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REACHING THE SUMMIT

As the adage says, if you're not pushing earnings higher, you're really slipping backward. Public and private E&P companies have taken this saying to heart. Their corporate strategies reflect their continuous efforts to grow profitably, and this always involves managing the portfolio to best effect.

That means buying and selling oil and gas assets.

This special report brings you up to date on macro-trends and deal techniques in the mergers and acquisitions space for 2007. The outlook is fairly sunny in the U.S. but partly cloudy in Canada.

Money in either country is not the problem. Private equity firms in the U.S. energy sector alone have at least $17 billion of dry powder (raised, but uncommitted, capital) on hand as of December 2006. This money will back buyers.

However, it may be hard to top the blockbuster level of A&D activity seen in 2006, when commodity prices soared and nine deals of greater than $1 billion closed, according to Merrill Lynch Petrie Divestiture Advisors.

Motivation is not a problem. A&D advisory firms and capital providers agree that this year, robust deal flow will result from a variety of factors: low interest rates, the increasing difficulty in finding oil and gas—and the high finding costs that result—and a strong bench of buyers with plenty of capital available.

The choice, as always, is between paying to drill and paying to buy. Tristone Capital reports that in 2006, U.S. deals averaged $3 per thousand cubic feet equivalent, while drilling costs rose to $3.50.

The year ahead may bring about more deals, as lower commodity prices and tax law changes in Canada are apt to bring buyers' and sellers' valuations closer to reality—and closer to each other.

Metrics of a deal may be a challenge. Observers hope as commodity prices trend lower in the spring and summer, sellers will adjust their expectations accordingly, although in Canada, some deals have been derailed already, reports Taryn Maxwell, editor of Hart's *A&D Watch* newsletter.

In addition, Maple Leaf deal multiples may decline modestly this year now that the Canadian government has promised to tax the highly acquisitive royalty trusts beginning in 2011. This has thrown a great deal of uncertainty into the Canadian marketplace, at least temporarily, as buyers and sellers assess its meaning.

Most agree on one thing: it levels the playing field between trusts and traditional oil and gas asset buyers.

—Leslie Haines, Editor-in-chief

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THE YEAR AHEAD

As commodity prices start to come off the unprecedented highs of the past two years, the M&A landscape is set to shift in 2007.

By Taryn Maxwell, Editor, *A&D Watch*

Lower natural gas prices in North America—and tax law changes in Canada—are expected to bring about more deals as buyers and sellers find themselves closer together on valuations. However, oil and gas prices aren't the only factors fueling the M&A flame these days.

Bill Marko, managing director, Jefferies Randall & Dewey, says the transaction market is being driven to a large degree by these factors: demand from the financial markets, low interest rates, excess cash on buyers' balance sheets, high finding and development costs that can make buying more economic than drilling, an oil futures market that is higher than First Call consensus, pass-through vehicles that trade on yield and the large amount of available private equity.

"Dividends have gone up as much as 80% in the past year," Marko says. "This demonstrates that energy companies have choices on what to do with their cash flow and they're using some of it to increase dividends and improve valuations."

The dividend increases are another indication companies have plenty of cash to fuel mergers and acquisitions. Companies not only have the way to do acquisitions, they also have the will this year.

"Public E&P companies continue to need to grow," Marko says. "The formation of the MLPs also has created companies with heavy appetites. We're seeing continued demand from foreign E&P companies. There's also the people leaving E&P companies, hanging out their own shingles and coming out with $100- to $200 million of private equity money to invest in A&D."

Now that commodity prices have shaken up the M&A space in North America, what is to come?

In the U.S., properties will be made available for those buyers who have been saving up their cash, especially through big corporate restructuring events such as that of Anadarko Petroleum Corp. and Dominion as well as by private equity companies ready to exit.

"Companies that decide to rationalize their portfolios this year will look at their properties in the Gulf of Mexico deepwater and on the shelf, and in the Barnett shale and other resource plays," Marko says. "Companies will start to look at their activities there and decide whether or not they're big enough to make a difference and compete, or are the valuations so good in those areas that they would be better off selling their properties to one of the big companies operating in the area."

Companies that do decide to divest their assets in the resource plays will do well, while those trying to exit the Gulf of Mexico shelf may not have quite as much luck, says Randy King, managing director of Merrill Lynch Petrie Divestiture Advisors in Houston.

"Resource plays look good to me," he says. "We run into a lot of companies that have taken spec positions in various shale plays around the country [because F&D costs tend to be lower in these plays]. If you're looking for liquidity for your shelf properties, that is difficult. The market has penalized companies on the shelf, but I think the Gulf of Mexico is an investment opportunity."

Though there might be a decrease in buyers bidding on properties this year, the bids companies do get will be good ones as the market continues to increase in sophistication and buyers devote their time only to properties they really want and plan to win. Prices for proved and unproved assets in the ground have risen steadily during the past three years.

"Buyers screen opportunities and sellers screen potential buyers better than ever," Marko says. "The supply of money in the market is also sophisticated and can respond to changing environments."

Expect to see the majors coming back to North America this year as well, he says. They started exiting the mature basins of the U.S. a couple of years ago, but many of them now wish they were here in a bigger way.

"The U.S. still offers some of the best margins in the world," Marko says. "The majors will have a hard time putting competitive valuations together to compete for a merger or acquisition, so we'll see an increased emphasis on farm-ins and joint ventures from them to gain access to the U.S. again."

Though commodity prices have experienced a dip, do not expect industry costs to do the same.

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Size ($Million)	2005 Count	2005 $Million	2005 $/Barrel of oil equivalent	2006 Count	2006 $Million	2006 $/Barrel of oil equivalent
>500	14	18,128	16.62	25	51,540	23.04
100-500	46	10,701	14.29	38	9,306	13.13
50-100	25	1,749	8.07	31	2,188	10.71
<50*	404	1,656	5.40	669	2,814	10.52
Total	489	32,234	14.53	763	65,848	19.06

*Includes deals that do not report metrics (Source: Jefferies Randall & Dewey database)

Announced U.S. M&A Activity

demand," says Candida Scott, a director with Cambridge Energy Research Associates. "We don't expect any relief coming to the marketplace that will allow costs to begin to decrease. Overall, we expect costs to continue to escalate in 2007."

CANADIAN OUTLOOK

If U.S. companies are ready, willing and able to snap up oil and gas properties stateside, Canadian companies are doing what they can to sell, though lower gas prices have made it difficult.

"We're definitely in an era of uncertainty, and we've even noticed it in some of the processes we've been executing on," says John Koyanagi, managing director of Calgary-based Canaccord Enermarket. "Bidders have been reluctant to get aggressive because they don't really know where commodity prices are going. This uncertain outlook right now is an issue."

A disturbing trend many in the Canadian M&A marketplace have noticed is more deals that do not close because the seller walks away unsatisfied with any of the offers received.

"One of the interesting things we're seeing is a lot of processes are resulting in things not being sold," Koyanagi says. "The sellers are just not getting acceptable offers. People aren't being as aggressive in terms of bidding. Though we've seen falling commodity prices, sellers are still holding onto the expectation that they can get the same dollar value as when prices were high."

Some blame the price uncertainty and the conservatism of the capital providers for the increase in unclosed deals in Canada this year.

"The capital providers seem to be a fickle bunch; they'll be here when the bulls are running, and they'll hide in the shadow of a bear," says Mark McMurray, managing director of corporate development for Calgary-based divestment services firm Rundle Energy Partners (formerly Kobayashi & Associates). "The sellers have come off frothy transaction metrics with expectations that don't correct as quickly as the capital markets correct. The gap that results stretches many deals out."

Many Canadian observers expect to see an increase in activity, including consolidation among the trusts, which are still struggling to regain their bearings after the October 2006 tax fairness plan announcement that will do away with their tax-free status in 2011.

"It depends on the size [of the trust]," says Martin Peters, a managing director of Calgary-based Canaccord Enermarket. "The larger trusts are well-positioned and have cost-of-capital advantages over the smaller trusts. They have a lot more flexibility to choose how they plan to go forward. The smaller trusts, because they don't have that depth to change their model, will probably resort to consolidation."

Many also think 2007 will be the year for companies to catch up on portfolio management, something they avoided doing when oil and gas prices were so high everything in the portfolio was making money.

"During high prices, the production and reserves booked on those interests was more valuable than the cash in their jeans," McMurray says. "Now, the cash in their jeans is king. Some will now be pushed into divestment. Companies that remain strong in the long run know that portfolio management is just good business." •

Acquisition Metric Trends
($ per Proved Thousand cubic feet equivalent)

Year	Value
1998	0.80
1999	0.75
2000	0.80
2001	1.00
2002	1.15
2003	1.25
2004	1.75
2005	2.30
2006	2.85

Source: Merrill Lynch Petrie Divestiture Advisors database and John S. Herold Inc.

Since 1998, the compound annual growth rate for prices paid for reserves per thousand cubic feet equivalent is 248%, say Merrill Lynch Petrie Divestiture Advisors.

KEEPING A&D TAX EFFECTS AT BAY

If your company will be buying and selling assets within six months of each other, are deferred or reverse like-kind exchanges for you?

