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The full potential of the Gulf of Mexico remains unharnessed.

MEZZANINE MOJO

Middle-market financings are becoming a suitable match for smaller producers that want capital access and overall growth—without giving up a large chunk of their success.

ARTICLE BY
BERTIE TAYLOR

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1616 S. Voss Rd.
Suite 1000
Houston, TX 77057
(713) 993-9320

As oil and gas executives consider the different paths for financing drillbit strategies and acquisition plans, mezzanine funding is still a stylish pick for smaller companies with veteran management teams, meticulous execution plans and assets in well-established plays.

Though surging commodity prices and healthy investor interest in oil and gas have made it easier for most E&P companies to access the capital markets, these doors have not flown wide open for smaller members of the pack. A smaller market cap, limited asset base and shorter production track record can make it difficult for these companies to claim success in the public-equity markets.

Alternatively, private equity can come with a hefty price tag. Mezzanine financing—in some ways, a hybrid of debt and equity financing—is an appealing middle ground for small to midsize companies that pass the basic litmus tests for quality management and assets.

Mezzanine financing is debt that's often subordinated to debt from banks or other commercial-finance sources. It usually consists of a secured loan with a coupon return plus an overriding royalty interest and/or warrants. To provide an adequate return to the lenders and operators, a project typically needs to have a total projected return rate that starts in the low to mid-teens.

In the producers' favor, the funding can be provided quickly, with liens against fewer assets than a commercial bank would require, and the transaction doesn't have the same dilution as an equity raise. Whether it's for buying new assets or accelerating exploration on existing ones, more midsize E&P companies are finding that mezzanine money fits the bill.

Three Houston-based lenders that are helping smaller producers grow with mezzanine funding are Houston-based NGP Capital Resources Co., Petrobridge Investment Management LLC and newly formed Post Oak Energy Capital.

Room for growth

NGP Capital Resources Co. is a publicly traded firm that invests predominately in small and midsize energy companies with a focus on domestic exploitation, development and production projects. To date, the firm has about \$239 million in committed and available funds for its 15 portfolio companies.

While the company has been in the mezza-

nine business for about two years, John Homier, president and chief executive, has been doing mezzanine deals in the upstream space for almost 15. "Most of what we do are loans secured with a first or second lien, depending on whether a senior lender is involved. Generally, our compensation is a coupon and an equity kicker. We have several individuals in the firm who have long, broad histories with mezzanine deals in the upstream energy space."

Homier says the general profile of the upstream companies seeking mezzanine money hasn't changed, though funding needs have grown because of increasing property valuations.

In late 2006, NGP Capital closed a \$12-million reserve-based debt facility for Dallas-based producer Sonoran Energy Inc. to accelerate development of its oil and gas assets. The OTC Bulletin Board-listed company had immediate access to \$7 million, with an additional \$5 million available as more reserves are proven up.

The firm also agented and closed an \$85-million senior secured credit facility and a \$10-million senior subordinated secured convertible term loan with privately held, Houston-based Resaca Exploitation LP in May of that same year. Initial availability under the facility was \$76 million. NGP Capital's portion of the initial funding was \$24.6 million under the facility and \$4 million under the term loan. Proceeds were used to acquire and develop oil and gas assets in West Texas and New Mexico.

In 2004, NGP Capital also provided California-based producer Crescent Resources LLC with \$47.2 million of senior subordinated debt and a \$10.6-million bridge loan to finance an asset acquisition.

"In all of these, the senior debt capacity of our client companies was less than what they needed. That's why they fit well with mezzanine financing. When properly employed, it gives management an opportunity to achieve their goals and lets them stick to a development schedule, without the dilution of an incremental equity raise."

Of the senior bank debt, equity and mezzanine options available to smaller oil and gas companies, mezzanine is often more attractive than bank debt because it gives producers more funds against the same assets, Homier says. NGP Capital can often lend 100% more than bank debt, or higher, on an excellent set of development projects.

