at 5 million per day.

"The exposure to 104 companies was a great marketing tool. When the wells hit, people knew who we were and saw our success," he says.

Capital partners. He used cash flow to grow the company's assets. "I built the company without debt the first five years. But to grow the company further we needed some debt." He chose Wells Fargo as the company's banker and says this was an important business decision.

"One of the key ingredients of building a successful company is having a great banking relationship." In hindsight, Voncannon says he should have brought in capital partners earlier and grown quicker.

At the time of the sale of his first company, its 27.8 billion cubic feet equivalent of reserves were 67% gas and 82% developed, split between East Texas and the Gulf Coast, mainly Louisiana. Monthly net production was about 32,000 barrels of oil equivalent.

The sale was handled by PetroGrowth Advisors, which initially had been retained to look at liquidity options and valuing the company. Ultimately, it was decided a divestment was the best option, given the seller's market in 2002.

His second start-up's E&P strategy was the same—"stick with what you know"—and Voncannon brought in private-equity funding from Natural Gas Partners.

"I would suggest finding a mentoring-type investor to get the first deal done that can be used as a stepping stone for the next deal." Ideally, the investor will have a history of having partnered with successful start-up companies.

Experience. "In addition to relationships, reputation and more personal assets, I had already gone through the administrative trials of negotiating lease space, having more office furniture than a cardboard box, setting up employee benefits, making a payroll and broadening my industry connections.

"I was 10 years older and had a documented track record as a deal closer. That helps. Confidence does too."

Costs. Given rising costs, Voncannon says it would be very difficult for someone to do today what he did in 1992 without an outside investor. "The costs are just too great. In 1992 dayrates were $5,200 for a 1,000-horsepower rig. Now they exceed three times that."

Also, a seasoned engineer's salary was about $75,000 per year. "Now it can cost as much as $300,000. I used to be able to get farm-outs and pick up acreage for $100 to $150 an acre. Now it's at least five times as much in the same trends and farm-outs aren't available."

Acquisitions. Here's his test for acquisitions. "When we look at any deal, I ask my staff, 'What's the joy in it? Is it financial or technical? Is this going to develop us or defeat us?' If there is no joy, or it is going to defeat us, we pass on it."

GEORGE SOLICH

Even before Denver-based Cordillera Energy Partners II LLC is sold, its management team is operating the next reincarnation, Cordillera III.

"We made the decision to form Cordillera III before we exited Cordillera II because we didn't want to lose people, momentum or opportunities," says president George Solich, who founded Cordillera I in February 2000. Cordillera II and III are operating simultaneously, but "are two separate corporations, with everything separate except for the management," Solich says.

George Solich,
Cordillera Energy Partners III

He and executive vice president and chief financial officer Tad Herz have worked together for about 20 years, including about a dozen years at Apache Corp. Solich was instrumental in the consummation of more than $1 billion in acquisition and divestiture transactions while at Apache and HS Resources Inc.

Cordillera II expects to this month to produce approximately 50 million cubic feet of gas equivalent a day. In the same timeframe, Cordillera III expects its daily net production to be running 10 million cubic feet equivalent a day.

THE PROS' NOTEBOOK

It is much easier to re-load than to start from scratch, says Randy Foutch, chief executive of Tulsa-based Laredo Petroleum. That includes re-starting with fellow managers with whom you've been successful before. Laredo is Foutch's fourth venture, and he is rejoined in this one by Mark Womble, chief financial officer; Pat Curth, vice president, exploration; and Oran Hall, vice president, planning and development.

Coming onboard is Jerry Schuyler, chief operating officer, who most previously was with St. Mary Land & Exploration Co.

Womble says a key to recruiting and retaining good employees is to create a culture where everyone's input is sought and valued, and there is a genuine feeling that everyone is in it together.

That means not only paying market-competitive salaries and bonuses, but allowing each employee to become a stakeholder to have a financial stake in the success of the company. Upper management must have money in the game, with the payment terms and conditions the same as for other equity providers, he adds.

"When we make a capital call, deciding how money should be spent, we all stand to benefit, when we make it work, or vice versa."

Schuyler calls a company's desire to use all skills of all employees, and to seek input, as "inclusiveness." It's not to be confused with democracy, as roles still need to be understood.

The most common failure in assembling teams is that managers too often duplicate, rather than complement, skill sets of managers, he says. That shortcoming could prove to be a fatal mistake for a company. Because successful companies create a culture and an expectation of success, they are always planning for it, he adds.

"With that culture, whenever good talent is available, you jump on it and bet on success."

Curth adds that the expectation of success applies to all aspects of the company. In the exploration division, it means staying focused on current projects, while also planning projects for three years out to try to stay ahead of the pack in the use of technology.