By Alan J. Brown, Lynch, Chappell & Alsup PC

Recently I received a phone call from a client who was reading the standard boilerplate language in a purchase-and-sale agreement, when he noticed a paragraph titled "Like-Kind Exchange." He asked whether such an exchange made any sense for his company—and that simple question ultimately saved the company $42 million in capital gains tax liability.

The oft-overlooked boilerplate actually represented a tremendous planning opportunity.

If you are a seller, your company may have plans in the near future to acquire other properties for your portfolio, which could involve a deferred like-kind exchange. As a buyer, your company may have plans to sell non-strategic assets in the near term, which could involve a reverse like-kind exchange. Regardless of which position you are in, it is to your advantage to consider how testing for the benefits of a like-kind exchange could become part of your standard acquisition and divestment strategy.

Oil and gas transactions frequently result in sizable capital gains taxes that have a negative impact on profitability. But Section 1031 of the Internal Revenue Code provides a way to defer the tax by using a deferred like-kind exchange process, whereby a business or investment property is sold and the proceeds used to acquire a new property.

These like-kind exchange regulations date from the 1920s but have changed significantly during the past 15 years with the issuance of regulations in 1991 and 1992 regarding deferred exchanges (see Treas. Reg. 1.1031(k)). The Internal Revenue Service made exchanging much safer as a tax strategy, less expensive to administer, and it broadened the scope of what qualifies as an exchange.

The IRS introduced the concept of a qualified intermediary (a third party to facilitate an exchange). This expanded the application from two parties getting together to trade properties, to include any seller who wants to take sales proceeds and within six months invest in like-kind property.

In 2000, the application of like-kind exchanges expanded further when the IRS gave taxpayers a safe harbor for reverse exchanges, where the acquisition of assets occurs before the sale instead of after. Deferred and reverse like-kind exchanges are now commonplace in the oil and gas A&D arena.

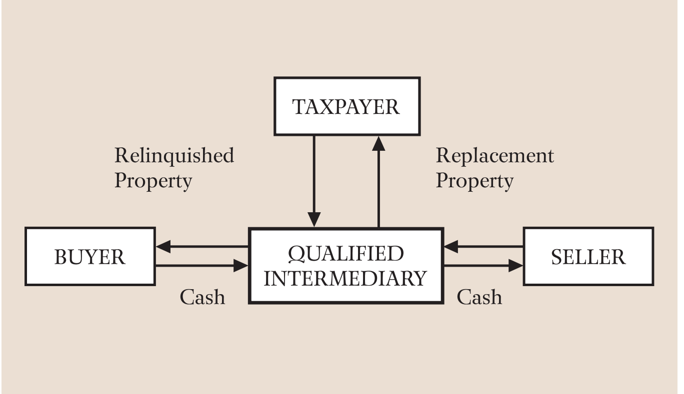

Diagram of a Deferred Exchange

THE DEFERRED LIKE-KIND EXCHANGE

In a deferred exchange, there can be a delay of up to 180 days between the sale of one property and the acquisition of another. In general, no gain or loss is recognized if property held for productive use in a trade or business, or for investment, is exchanged solely for property of a like-kind to be held for productive use in a trade or business or for investment.

In a typical deferred exchange, the taxpayer (seller) arranges to sell a property to a prospective buyer and includes the appropriate language in the purchase-and-sale agreement. At this point, the seller makes arrangements to involve a qualified intermediary in the transaction, and together they execute an exchange agreement and an assignment to the qualified intermediary of the proceeds of said sale.

These documents set forth the circumstances under which the qualified intermediary can disburse the funds

and under which the seller (taxpayer) can receive funds. Documents provide the security the seller needs while structuring the exchange within the safe harbor of the regulations. It is critical that all agreements limit the seller's right to receive, pledge, borrow or otherwise obtain the benefits of any funds held by the qualified intermediary through the escrow holder.

Only under very limited circumstances may the seller receive the funds, and those are specifically set forth in the regulations until the exchange is completed.

At or before closing of its sale, the seller must notify the buyer in writing of the taxpayer's intent to complete a like-kind exchange.

The seller then transfers the property, now called the relinquished property, to the buyer using direct title transfer—and the proceeds are deposited with the qualified intermediary. (It is not necessary for the intermediary to be in the chain of title.)

Within 45 days after the transfer of the property, the seller must specifically identify possible replacement property and then negotiates to purchase replacement property or properties with a seller. When a purchase-and-sale agreement is executed, the qualified intermediary is assigned into the agreement, and the intermediary uses the exchange funds to pay for the purchase at closing. The title is transferred directly to the taxpayer.

All purchases of replacement property must occur within 180 days of the original sale.

After all identified replacement property has been acquired or the 180-day exchange period has expired, the remaining funds, if any, are returned to the seller (taxpayer) along with any interest earned during the exchange period.

Finally, in preparing the tax return, the seller will report the exchange on IRS Form 8824. If this process is followed and the full proceeds are invested, the seller will not recognize any gain on the sale of property but will have the same tax basis in the new replacement property that he had in the original property, adjusted for any additional money invested.

THE REVERSE EXCHANGE

The reverse exchange arises when the seller (taxpayer) anticipates the sale of a property will occur in the near future, but the acquisition that would match up as a part of an exchange will close first.

The 1031 regulations do not provide for a reversal in the sequence; therefore, creative planners devised various methods for making the transaction fit within the regulations. The basic premise was to use an entity unrelated to the taxpayer to "park" the property until the taxpayer could close the sale and then acquire the parked property through a deferred exchange.

The IRS eventually acknowledged this practice and issued Rev. Proc. 2000-37 to set out a safe harbor. The rules are almost identical to the deferred exchange but with the time periods and identification rules applied to the property to be sold.

In the most common structure, the qualified intermediary forms a special-purpose entity, called an accommodator, for the ownership of the property to be acquired, called the replacement property. The accommodator steps in or replaces the seller (taxpayer) and actually buys the replacement property and holds legal title until the appropriate time.

Generally, the taxpayer arranges for the financing of the purchase with funds from a third party or loans funds directly to the accommodator, secured by the replacement property.

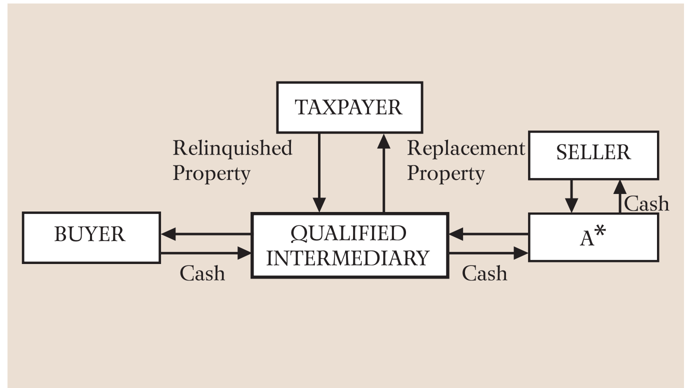

*Diagram of a Reverse Exchange (*accommodator)*

The seller and accommodator enter into an exchange accommodation agreement. This gives the seller the option to purchase the replacement property from the accommodator, and the accommodator has the right to put the replacement property to the taxpayer at a specified time in the future, no more than 180 days from the date the accommodator takes title to the replacement property.

Once the taxpayer sells its property, called the relinquished property in a typical deferred like-kind exchange, the replacement property is purchased from the accommodator.

The reverse like-kind exchange is more complicated because the accommodator actually owns legal title to the property during the holding period.

The taxpayer usually will enter into a management agreement with the accommodator allowing the taxpayer to manage the property during the interim. This is especially important to taxpayers in the oil and gas industry because operated working interests require a great deal of supervision by the owner and can involve significant expenditures to properly develop the property.

Most taxpayers are unwilling to relinquish this responsibility to a third party, and in most every instance, it is impractical to do so. Things like consents

to assign, preferential rights to purchase, joint operating agreements and joint interest billings must be taken into account in the process and must be addressed in advance of closing.

Because of these unique issues, an oil and gas transaction must involve enough dollars to justify the added transaction costs associated with a reverse exchange.

FINDING THE RIGHT PROPERTY

One of the common problems with like-kind exchanges, particularly in the oil and gas industry, is finding an appropriate property to acquire within the time period allowed. Dale A. Brown, president of Petroleum Strategies Inc., a qualified intermediary based in Midland, Texas, has dealt with more than $6 billion in like-kind exchange transactions during the past 15 years. He says clients struggle with the problem of finding and closing on good oil and gas properties within the 180-day timeframe.

"On average, our clients have only been able to close on just a little over half of the dollars they have placed with us as a part of an exchange," says Brown. "This is a competitive market, and good properties have multiple parties vying to be the high bidder. A potential buyer can spend a great deal of time and effort evaluating a set of properties only to be outbid." Given the limitations on the identification of potential properties within 45 days of closing, many taxpayers see the properties they identified sell to other buyers.

To confront this problem, many oil and gas companies are taking a more strategic approach to incorporating like-kind exchange transactions into their A&D planning. These companies are tasking one individual in their A&D organization to look for potential matches for deferred like-kind exchanges. That person reviews every sale or purchase across an owner's asset base prior to closing to see if a like-kind exchange is possible. The smart company will routinely put like-kind exchange language into every purchase-and-sale contract and then look at every division of the company for an acquisition that might match up.

Many of Petroleum Strategies' clients have found it is much easier to time their sales rather than their acquisitions, so they are looking more often to do reverse like-kind exchanges.

"A forward-thinking client will look at each transaction where it is the successful high bidder and consider whether any potential property sales are on the horizon," Brown says.

The success rate for clients of Petroleum Strategies entering into reverse like-kind exchanges matching a buy with a sale is more than 90%, he adds.

The difference in the success rates makes sense because a seller (taxpayer) has much more control over whether it sells its own properties than whether a third party will sell their property to the taxpayer.

CONCLUSION

Most successful oil and gas companies are constantly evaluating their portfolio of assets to determine their core and non-core areas and making adjustments to the portfolio accordingly. Once those determinations are made, every acquisition that arises should be considered a potential candidate for a reverse exchange.

Both the deferred like-kind exchange and the reverse like-kind exchange ought to be a strategic part of every company's A&D group. The deferred exchange is a much more common and inexpensive method for completing a deal, but the time limits are rigid. On the other hand, the reverse exchange can offer an effective way to manage the exchange process to a successful result. Although it involves the same time periods, the taxpayer has much more control over the process.

The like-kind exchange structure, whether deferred or reverse, offers A&D advisors an effective method for holding the tax consequences at bay. •

Alan J. Brown is an attorney and shareholder with Lynch, Chappell & Alsup PC, a Midland, Texas, law firm. He consults with oil and gas companies on issues related to like-kind exchanges and is a frequent speaker on the topic of 1031 transactions. He can be located at abrown@lcalawfirm.com

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AN UNUSUAL PAIR

Helix Energy's acquisition of Remington Oil and Gas greatly advanced its hybrid strategy of being an offshore service company and producer.

By Gary Clouser, Contributing Editor

Perhaps no merger in 2006 was more intriguing than the one between Houston's Cal Dive International, primarily an offshore service provider, and Remington Oil and Gas Corp., a Dallas independent noted for its Gulf of Mexico assets, in a deal valued at about $1.4 billion.

Cal Dive, which has since renamed itself Helix Energy Solutions Group, subsequently "carved out" and spun off a portion of its Outer Continental Shelf shallow-water contracting business, called Cal Dive, in an IPO of 27% of its interests in the subsidiary, raising about $345 million.

It's been a fascinating 18 months for the parent company, Helix. The shareholders now own a company with the dual strategy of being a marine service company and a producer of oil and gas. Helix and Cal Dive, each based in Houston, now trade on the New York Stock Exchange under the ticker symbols HLX and DVR, respectively.

The transformational merger has vaulted Helix into a new league, increasing its E&P business and moving it into deeper-water prospects than it previously pursued. Its exploration budget for 2007 will be about $100 million versus $65 million in 2006. It plans to drill 16 wells—13 of which are in deep water. That compares with an average of about 20 shallow-water wells in each of the past few years.

Helix's services now include deepwater and shelf construction, robotics, well intervention and abandonment, diving, subsurface services and consulting, platform development and operations, and development of deepwater stranded fields.

The "new" Cal Dive inherited all of Helix's shallow-water marine contracting business, which includes construction and maintenance of offshore production and pipeline infrastructure.

Helix, which still owns nearly three-fourths of Cal Dive, has a market capitalization estimated at $3.17 billion. Cal Dive's market cap is an estimated $1.04 billion.

THE REMINGTON DEAL

Most noteworthy for Helix among all that internal juggling was the acquisition of Remington, which at the end of 2005, had about 280 billion cubic feet equivalent (Bcfe) of proved reserves—but more potential, with 150 identified prospects with risked reserves of over 1,100 Bcfe.

Martin Ferron, CEO of Helix, notes it would take more than $100 million and several years to build a similar prospect pool from the ground up.

The Remington deal closed in July 2006. It doubled Helix's proved reserves and significantly expanded its daily production. Anticipated production in 2007 is about 230 million cubic feet of gas equivalent per day. At the time, Remington was folded into Helix's existing oil and gas division, Energy Resource Technology. Company oil and gas sales increased $53.8 million primarily because of the production added from Remington.

At the time of the deal, Helix chairman Owen Kratz said, "The acquisition of Remington is the next key step in the evolution of the company's unique production-contracting-based business model. Access to both deepwater hydrocarbon prospects and the available means to exploit them, as an operator, should lead to the continuation of our differentiated long-term earnings growth."

The deal provides Helix with a natural "hedge" to market exposure for the services it provides to other energy companies, such as installing subsea pipelines and using remotely operated vehicles for underwater repairs.

"To have less exposure to market risk we need a backlog of internal work of sufficient size," Kratz says. "When demand is high on the open market, we'll go after that, and when demand softens, we'll add internal projects. We are not transitioning Helix into another exploration company. At the same time, we're not overreacting and taking the other course, responding to the current high demand in the service industry."

Analysts said at the time that Helix (then Cal Dive) paid a 22% premium or almost $5 per thousand cubic feet of proved gas reserves. They also said that while the purchase price was high, Remington had sizable drilling prospects that don't figure into that calculation.

Remington, at the time of the sale, was not looking for a buyer. However, when representatives from the buyer made an offer, it was attractive to Remington's officers when benchmarked against the many other mergers and acquisitions occurring in the industry.

The deal appears to be paying off. The first exploratory prospect from the former Remington portfolio was recently completed, and Helix announced in February a deepwater discovery estimated to hold at least 100 Bcfe. Drilling was on its 100%-owned Noonan prospect on Garden Banks Block 506, about 145 miles offshore Galveston in 2,700 feet of water. First production is expected in the second half of 2008.

"We are obviously very pleased to have made a commercial discovery with the first prospect drilled from the deepwater inventory acquired as part of the Remington Oil and Gas transaction last year. This demonstrates the considerable potential value of our deepwater resources, especially since we have over 20 high-quality prospects left to drill," Ferron says. "All of the development work for Noonan will be performed using Helix assets and services, and we estimate this work will generate around $100 million of revenue at market rates."

Helix may sell up to a 50% interest in the Noonan asset to cover development costs and provide cash for possible debt reduction and/or stock repurchase, he adds.

Taking in Remington was not the company's initial plunge into E&P. Even before that, its strategy was a hybrid of marine contracting and oil and gas production, but the purchase expanded its production business and further differentiates Helix from being just about subsea construction or diving services.

"We differentiated ourselves as a service contractor by taking equity interests in some marginal offshore fields," says Kratz. "We started in 1992 with mature reservoirs in

Recent Transformation of Helix Energy and Cal Dive International

ACTION	DATE
Cal Dive International agrees to buys fleet of vessels from Torch Offshore in deal estimated at $92 million	April 7, 2005
Cal Dive International agrees to acquire the diving and shallow water assets of Stolt Offshore (now known as Acergy), operating in Gulf of Mexico and Trinidad in deal estimated at $125 million	April 12, 2005
Cal Dive International announces plans to acquire Remington Oil and Gas	Jan. 23, 2006
Cal Dive announces change of corporate name to Helix Energy Solutions Group Inc.	Feb. 27, 2006
Helix Energy Solutions announces plan to sell a minority stake in its Outer Continental Shelf shallow water contracting business through an IPO, naming it Cal Dive	May 31, 2006
Helix Energy Solutions completes acquisition of Remington Oil and Gas in deal estimated at $1.4 billion	July 18, 2006
Helix Energy Solutions transfers trading listing from Nasdaq to New York Stock Exchange, trading as HLX	July 3, 2006
Martin Ferron, who had been president and chief operating officer, is promoted to chief executive of Helix Energy Solutions. Owen Kratz, former CEO, retains position as board chairman	Oct. 1, 2006
Cal Dive International's first day of trading on NYSE, under ticker symbol DVR. Helix Energy Solutions retains majority ownership.	Dec. 14, 2006
Helix Energy Solutions and Cal Dive International hold separate conference calls with analysts to discuss results of Q4 2006 and give guidance for 2007	Feb. 27, 2007

shallow water and more recently have secured working interests in several deepwater development fields." Remington will help Helix better identify, drill, develop, maintain and finally abandon its own reservoirs with the status of operator.

Why the name Helix?

Says Kratz: "Helix is a spiral, and more interestingly, a double helix is the natural shape that defines the structure of DNA, a basic building block of all of us. The two strands of the double helix are anti-parallel, which means they run in opposite directions. The clear analogy for us is that we regard it as entirely natural for our strategy to have the two strands: energy service and production. These strands have also proven to be counter cyclical."

In a conference call February 27, Ferron said that for Helix, the years 2005-2006 were a period of acquisitions and transition and that the focus for 2007 will be on execution. Helix's revenues for 2006 were $1.36 billion, and excluding the effect of the gain on the Cal Dive IPO, its earnings per share were $2.85. Its projected earnings guidance for 2007 is from $3.02 to $4.37 per share.

The reshaped Cal Dive kept the assets from two acquisitions in 2005. At that time, it acquired the fleet of vessels from Torch Offshore in a deal estimated at $92 million and the diving and shallow-water assets of Stolt Offshore (now known as Acergy) in a deal estimated at $125 million.