"Despite whatever success you have had, you can't sit on your laurels. You have to have all needed systems in place as soon as possible—information technology, computers, accounting or infrastructure—otherwise you end up wasting time and efficiency."

A factor in the success of Foutch's companies is that, whenever an opportunity was identified, its implementation was never capital constrained, Curth adds.

"A management team that has experienced success has pride in its accomplishments, enjoys the business and wants more success, but should constantly surround itself with employees that are hungrier than it is."

Cordillera II's production is focused in East Texas and the Anadarko Basin, primarily in the Texas Panhandle. Cordillera III's current production is in East Texas and the Texas Panhandle.

"Our strategy with Cordillera II and III is the same: to find more value in assets than was there before. We consolidate assets in a few key areas, and we add reserves, production and cash flow. We bring focus and good science to the table, and we think we buy the right properties, in good fields and in good areas," Solich says.

Capitalization. Cordillera I, with a $10-million commitment, was formed 100% with EnCap Investments LP private-equity financing, and was sold in late 2003 to Patina Oil & Gas Corp. for $247 million.

Eight months later, Cordillera II was in business. In January 2005, it announced that its key executives had stuck together and obtained $500 million of capitalization, in the form of a private-equity placement and a credit facility. EnCap led a $200-million private-equity placement, along with five other institutional investors, two private investors and the company's management.

Cordillera III is structured in a similar manner. In fact, except for one, all of the investors in Cordillera II have invested in III, and additional investors have come onboard. Cordillera III's equity capitalization consists of $500 million from EnCap and 12 institutions and individuals.

All three Cordillera entities have relied on a strong credit facility of six banks led by JP Morgan Chase.

Management. Cordillera III kept Solich as president and Herz as executive vice president and CFO, as well as retaining several other top executives. All of the top managers before joining Cordillera had worked together somewhere, or perhaps, across the table in other deals, Herz says.

Recruiting. "Attracting and retaining the smartest and best people is the No. 1 challenge for a start-up company," says Solich, adding that there is a current shortage of such personnel, particularly those in the geosciences.

Unlike years ago, when such professionals spent their career with a single company, the younger professionals moved around because of demand for their services. "Assets don't create value; people do," Solich says.

The technical expertise is essential as a company won't be successful, regardless of how much access to capital is available and how much land has been acquired, without it, he cautions.

Costs. Commodity prices, costs and advanced technologies are the biggest changes in the industry this decade, Solich says. "You can't think any more in terms of $2 (per thousand cubic feet of natural) gas and $20 (per barrel of) oil" that were the benchmarks in 2000.

"The economics are completely different now. That has allowed companies to unlock the potential in new plays today we wouldn't have even looked at then. But, the business is the still the same in the sense of trying to create value by taking appropriate levels of risks."

MAURICE STORM

By 2002, Maurice Storm and Pat Hall, two upper-management members of large independent E&P companies they had recently left, decided it was time to go into business for themselves. They formed Tulsa-based Crow Creek Energy.

"When I left the old Barrett Resources in 2000, I was the vice president of business development, having started about nine years earlier as the Midcontinent exploration manager, and took a few years off," Storm says.

"In 2002, I was ready to go back to work and wanted to start my own company. Pat Hall had recently left Samson Resources where he was the vice president of accounting and was looking for a new venture.

Maurice Storm, Crow Creek Energy II

"We met through a friend who had his own NGP (Natural Gas Partners portfolio) company in Tulsa. We decided to partner up and started Crow Creek Energy in October 2002 to do acquisitions and drilling in Oklahoma."

The company was funded by equity contributions from management and a $15-million equity commitment from NGP. It focused on the Midcontinent, specifically the Anadarko and Arkoma basins in Oklahoma.

In June 2006, Crow Creek Energy sold all of its stock to Penn Virginia Oil & Gas Corp. for $71.5 million. The company's assets then were primarily horizontal coalbed-methane producers in the Arkoma Basin in Oklahoma and the Granite Wash in Washita County, Oklahoma.

"We had a great team of people that worked well together and had been successful, so we wanted to continue that and formed Crow Creek Energy II," says Storm, who remains president and chief executive, with Hall as vice president and CFO.

Management. "I think the key to keeping the team together is that everyone has to work. There really isn't room in a start-up for someone to be a figurehead and simply tell others what to do. All of us in the management team have primary responsibility for our areas of expertise and work it day to day.

"We were very happy with the job NGP did for us in the first company, so we brought them in as an equity backer on Crow Creek II in late 2006, initially with a $25-million equity commitment."

Within three months, Crow Creek II had closed on a $10-million acquisition of Oklahoma properties from EnCana Corp. In May 2007, it had an opportunity to make a large acquisition and signed a purchase agreement to acquire $300 million of properties from Encore Acquisition Co.