Cal Dive remains a marine contractor that provides manned diving, pipeline and pipe burial services. The company has a fleet of 26 vessels, including 23 surface and saturation diving support vessels as well as three shallow water pipelay vessels.

ANALYSTS' REACTION

Joe Agular, analyst with Johnson Rice & Co., says Helix is "definitely now a hybrid, and it had been moving in that direction for some time." The Remington acquisition was a "big step in that direction" that illustrates not only a growing focus on production, but also a shift toward deepwater exploration, rather than development of shallow-water fields.

"That has introduced an exploration risk," Agular says. "If it works and the company leverages its skill sets and discovers deepwater commercial fields, it will look very good."

Including its stake in Cal Dive, Helix's profits in 2006 were split 60% to 40% in favor of marine services versus oil and gas production, but the trend lines are going the opposite direction. Traditionally, the company's profits came 70% or more from marine services.

Agular suggests the sale of 27% of its ownership in Cal Dive, the emerging shallow-water subsidiary, also illustrates Helix is shifting its focus to deepwater rather than the company's historical focus on shallow water.

The name changes, in which a spun-off subsidiary kept the original Cal Dive name, were "admittedly very confusing" at first, Agular says, but the investment community is now familiar with the Helix name, and it makes sense to associate the Cal Dive name with shallow water.

Phil Dodge, an analyst with Stanford Eagle, says, "The production/contractor game plan makes sense due to the cyclical nature of marine contracting and also arguably production itself. Helix intends to employ as much as 30% of marine contracting capacity internally, transferring costs at a 20% discount to market and amortizing back the savings over the lives of the projects. Marine contracting does not appear to have suffered due to competition with customers."

Dodge says the acquisition of Remington was "difficult" and that initial personnel defections disrupted operations. "Combined production of 250 million cubic feet a day proved far too optimistic. The December 2006 quarter was 164 million a day and the guidance for 2007 is 233- to 260 million a day. Recent announcement of a 100-Bcf discovery at Noonan is the first item of good news."

There are investor concerns about the debt level, which can be reduced by further sales of the remaining interest in Cal Dive, but probably at a higher price, Dodge says. The new 2007 earnings guidance for Helix is $3.02 to $4.37 per share, taking out the Cal Dive 27% minority interest, he adds.

In a February research note, Raymond James & Associates Inc. noted that 2006 production levels had not met Helix's expectations, but that the recent Noonan deepwater discovery was encouraging.

Analysts J. Marshall Adkins and James Rollyson said Noonan adds to the many benefits of Helix's business model as to why the Remington acquisition made sense. That project will also result in related marine contracting work that will be derived as a result, the report said. "Contrary to popular belief, Helix does not appear to be abandoning its oilfield service roots," according to the report.

The year "2006 proved to be a disappointing year from a production standpoint, with the early quarters impacted by hurricane-related shut-ins and the latter-half by third-party pipeline and Remington integration issues," the report says. Fourth-quarter production of 15.1 Bcfe was about 0.5 Bcfe, or 3%, below expectations. Still, full-year production of 47.3 Bcfe marked growth of 43%.

Raymond James has a Strong Buy recommendation, saying, "Despite the 4Q06 shortfall and the occasional glitch, the plans appear to be in place for Helix to achieve its goal of at least 25% bottom-line growth over the next three years. This comes after recording nearly 50% growth in 2006."

It looks as though the merger has unlocked value on both the E&P and offshore service sides of the fence. •

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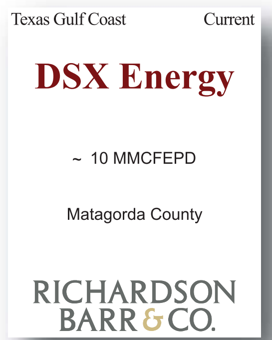

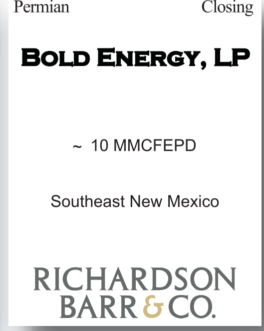

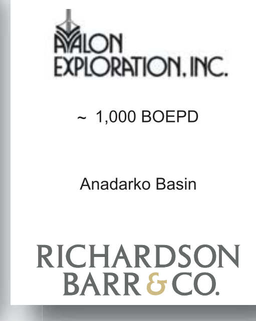

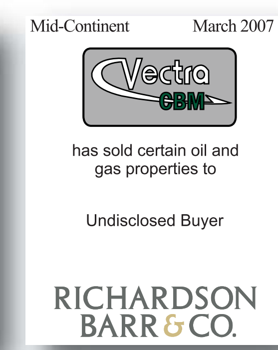

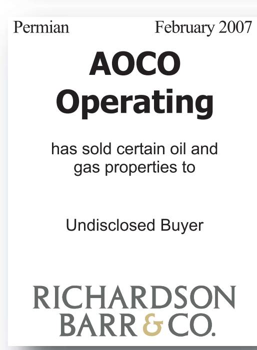

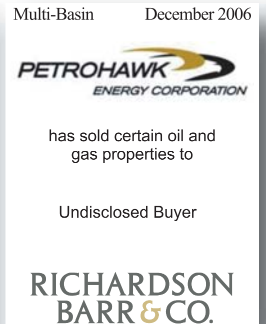

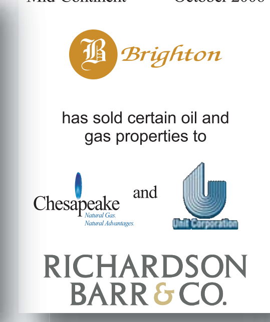

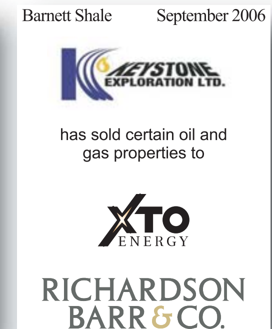

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CAPITAL PROPELS DEAL FLOW

The industry is awash in capital to finance a thriving A&D market, while buyers' and sellers' valuations have gotten closer.

By Gary Clouser, Contributing Editor

Capital providers and A&D advisors agree: the current mix of high commodity prices, low interest rates, a dearth of new discoveries, higher finding costs and a well-capitalized set of buyers will continue to propel robust deal flow in 2007. But it may be hard to top last year's action.

Because of skyrocketing oil and gas prices last year, 2006 set a record in terms of dollars spent on property acquisitions in North America at $28.7 billion, topping the 2005 mark of $23.3 billion.

The record was set in part because of the larger number of transactions in excess of $1 billion, says Sylvia Barnes, managing director of Merrill Lynch Petrie Divestiture Advisors. Four asset sales topped $1 billion in 2005, but there were nine deals of that size or greater in 2006. Merrill Lynch Petrie is based in Houston, with offices in Denver, Calgary, London and six other countries.

Motivation for deal-making hasn't changed. In the ongoing debate between buy versus drill, or organic versus non-organic growth, Tristone Capital reports that for 2006, U.S. asset transactions averaged $3 per thousand cubic feet equivalent (Mcfe), compared with reports that average finding and development costs are nearing $3.50 per Mcfe.

Energy companies continue to achieve competitive advantages by acquiring additional properties in core areas, divesting non-strategic assets and pursuing market opportunities to achieve strategic objectives, says Randy King, managing director and head of Merrill Lynch Petrie.

The number of divestitures and the size of the deals have grown exponentially during the past few years, he says. From 2001 to 2006, the number of "material divestitures" (defined as $10 million or more) increased from 28 to 94, with the average deal size rising from about $126 million to $310 million.

Public E&P mergers reached a high of $80 billion in 2005, but those numbers were skewed by two huge deals: the ConocoPhillips buy of Burlington Resources and Chevron's acquisition of Unocal. By comparison, 2006 was the only other year since 1997 when merger totals topped $20 billion. That was propelled by Anadarko Petroleum's $23-billion acquisitions of Kerr-McGee and Western Gas Resources.

HIGHER DEAL METRICS

The value of reserves in the ground continues to climb. From 1998 through 2006, there has been nearly a 250% increase in the average price paid per proved Mcfe, going from about 80 cents per Mcfe to almost $3.

The increase has been equally significant for another important transaction metric, flowing, or producing Mcfe per day. In 2000, buyers paid an average of just under $3,800 per flowing Mcfe per day compared with just under $12,000 in 2006, King says.

Put another way, the average price paid on a per-barrel basis has increased in the U.S. by almost 50% every year from 2004 through 2006, according to Jefferies Randall & Dewey, a Houston energy investment banking and advisory company.

It jumped from just under $10 per barrel of oil equivalent in 2004 to just over $19 per BOE by 2006, roughly keeping pace with the doubling of the commodity price during that same period, from $30 per barrel in January 2004 to about $62 per barrel in January 2007.

Tristone Capital reports the total dollars spent on U.S. assets rose from about $10 billion in 2004 to more than $24 billion in 2006, with similar proportionate increases in Canada. Maple Leaf deal multiples are expected to decline moderately in 2007, reflecting an increased cost of equity as a result of the government's October 2006 announcement of future taxation of royalty trusts, which had recently been the most active buyers. The Calgary-based global energy advisory firm provides investment banking, acquisition and divestiture as well as capital market services. It also has offices in Houston, London and Buenos Aires.