NGP upsized its commitment to Crow Creek II to $170 million, and the Encore deal was closed in late June 2007, financing it with half-equity and half-debt. The company now has a $285-million syndicated credit facility in place with Wachovia and 10 other banks.

Financial partner. "Picking the right financial partner is critical to your business. They need to complement your skill set and do things for you that you don't do as well as they do. We don't look to our private-equity people for advice on engineering and geology questions or which deals might be a good fit for us," Storm says.

"We need them to be a business reference to financial institutions, help us put together credit facilities, and guide us on hedging strategies and execution."

Crow Creek II produces more than 30 million cubic feet equivalent per day, net, and has reserves in excess of 160 billion cubic feet equivalent. Its main areas of focus are in the deep Anadarko Basin of Oklahoma, the Woodford shale in the Arkoma Basin and the Barnett shale in the Fort Worth Basin.

Capital access. Since 2002, commodity prices have gone up fivefold and costs have only doubled, so it has been an "up market for some time," Storm says.

"Capital availability has never been better than it is today, both from a private-equity perspective to commercial credit. There is plenty of money out there for experienced management teams, both on the equity and the debt side.

Recruiting. "The greatest challenge in building a company is finding good people. If you are going to be cost-efficient, you can't have a huge staff, so the people you get have to be very talented.

"There isn't a big pool of talent to draw from in this business to begin with and everyone is very well paid. Trying to match, much less beat, the types of packages the publicly traded independents have these days is very difficult."

Focus. His peers who have been successful have focused on doing what they are good at and in areas that they know well, he says.

"With a start-up you can already be at a pretty large disadvantage in an area, since you don't own any acreage or production. If you don't know the players, the geology of the basins or the service companies, then you really have a tough road ahead," Storm says.

Flexibility. Opportunities also exist for those who are flexible in their business model, he adds. "If a company is comfortable making acquisitions and buying acreage and drilling, then they can always make money across different cycles.

"For example, early on in developing resource plays, there are opportunities to put together an acreage position, drill some wells and sell out. As the resource plays become more popular, a lot of independents will cycle out of conventional plays and sell assets, creating acquisition opportunities.

"If the resource plays don't work out as well as expected, publicly traded companies will try to boost their production and reserves by buying safer, conventional production. So if you are in the business over time, there are always going to be good times to be an acquirer or a driller and either a buyer or a seller."

Choosing deals. Some years ago, Storm was told that the most critical factor in the business is the ability to tell the difference between a good deal and a bad deal.

"That seems a little obvious, but it really is what the business comes down to. Unless you can buy wholesale and sell retail, you won't make much money," Storm says. "Be aware of the scale of your business so that you never invest so heavily in one project that its failure would wreck you."

He has enjoyed the process of starting with a blank paper and building an E&P into a large going concern.

"We have the access to capital in this business that allows us to create an incredible amount of value in a few short years that very few other businesses can even come close to. It is very satisfying to take risks and have them pay off for your team and your investors.

"That is what makes people come back and do the third and fourth companies."

> "If you don't know the players, the geology of the basins or the service companies, then you really have a tough road ahead."
>
> Maurice Storm, Crow Creek Energy II

ALAN SMITH

Alan Smith's background and experiences provide him with a unique perspective on the paradigm of starting and funding an E&P company, investing in its growth, selling the assets, and then starting all over again—as he has been part of teams that have done that multiple times.

Smith and Tom Campbell in 2003 formed Chalker Energy Partners, a portfolio company of Quantum Energy Partners. Chalker was started with a $15-million commitment from Quantum. Since then, Chalker I has been sold, and the assets of Chalker II have been substantially divested. Now, as a board member, Smith is involved in the planning of Chalker III, and is a managing director of Quantum.

Chalker I had a combination acquire/exploit/drill strategy and spent $55 million through the drillbit between January 2005 and March 2006. It drilled 45 wells in East Texas and achieved production of 14 million cubic feet per day and had proved reserves of 110 billion cubic feet equivalent on approximately 26,000 net acres, of which 15,000 were targets for Cotton Valley gas. It sold substantially all assets in March 2006 to Forest Oil Corp. for $223 million. Upon the sale, Smith joined Quantum as a managing director.

For Chalker, Smith says, the exit criteria were in place from the start: build net daily production to at least 10 million cubic feet equivalent per day, build a leasehold position of at least 10,000 net acres and have proved reserves of at least 100 billion equivalent.

With the success of Chalker I, financing Chalker II wasn't an issue as it, like its predecessor, was a portfolio company of Quantum. Chalker II was started in spring 2006 with the strategy of repeating the success of Chalker I through acquisitions, acquiring land, adding reserves and production, and then exiting.