CAPITAL CHOICES

Plenty of capital is available from many different sources including the banks, mezzanine funds, private equity investors and public markets.

Robust deal flow has been supported by unprecedented levels of capital availability and risk management products, says Greg O'Brien, managing director and head of Merrill Lynch Capital Energy Group. Increasingly sophisticated and long-dated hedging alternatives allow buyers to extract more value, and these enable lenders to finance more in acquisition scenarios.

O'Brien also says access to capital has increased not just at the senior, secured level where ML Capital specializes, but also for unsecured and junior debt, and equity funding.

For example, equity providers who are rewarded not just for return, but also for capital employed, are increasingly motivated to provide funding for start-ups and acquisitions. Likewise, tax-advantaged structures, master limited partnerships (MLPs) and limited liability corporations and equity funds targeting tax-exempt investors are providing lower-cost capital to the upstream sector.

Randy King, managing director & head of Merrill Lynch Petrie Divesture Advisors

Rising asset prices and the size of the deals have not changed the structuring of deals to any great extent, says William Marko, managing director for Jefferies Randall & Dewey. "Most deals are still done for cash, with a few partial stock or all-stock mergers.

"What is different is that because they cannot compete and pay a 'going rate' cash value for non-proven reserves, larger companies are now doing farm-ins with other companies for access to resource plays in areas such as the Barnett and Fayetteville shales, and the Delaware and Piceance basins. These deals are structured as a combination of cash and carried drilling programs with earn-ins for hitting pre-established progress targets."

The M&A market has been driven to a large degree by demand from the financial markets, Marko says. Factors include low interest rates; excess cash on the balance sheet for many E&P companies; high finding and development costs, which tip the scale in favor of the buying properties versus drilling; and the unprecedented large private equity available.

Bill Marko, managing director, Jefferies Randall & Dewey

Equity availability continues to be strong. "The capital may be in the form of private equity, preferred or common issues from public corporations, or from new equity being raised by new or recently formed MLPs," says Rob Bilger, Tristone managing director of acquisition and divestitures.

Traditional bank financing still only considers proved reserves. "The public equity markets have a strong preference for a defined use of proceeds, including acquisitions with a solid base of proved developed reserves, combined with a good inventory of drilling locations to add reserves and production," Bilger says. "However, the private equity providers are now committing substantial backing to management teams that have exploitation and exploration drilling as a primary growth strategy, compared to the historical 'acquire, exploit and divest' strategy."

PRIVATE EQUITY'S ROLE

Indeed, since 2001, private-equity sponsored M&A activity has increased more than five-fold. E&P companies have been generating large amounts of discretionary cash flow, which provides funding to fuel merger and A&D activity.

"Private equity is playing a much larger role in MA&D. The demand to invest funding by private equity continues to bolster deal flow," Marko says. The transactional market has been driven to a large degree by demand from the financial markets, where financial sponsors have earmarked more than $50 billion for the energy industry.

Hedge funds are playing a more meaningful role in M&A dialogue as well. There are more than 500 hedge funds focused on energy with $67 billion of capital dedicated, he says.

Billy Quinn, managing partner of Natural Gas Partners, an Irving, Texas, source of private equity, says that for the past few years, the industry saw a record-setting sellers' market. During the past six to nine months, however, the frothiness has come off the lofty prices paid. But it remains a sellers market, just not to the extent that it had been.

"Tremendous investor demand remains for everything related to the energy industry," Quinn says, although that interest has historically been cyclical, and there is no doubt that we are currently still in an upward slope.

"That's why Natural Gas Partners, while still growing its base business of private equity investing, has also branched out to include funds that provide financing for energy infrastructure projects and energy technology companies in the oil and gas and alternative fuels sectors," Quinn says.

Bilger cites two major trends. "First, the equity providers have been raising much larger funds, which has led them to make larger commitments and investments in previously successful management teams. The top group of equity providers raised $20 billion-plus in 2006.

"Second, MLPs in both the upstream and midstream sectors have been very successful in raising

equity to fund their substantial acquisitions, thus making MLPs some of the most aggressive acquirers."

Bank and equity financing capabilities have increased correspondingly with the higher acquisition transaction multiples.

Says David Vetters, managing director, Tristone Capital: "Banks have increased their price forecasts, thus increasing borrowing bases for their clients. Public and private equity financing capacity has increased as a function of impressive rates of return over the past few years."

GOOD ECONOMICS?

The transaction multiples associated with buying quality properties continue to be strong, "but the economics are still attractive given the relatively low cost of capital and high commodity prices," Bilger says. "In particular, low operating cost, operated properties are always highly sought after that are in proven traditional basins or resource plays, with running room to develop additional reserves and production."

Billy Quinn, managing director, Natural Gas Partners

Sellers continue to be primarily private companies, with the exception of large, strategic divestments such as those of Anadarko and Dominion. Private sellers are driven by high commodity prices and the opportunity to achieve liquidity and capture capital gains tax treatment, while most public companies are focused on growing their production and reserve bases, with limited asset pruning of their non-core properties, Bilger notes.

Just a few months ago, John Walker, chief executive and president of EnerVest Management Partners Inc., a frequent buyer and seller of properties, was cautioning the industry against "irrational exuberance." He said many companies were being bailed out from overpaying for assets by rising commodity prices.

There has been a slight correction in recent months, he says. Although the industry is still awash in capital, it is not quite as easy to get financing now as it was during the 2006 peak. Now that commodity prices have come down a bit, he thinks many investors won't get the minimum 15% return on investment because they relied too much on commodity price and not enough on traditional due diligence.

Walker said Houston-based EnerVest has averaged a 30% return of investment, in part, by not being overly concerned about the snapshot price of the commodity. Instead, the company has hedged extensively and concentrated on due diligence and efficient business operations.

Rules of thumbs can be misleading as the specifics of an individual deal are much more dependent on reserve life, location and upside potential, Walker said.

Changing Landscape of A&D Advisors and Capital Providers

ACTION	DATE
Jefferies & Co. buys Randall & Dewey	February 2005
Morgan Keegan buys Albrecht & Associates from Compass Bank	April 2005
Scotia Capital buys Waterous & Co.	June 2005
FirstEnergy Capital Corp. and SG Corporate & Investment Banking, part of Societe General, announce partnership for energy financing	November 2005
Merrill Lynch buys Petrie Parkman Co.	October 2006
Barclays Capital buys 40% stake in NGP Energy Capital Management	October 2006
Tristone Capital completes a management buyout from its parent company, P2 Energy Solutions (previously known as Petroleum Energy Services, later Tristone Energy Services Inc.), which is a provider of oil and gas information technology and the owner of The Oil & Gas Asset Clearinghouse. Tristone Capital had considered an IPO and merger opportunities before electing to complete the buyout and emerge as an independent company.	January 2007

DEAL PACE

For the past three or four years, ending in 2006, there was an unprecedented scramble on the part of public and private companies to buy production or capture opportunities for exploitation.

There is no escaping the link between commodity price and the price paid for assets, and the level of activity in the A&D market. Marko of Jefferies Randall & Dewey says simply: "High rate of deal flow will continue presuming commodity prices remain in a range of $6.50 to $7.50 per Mcf for gas and $55 to $65 per barrel for oil."

Rob Bilger, managing director of acquisitions and divestitures, Tristone Capital

Quality properties are still in high demand from a well-capitalized acquisition market "hungry for product that is needed to execute the companies' growth strategies," says Bilger.

"Because the demand was greater than the availability of proven reserves, buyers were willing to lock into deals for fields that were less mature in their development. Capital providers still expected the same return on their investment—double digit-plus returns—but they had an increased risk tolerance. Natural gas is the driver," King says.

Expectations of sustained higher oil and gas prices, liquidity and access to capital will support a continued robust asset market in 2007. But by historical standards, King expects a bit slower pace in 2007, at least through the first half.

Commodity prices peaked in 2006 after a run-up caused by hurricane-induced shortages the prior year and global geopolitical tensions. Prices slipped considerably when the 2006-2007 winter was warmer than usual. That has created a bit of a pause, King says, even though large asset sales are expected this year by Anadarko Petroleum and Dominion Resources.

A slower pace, however, will be temporary, King thinks.

"We are in a multi-decade bull market for energy," he says.

He expects big integrated companies, faced with aging fields and limited access to possibly rich new resources in places such as Venezuela and Russia, will eye the smaller North American-based companies as a way to boost their oil and gas reserves.

Change will be the one constant, says Tom Petrie, a vice chairman of Merrill Lynch & Co. "The whole reconfiguring of this industry is going to continue. There is a need to raise new money; the need to figure out logical combinations of companies; the need to create new companies. That's all a part of the picture," he says. •

Each year it gets more and more competitive in the oil and gas business. Good prospects are harder to find and often come with complex title issues, low NRIs, and potential litigation over ownership of working interest, royalties, overrides, or back-ins. If you manage to avoid those hazards, your newly acquired leases might have expired fifteen years ago due to cessation of production or failure to produce in paying quantities. Get past that, and you then might find yourself sued over failure to develop or failure to protect the lease from drainage. You could even get good title only to have your service company lose the hole, turn over a rig, or severely injure an employee on location. You don't need just a lawyer —

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Some Newly Funded E&P Buyers

Company/Headquarters	Contact	Focus	Start-up Funding
Augustus Energy Partners LLC/ Billings, Mont.	Steve Durrett 406-294-5990	Onshore properties in the Rockies, Midcontinent and Gulf Coast regions	$288 million
Broad Oak Energy Inc./ Dallas	David B. Braddock 469-522-7800	Oil and gas leasehold interests in basins between the Texas Gulf Coast, northern Louisiana and New Mexico	$150 million
Canaan Resources LLC/ Oklahoma City	Brent Beebe 405-604-9290	Onshore, domestic long-life gas reserves	$150 million
Celero Energy Co. LP/ Fort Worth, Texas	Jack Hightower 817-708-3800	Oil and gas producing properties and reserves in North America	$1 billion
Celtique Energie Ltd./ London	David Williams +44 (0) 207 868 2290	E&P onshore France, Switzerland and Niger	$50 million
Cobalt International Energy LP/ Houston	Joseph H. Bryant 713-579-9100	Deepwater Gulf of Mexico/ off-shore international areas	$500 million
Compass Resources Corp./ Houston	Douglas Brooks 281-768-5620	Low-risk resource plays and special situations in conventional fields in the Rockies and Texas.	$100 million
Classic Hydrocarbons Inc./Fort Worth, Texas	Rob Jacobs 817-731-4100	Oil and gas opportunities in East Texas and north Louisiana	$30 million
Energy XXI/Houston	John Schiller 713-659-2100	Gulf of Mexico and offshore West Africa	$300 million
EPiC Capital Group Inc./ The Woodlands, Texas	Rex Doyle 281-419-3742	Producing assets in Louisiana, Texas, Oklahoma, the Midcontinent and Rockies	
Milagro Exploration/ Houston	Marshall Munsell 713-307-7000	Oil and gas assets on the onshore Gulf Coast	$11 million
NFR Energy LLC	Gene Isenberg 441-292-1510	Worldwide oil and gas exploitation opportunities	$1 billion
Montierra Minerals & Production LP E&P Co./Houston	Joe Mills 713-907-9267	Oil and gas royalty and mineral interests in North America	$200 million
Phoenix Exploration Co. LP/Houston	William H. Flores 713-756-2400	Exploration and property acquisitions in the Gulf Coast and Gulf of Mexico	$250 million
Sequoia Resources LP/ Houston	Steve Salge 281-405-2650	E&P in the South Texas and Gulf Coast areas	$19 million
Quantum Resources LP/ Denver	Don Wolf 303-573-7011	U.S acquisitions	$1 billion
Talon Oil & Gas LLC/Dallas	Grant Henderson 214-751-2900	To acquire and exploit assets in Texas, Midcontinent, north Louisiana.	$160 million
Vantage Energy LLC/Denver	Roger Biemans 720-228-4191	Unconventional gas resources onshore in North America	$470 million
1270194 Alberta Ltd./ Toronto	Michael Coulter 416-368-3332	Western North America, chiefly in southern Alberta and Wyoming	$500,000

Source: ***Oil and Gas Investor This Week***

TIPS WHEN CONSIDERING A CARVE-OUT

It's still a seller's market, but carve-outs are getting more attention as an alternative to an outright asset sale.

By Tony Bohnert, Partner, KPMG LLP

As the oil and gas industry experiences the forces of technological change, lightning shifts in supply and demand and an ever-changing regulatory environment, companies are increasingly looking to carve-out—sell or spin off—portions of their operations to reposition their business in the marketplace.

According to Thomson Financial, between October 2004 and June 2006 there were 414 announced carve-outs with energy companies accounting for 38 or almost 9%. These numbers are expected to increase in 2007.

Some diversified energy companies have exited their oil and gas exploration and/or midstream business simply by selling assets outright. Others have chosen a different path by spinning these (or a portion thereof) off in a separate IPO as they strive to improve their competitive position and unlock value.

SELL OR CARVE OUT?

Some dispositions aim to increase shareholder value and take advantage of the current abundance of capital—and the increased multiples being paid for oil and gas reserves and midstream assets such as pipelines, storage and terminal facilities. On the other hand, some companies sell their oil and gas assets to free up capital or raise proceeds for planned capacity expansion in their remaining core business.

The form of the disposition depends on a number of factors beyond merely the value of the business or asset. Divesting oil and gas reserves and/or midstream assets in a carve-out through a partial IPO of 20% or less, followed by a spin-off of the balance later, often results in the parent company not incurring the capital gains taxes it could pay in an outright sale or full IPO for cash.

The parent company (seller) could also spin off the business or assets to its existing shareholders in a tax-fee divestiture whereby management maintains short-term control over the carved-out entity but is free to raise additional capital to fund its core business. Any divestiture structure will carefully weigh the potential tax liability to be incurred by the parent or seller.

Other factors revolve around the parent company's long-term objectives. If it is seeking to unlock value while positioning the subsidiary for an eventual change in control, then a carve-out IPO or spin-off may be more attractive.

In this environment, the subsidiary will likely have an opportunity to establish itself with investors, customers and competitors in the initial divestiture phase and could benefit the shareholders of the parent who profit from a spin-off or sale of a mature established business in the future.

Alternatively, if a parent company (seller) believes its oil and gas reserves or midstream assets no longer have a strategic fit and the company wants to focus on the core business, then an outright sale may be the preferred form of divestiture.

Recent examples of these types of dispositions include the completed IPO spin-off of some of EnerVest Management Partners Ltd.'s long-life reserves into EV Energy Partners LP and Duke Energy's gas transmission and distribution business into Spectra Energy. Utility holding company Dominion has announced its intent to sell most of the E&P assets of Dominion Resources to focus on its core business of power generation. Finally, Encore Acquisition Co. has said it may spin out certain long-life E&P assets into a yield vehicle as well.

CHANGING MARKET DYNAMICS

The emergence of energy-focused private equity funds and public master limited partnerships has significantly increased the number of bidders for oil and gas reserves and midstream assets.

All companies are looking for synergies that can emerge from acquiring or shedding assets. Some want to shed parts of their business that don't directly support their new strategies, which may be pure plays in electricity, gas or oil, or concentrations on pipelines and storage operations. Also, differences in how the

market recognizes shareholder value, for example, earnings performance versus cash-flow generation, can result in large discrepancies in a conglomerate compared with disparate standalone businesses.

The way in which most diversified energy companies have been built, operated and monitored in the past does not always align with the value proposition that can be unlocked today. That's why carve-outs and other separation transactions, from major divestitures to minor asset disposals, are a growing trend in diversified energy companies and other industries worldwide.

While acquisitions often generate headlines, divestitures and disposals can be equally important when it comes to potentially creating or destroying value, and wreaking havoc within an organization's culture and workforce, customer base and competitive position.

Few diversified energy companies have the expertise or internal resources to accomplish everything required for a successful carve-out sale or spin off. Factors include preparing financial statements, assessing the tax implications, conducting due diligence from the buyer's or investor's perspective, developing an internal control structure and implementing standalone corporate governance.

MEASURING SUCCESS

A KPMG survey of corporations and private equity

Top 10 Factors to Think About When Considering A Carve-Out

IDENTIFY THE REAL COSTS

Energy companies are rarely built with the idea of being unraveled. They may have evolved under regulatory rules that focus on rates based on overall costs instead of individual product or service costs. Therefore, identifying revenues, costs, including allocating corporate costs, assets and liabilities, of the part of the business targeted for disposal is a necessary, but complex and time-consuming undertaking.

BE REALISTIC ABOUT HOW LONG IT TAKES

Companies tend to underestimate the time it takes to complete a carve-out transaction, which is typically a range of six to 18 months.

KPMG's recent survey of companies completing divestitures indicated 80% of the transactions took six to 12 months with the remaining 20% taking more than one year to complete. Managers do not anticipate how much effort is necessary, the burdens placed on their internal resources and the additional workload on employees. For example, board approval alone has become a very complex and time-consuming process.

DON'T UNDERESTIMATE THE ORGANIZATIONAL IMPACT

Carving out the parts of the business to be separated disrupts a large part of the organization. It spans virtually every function from corporate development, accounting, tax and legal to finance, operations, information technology, communications and human resources. Resources, assets and people have to be identified as moving with the transaction, remaining with the parent company or redeployed outside the organization. Even a company's systems have to be segregated. The new entity needs to choose new systems before it can be operational.

ASSESS FUNCTIONAL SUPPORT CENTERS

Every functional support center needs to be analyzed. An objective assessment will determine what both entities will need to generate value. Subsequent to the divestiture, the services of these support centers may need to continue for the parent company and the carve-out entity. Determine whether transition service agreements are needed.

These functional support centers typically have the greatest amounts of shared human resources, so management needs to identify and prepare individuals who will be supporting the carved-out business, the retained operations or will be subject to potential reassignment or reduction in force.

It is important to ensure there are no "stranded costs" retained by the former parent as a result of excessive functional costs for the newly sized business.