Alan Smith, Chalker Energy II/Quantum Energy Partners

Smith remained the chairman of Chalker II, but recruited Doug Krenek as the president and chief executive. Smith had worked with Krenek for four years at Ocean Energy Inc. (which was sold to Devon Energy Corp.) and believed he would be a great fit with the Chalker team.

Chalker II grew to include assets in three Texas plays: East Texas, Fort Trinidad/Buda and the Fort Worth Basin. In December 2007, Chalker II and Rusk Energy Ltd., a subsidiary of Chalker II, sold substantially all of their East Texas oil and gas properties to NFR Energy LLC, a joint venture of First Reserve Corp. and Nabors Industries.

The sale included more than 24,000 acres of leasehold in the Cotton Valley Trend of East Texas, 85 producing wells yielding approximately 23 million cubic feet per day, and proved reserves of nearly 300 billion equivalent. The terms of that sale were not disclosed, although Chalker says it provided a multiple of 4.0 return on investment on a $40-million equity investment.

Chalker II, which also had leased 17,000 acres in three separate transactions in the Buda play in the Fort Trinidad area of Texas, sold down 50% of its position in that play, while maintaining operations. In May 2007, it drilled one horizontal well and later sold the balance of its position to PetroQuest Energy Corp. for $20 million.

In the Fort Worth Basin, Chalker II had acquired 800,000 cubic feet equivalent of daily production, and 10,000 acres in three transactions and expects to exit by the end of June.

Chalker III will start anew with no production or reserves. Smith will be a member of its board, as a representative of Quantum just as he is with several other Quantum E&P portfolio companies. Smith will not, however, hold any executive position with Chalker III.

Capital access. Smith notes that capital availability for E&P companies, even start-ups, has never been higher because investors are bullish on the sector and private-equity providers are eager to increase their exposure to oil and gas.

Still, to get funding, an E&P management team must demonstrate a proven track record of success in a prior life. The team must be able to illustrate that they have successfully allocated capital, have solid experience in the area of their business plan and possess strong execution skills.

Many times, these teams come out of larger companies where the leader has been a regional or division manager.

Capital partner. Smith's advice concerning selecting a financing provider: make sure you select a partner and not just an investor. Select a firm that can add value at a strategic level, complement your team where it doesn't have the expertise and contribute to your deal flow.

For entry-level companies, the greatest challenge now is not access to capital but finding the right opportunity, at a reasonable cost, that matches management's ability to execute and create value, Smith says.

Strategy. "It is important to have a focused business strategy that is consistent with the complete team's expertise—geology, engineering, operations and land—as it pertains to the geographic location and type of play," he says, adding he is not a proponent of outsourcing such essential management positions.

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>
> ALAN SMITH,
> CHALKER ENERGY II/
> QUANTUM ENERGY PARTNERS

"Mistakes that E&P companies make are spreading themselves too thin geographically, spending too much capital prior to generating cash flow, and lacking expertise in one or more of the key management functions."

The margin for error for a start-up company, particularly at its earliest stage, is very small, Smith says. "You want to make sure you don't put yourself behind the 8 ball by overpaying for an acquisition or land deal right out of the blocks."

Costs. The cost of doing E&P business is up dramatically across the board, including costs for assets, drilling and completion. For example, in 2003, acquiring reserves in the ground would have cost about $1.50 per thousand cubic feet, but now that price is $2.50 to $3, he says.

"Many start-up companies now have a new challenge. In decades past, the name of the game was drilling conventional plays where faults, structure and presence of reservoir rock ruled the day.

"The focus now is on unconventional plays, where we know the gas is in the ground, but we have to figure out how to economically get it out of less-than-desirable rock. The unconventional plays are more capital-intensive and require additional technical expertise to be successful." •

BOLO systems

Helen Leeke
713-850-1812 Ext. 401
helen.leeke@wellpointsystems.com
WellpointSystems.com

NGP ENERGY CAPITAL MANAGEMENT

Kenneth Hersh
972-432-1440
inquiries@ngpenergycapital.com
NGPEnergyCapital.com

QUANTUM ENERGY PARTNERS
The best energy companies start here.

David Bole
713-328-0022
dlb@quantumep.com
QuantumEP.com

RAYMOND JAMES
www.rjcapitalmarkets.com

Howard House
713-278-5252
howard.house@raymondjames.com
RaymondJames.com

The Rodman Energy Group

Cameron O. Smith
212-697-0100
cos@coscocap.com
COSCOCap.com

TUDOR PICKERING HOLT & CO
ENERGY INVESTMENT & MERCHANT BANKING

Alexandra Pruner
713-333-7100
apruner@tudorpickering.com
TudorPickering.com

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