USE PROJECT MANAGEMENT SKILLS

To keep carve-out projects on track requires clear goals, progress benchmarks and issue identification and resolution. The first thing needed is project management, the administrative oversight of individual tasks such as assembling the audited financial statements for a carve-out. This may require many tasks, coordinating large amounts of data requests, and using various internal and external parties.

firms found only 50% of companies and 75% of PE firms think they maximized value from their last sale.

One merger and acquisitions director said, “The longer a deal takes, the more value we lose…and business risks may get managed differently through the sale process than they would normally.” Others say value leakage was a big issue once the deal was completed. More than two-thirds of sellers say they experienced post-completion issues, especially in the area of warranty and indemnity claims and completion accounts disputes.

In the end, it is clear, at least to the sellers surveyed, whether selling or buying, the greatest advantage goes to the company with the best advance planning and preparation.

For diversified energy companies, maximizing value through carve-outs means managing the burden of increased regulation, greater levels of due diligence and disclosure to the buyer and a massive assessment of the entire business. It also takes effective planning and preparation and, not to be underestimated, patience, time and resources. •

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Second, there is program management, consisting of coordinating the various individual projects within project management to deliver a cohesive work product and achieve the overall project objective. At this level, work streams are coordinated, monitored and jointly managed to ensure interdependencies are known and coordinated, decisions are made jointly with appropriate functional and technical input, and critical path tasks are properly flagged and managed to assure objectives will be met.

This involves the overall separation and sale transaction and every function critical to successful completion.

DETERMINE THE LEGAL AND ACCOUNTING STRUCTURE

As the organization structure of diversified energy companies was not set up with the idea that specific portions of the company would one day be sold, the structure prior to the transaction has to be realigned for the new business. The legal structure for the transaction has to be developed and supported by a host of legal, tax and accounting requirements, which can be enormously complex. A carve-out may or may not qualify as a tax-free transaction under Internal Revenue Code Section 355.

COMMUNICATE, COMMUNICATE

Divesting a business or some assets impacts many people, including employees, vendors, regulators and other constituents. Continuous, effective communication and change management efforts are a priority, even after the transaction is completed, to minimize disruption for the retained business and preserve the value of the business being separated.

CALL THE ACCOUNTANTS IN EARLY

Transactions that involve an equity or debt offering, which most carve-outs do, require specialized knowledge and experience about capital markets and financial advisors, as well as knowledge of unique Generally Accepted Accounting Principles (GAPP) requirements and SEC financial reporting standards and practices for carve-out registration statements. Determine the form of the transaction and get the experts focused on the job as soon as possible.

FOCUS ON MARKET OPPORTUNITIES

Financial results and performance must be reassessed in a way that aligns with current market opportunities. This may lead to the need for building new systems, recasting existing data or creating new ways of analyzing information to meet management, performance measurement, regulatory and GAAP reporting requirements for a transaction.

PROTECT AGAINST VALUE LEAKAGE

Potential buyers, investors and analysts look at operating metrics such as earnings forecasts, free cash flow, standalone cost projections, debt coverage and other measurements that may have been of less importance to the seller.

This information must be protected. If word of the deal gets out, the danger of information arbitrage increases. Understanding the importance of the information given to potential buyers, investors and analysts is critical. It must be presented in a manner that meets their needs. Moreover, selling companies must understand the buyer's strategy as well as the track record and future business case for the carve-out entity as seen from the buyer's or investor's point of view. •

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BUYERS' ROUNDTABLE

Three active acquirers share their views of the market and how A&D fits their growth plans.

By Kelly Gilleland, Contributing Editor

This year is already shaping up to be another roller coaster ride for A&D activities in the exploration and production sector, with headline grabbing divestments by Anadarko Petroleum Corp. and Dominion Resources taking center stage. Numerous public independents of all sizes will be in the market as buyers, sellers or both.

To find out what strategies independents are using to capture value, optimize risks and rewards, and expedite deals, Oil and Gas Investor *asked three active domestic players to share some corporate philosophies and do a little crystal-ball gazing about the coming year.*

Each of our participants closed major deals in 2006 and each is based in Houston: Bruce Vincent, president of Swift Energy Co., which continued to build up its growing core area in south Louisiana last year; Michael C. Linn, chairman, president and chief executive officer of Linn Energy LLC, which quadrupled reserves through several key deals; and Steve Herod, executive vice president, corporate development, Petrohawk Energy Corp., which doubled in size last year after pairing with KCS Energy Corp. in a $1.9-billion merger.

Michael Linn, chairman, president, CEO, Linn Energy LLC

Oil and Gas Investor Now that oil and gas prices have softened a bit, do you see A&D activity picking up this year or moderating?

Michael Linn Although spot prices have come off somewhat from their recent historic highs, the forward strip prices are still historically strong. While we aren't currently in a $75 oil and $15-per-Mcf [thousand cubic feet] gas environment, we have seen continued market support for oil between $55 and $65, and gas between $6.50 and $8.50. So, we believe that longer periods of sustained prices in these ranges will eventually create more deals as buyers and sellers come together with consistent price decks and more reasonable assumptions.

No one knows for sure where prices will go, but we can all get more comfortable with forecasts if we see flat commodity prices around their current levels. I think a lot of potential sellers, who missed their chance to capitalize on historic highs and have been waiting for prices to return to those levels, are starting to reconsider their strategies and value requirements. I also think buyers will continue to refine their acquisition performance targets as prices begin to stabilize.

Bruce Vincent We believe that this year will be very similar to last year. There is already one significant package on the market (the $15-billion sale of Dominion Resources' oil and gas exploration assets onshore and offshore the U.S.) that will help take the mergers and acquisitions market to an aggregate dollar level similar to 2006.

Predictable commodity prices help narrow the bid/ask spreads with regard to acquisitions. Yes, prices are softer at this time, but we still believe we will see considerable price volatility in 2007. This may forestall some acquisition activity early in the year, but we still expect a very active M&A market overall.

Steve Herod We expect 2007 to be very active in the exploration and production sector, particularly in the mid- and large-cap group. Since many companies are having difficulty replacing reserves organically, they will be pressed to make acquisitions in order to achieve their objectives. Although acquisition prices seem high, they are still favorable when compared with the forward price curve and look very attractive when compared with many companies' organic finding and development costs.

On the divestment side, we think this will be a busy year as private-equity backed companies continue to monetize and as the large caps sell off properties acquired in major transactions. As always, it will be a very competitive market with potential buyers outnumbering sellers.

Investor Do you favor making small bolt-on deals, or larger ones, this year?

Vincent We expect it to be a busy year reviewing opportunities. In 2006, Swift had one significant new property acquisition and two bolt-ons. These deals were funded

through our internally generated cash flows and bank debt. We are continually screening opportunities that make strategic sense and where we can lever our technical strengths and add value to the company.

We look for properties that have the characteristics to become a core property for Swift Energy. This will include bolt-on deals in or near our existing properties, or a new property that would provide additional opportunity in new areas. That being said, we feel that we have an internally-generated opportunity set of drilling activity that will help to drive growth in the near term.

Herod At Petrohawk, we are always looking for opportunities to add quality properties to our asset base, but our approach is very disciplined. Our focus is on operated gas properties concentrated in our core areas that we feel have significant drilling upside.

A key question we ask ourselves is: Will this property enhance our overall property set? We've worked very hard over the past two years to assemble a high quality property portfolio, and we won't make a deal unless we feel it will make our company better.

Linn We're always looking at bolt-on opportunities within our core areas. We talk to potential sellers of both small and large properties and choose strategic deals that make sense with our existing operations in these regions. We've added experienced operators to our management team to help us execute our A&D strategy. In addition, we've demonstrated a willingness to step out from our existing core areas and will continue to selectively consider larger acquisitions in new basins.

Investor How important is A&D—where does it fit in as a percentage of the whole?

Linn Our business is focused on development and acquisitions of long-lived properties to deliver stability and growth in distributions to our unitholders. Linn Energy has an active drilling and development program to replace reserves and maintain production, but acquisitions are the main driving force of our growth.

Investor Why did you choose the publicly traded limited liability company for your corporate structure?

Linn Because we believe it provides the most competitive cost of capital to allow us to pursue our business plan. When we completed our IPO in January 2006, we were an Appalachian Basin natural gas company, but we knew we would be targeting acquisitions in basins throughout the country for our long-term growth. We were very active in the marketplace in 2006, and today we have added significant operations across the United States in Texas, California and Oklahoma. Natural gas accounts for about half our product mix, with oil and NGLs [natural gas liquids] comprising the other half. We will evaluate oil and gas deals within these and other areas as we continue our consolidation strategy.

Investor Steve, describe how A&D shapes Petrohawk.

Herod Acquisitions and divestitures are a key part of our strategy. Petrohawk has grown from zero to about 1.1 Tcfe [trillion cubic feet equivalent] of proved reserves in less than three years. We've done that via acquisitions, coupled with an aggressive drilling program on the properties we've bought. Divestments are also a big part of what we do—we've sold several thousand wells that were non-core to us for excellent prices. Through this process, we have tightened our property base, lowered our unit operating costs and made our company easier to manage.

Investor Bruce, what about Swift?

Vincent Our corporate strategy uses a tandem approach of drilling and acquisitions. Three basic traits we look for in our acquisitions include areas that have exploitation with exploration upside, have multiple horizons, and have an opportunity set of acreage and geologic targets to repeat our successes again and again. Because of these traits, we have mainly focused our efforts on Louisiana and Texas. This strategy has proven to be very valuable to us.

Bruce Vincent, president, Swift Energy Co.

Over our 27-year history, we have tended to drill for reserves when commodity prices are up and acquire when the market turns down. However, we have been very effective since 1995 to move with the compressed price cycles and make timely strategic acquisitions. In 2006, just over 50% of our reserve additions came from acquisitions.

Investor Mike, describe Linn's latest deal and what it did for your company.

Linn The Stallion Energy deal in February 2007 was our largest acquisition to date for over $400 million. It added a new core area in the Texas Panhandle and significantly added to our production, reserve base and development inventory. We picked up 820 producing wells and 55 million BOE [barrels of oil equivalent] in proved reserves. In addition, we picked up considerable NGL volumes, which we hedged with crude oil puts at $65 per barrel.

Also, around the time of the acquisition, we announced Mark Ellis had joined our senior management team as executive vice president and chief operating officer. Mark came to us from ConocoPhillips, where he was president of E&P for the Lower 48, and before that Burlington Resources. (We have also recently added other experienced operators to our management team to help integrate and run our newly acquired and existing assets across the country.)

Larger acquisitions like Stallion are important to us as they allow us to diversify our operations, grow quickly and attract high-caliber talent to help us execute our business plan.

Buyer Profiles

Swift Energy Co. focuses on the U.S. onshore and inland waters of the Gulf Coast as well as in New Zealand's onshore Taranaki Basin. Last year it acquired property from BP America Production Co. for $157.3 million in five primarily onshore south Louisiana fields. More recently it announced another $20.4-million purchase of wells and acreage in its largest field, Lake Washington in Plaquemines Parish.

During the past five years, the company has achieved an average compounded growth rate in proved oil and gas reserves of about 5% per year. Swift's goals for the next five years are to increase its proved oil and gas reserves at an average annual rate of 5% to 10%.

Swift sold minority interests in a gas processing plant and infrastructure that served its fields in Texas and Louisiana for $20.3 million last year.

Linn Energy LLC went public in January 2006 and since then has grown its proved reserves from 193 billion cubic feet equivalent (Bcfe) at year-end 2005 to more than 800 Bcfe at December 2006. Since its IPO, Linn's market cap has increased from about $580 million to more than $1.8 billion.

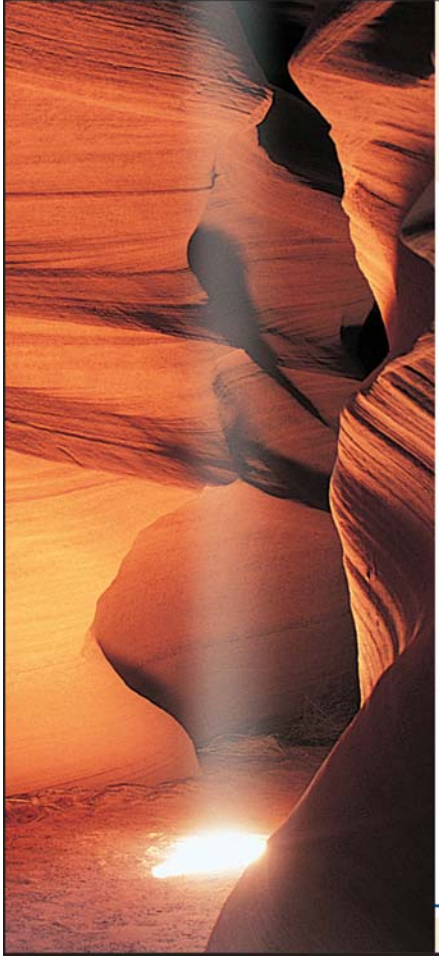
Linn accomplished its considerable growth by a combination of drilling and a series of deals in four regions across the U.S. totaling nearly $1 billion. Now it operates in the Appalachian Basin, the Texas Panhandle, Los Angeles Basin and the Sooner Trend in Oklahoma. Linn intends to continue to build positions in its core areas as it evaluates additional opportunities to enter new basins.

Petrohawk Energy Corp.'s core operating areas are the Midcontinent, Gulf Coast and Permian Basin, with proved reserves of more than 1 trillion cubic feet equivalent. Its strategy follows a pattern of A&D activities emphasizing natural gas reserves in concentrated geographic areas, continual high-grading of its property base through divestment of non-core properties and the use of the latest technologies for high-impact exploration.

Petrohawk's biggest coup to date has been its purchase of KCS Energy last year. The $1.9-billion merger formed one of the country's leading onshore independents, now with an enterprise value of more than $3.3 billion. Previously, Petrohawk grew primarily through A&D activities, while KCS's growth came from its success in exploration and development. The combination of the two creates substantial upside potential within the combined portfolio.

Also last year, Petrohawk sold several non-core properties, including all of its Gulf of Mexico assets, for $52.5 million, and late in the year sold assets in Wyoming, Michigan and California totaling about $135 million.

The company also closed several strategic smaller deals, including $262 million of gas properties onshore northern Louisiana. •



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Investor Steve, your $1.9-billion KCS deal doubled the size of the company, right?

Herod Yes. KCS was a perfect overlay of properties with our existing assets and created a company with excellent growth opportunities through a large development drilling inventory, combined with a technology-driven exploration program.

But we had an outstanding 2006 with the drillbit, too—over 400% reserve replacement with finding and development costs of $1.65 per Mcfe. KCS fit all of the criteria we look for in an acquisition, and so far it has worked out better than we expected.

Investor Swift keeps adding to its south Louisiana position.

Vincent In the fourth quarter of 2006, we had three deals. The most significant was the acquisition of five fields in south Louisiana from BP America. They are close to our existing fields in the area and complement our strategy very well. The acquisition was facilitated through our large regional data set, which we believe was the competitive differentiator in this transaction.

This deal helps add diversity to our south Louisiana region and substantially increases our portfolio of opportunity. We have been adding properties that act as anchor assets in this region, giving us infrastructure and access to deeper resources across the prolific south Louisiana region. We expect that Swift Energy can grow the reserves and production from this acquisition significantly over the next several years.

Steve Herod, executive VP of corporate development, Petrohawk Energy Corp.

Investor What price deck are you using for 2007, and will you hedge your deals to improve the economics?

Linn We anticipate oil to be $50 to $65 and gas to be $6 to $8.25. Hedging is a significant part of our business strategy, since we pay out a large percentage of our cash flow in the form of distributions to our unitholders.

In January 2007, we announced we had expanded our hedging portfolio to include fixed price swaps and puts covering a significant portion of our anticipated oil and gas production for five years, through 2011. And, we entered into crude oil puts to hedge NGL revenues associated with our Stallion asset. We believe that a disciplined and transparent hedging policy benefits our unitholders. It allows us to lock in acquisition margins to help maintain stability and predictability of our revenue streams.

Herod As do most companies, we run several price cases when evaluating acquisitions. We'll run flat cases at various prices as well as a three-year strip price scenario. At Petrohawk, hedging is an important part of our business plan. When we make acquisitions, we'll typically hedge 50% to 60% of expected production for the first two or three years.

Vincent We use multiple price decks to review deals, including below-market-price sensitivity, expected base-case economics, and utilizing the current strip to understand the commodity price effect on the near-term economics of the deal and determine its value to Swift Energy.

The recent deals we've completed have largely been funded through cash flow and bank debt, and we have chosen to not use hedging to lock in the base economics. If we were to undertake a larger deal that included substantial proved producing properties, we might consider using hedging strategies as a part of the acquisition.

Investor What is your preferred method for funding A&D deals at the moment? Why?

Vincent We would love to fund all of our deals from cash flow, but that is not realistic. We have a significant opportunity set that we have developed at Swift Energy that is competing for capital, so it is our job to steward those funds to deliver economic growth in the form of our reserves and production.

Depending on the size of the deal, we would turn to cash flow first and then look for the appropriate mix of equity and debt to maintain our balance sheet. Today, we have an extremely strong balance sheet and bank facility that gives us plenty of flexibility in the deals we review and our funding mechanisms that we would employ.

Linn In December 2006, we announced that we had fully funded our Stallion acquisition through a combination of private equity and bank debt. We raised nearly $1 billion of equity, including our IPO, in 2006 and have received a high level of support from the private equity community. We have found that private equity concurrent with closing our acquisitions provides the most flexibility from a timing and execution standpoint, in addition to the most compelling acquisition economics.

Herod Conventional bank debt is our first choice for financing transactions. While interest rates have risen over the past year, they are still quite low on a historical basis. If you think about interest rates in relation to product prices, the opportunity versus cost in our business has never been better.

Petrohawk has significant unused capacity under our credit facility with BNP Paribas, and we feel that having plenty of "dry powder" gives us an advantage in the market.

For a very large transaction, we would also access the equity market in order to keep our balance sheet strong. Maintaining financial flexibility is a fundamental part of our overall business plan. •

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