"It's also often more attractive than equity



If a company believes in its projects and their potential, it will do them with debt every time, says John Homier, president and chief executive of Houston-based NGP Capital Resources Co.

because of the limited dilution. But, in exchange for that benefit, the company takes on the more stringent structure of a debt financing. Our proposition to management of a company is, if they truly believe in their projects and their potential, they will do them with debt every time.”

However, mezzanine finance isn't something that can displace equity in situations for start-up financings or exploration drilling. “It is best in situations where a company has assets under its belt or it's about to acquire those assets. They should be engineering- and development-oriented and it's always a plus to have an initial base of production.”

Since mezzanine financings can be asset-development-intense, the firm looks for management teams that can control the pace of development and operations for the project being funded. “This often means they wind up being the operator. For the assets, we look at reserves development and engineering plays.”

During the past 12 months, NGP Capital grew its target investment portfolio from \$93 million outstanding to \$202 million, with a commensurate increase in overall commitments from \$98 million to \$239 million.

“We looked at more than 130 potential transactions throughout 2006, with the potential combined value of more than \$2 billion. That's not too unusual, since we're in a 3% business; you often have to look at 30 deals to do just one.”

Drillbit transactions in the mezzanine space have been on the rise during the past few years, thanks in part to high commodity prices that encourage owners to hold onto marginal assets.

“High prices have caused a migration of mezzanine finance from something that was primarily acquisition-focused to something that's more balanced between those transactions and development drilling. This year, we may see movement back toward acquisitions because prices have softened from their historic highs. But the prices are still high enough to make development-drilling deals economic, even with today's drilling costs.”

Homier says the mezzanine-finance business has not been diluted by new entrants. Most of the new capital available for oil and gas financings is going to transactions that are more equity-like, or to transactions that are \$100 million or larger, or outside of the firm's \$10- to \$15-million mezzanine scope, he adds.

“There's much variability in the way mezzanine financings can be viewed and structured. We're happy to have a return range anywhere from 10% to the low 20s. As long as our return supports the risk, we're comfortable operating anywhere in that band. There are other financing sources that have minimum rates of return in the high teens, so they can't compete with us on the lower-risk transactions. All of the mezz providers can have their space.”

Homier expects flattening commodity-price expectations to stimulate even more activity

within the mezzanine arena this year.

Building value

Rob Lindermanis formed Petrobridge Investment Management LLC with partner Mike Keener in 2003 and has raised approximately \$1 billion for E&P investments. The firm lends capital in the form of stretch senior secured debt, subordinated debt, mezzanine debt and production payments. Of the 12 companies in its portfolio today, 11 are upstream and all involve mezzanine financings.

2006 was one of the firm's biggest years in terms of capital deployed. It issued about \$234 million in capital and had completed seven new deals by year-end. The firm prefers to get involved during a project's early stages, and it provides capital in line with performance, so deals are typically not one-time transactions.

Since inception, the firm's average repayment timeline has been 12 to 24 months for anywhere from \$4- to \$70 million. Lindermanis expects this to stretch into 18 to 36 months.

“When I talk to many of my peers, all of them would like to put out more money, and there is still a large appetite for mezzanine capital today. Oil and gas is a capital-intensive business, but companies today have a better understanding of the capital markets and the process of selecting capital that suits their needs.”

In 2006, Petrobridge completed a refinancing for a Houston-based producer to help it accelerate a drilling program for assets in the Barnett Shale. The firm recently closed another financing for a Midland, Texas-based producer that has a West Texas drilling program. It also closed a financing with a private, Dallas-based producer for development of an East Texas drilling program that targets Cotton Valley gas.

“The West Texas program is unique because even though it's structured as debt, I'd call it project equity. It's a new structure that we came up with 18 months ago that allows us to get involved much earlier than usual, but still use our existing structure to support drilling programs.”

Lindermanis says all of the transactions were a nice fit for mezzanine financing because they were backed by strong management teams with good assets and a plan the firm could support. Most of the companies Petrobridge works with are led by management teams it knows.

“They needed the advances and flexibility that we could provide. We look at the assets really hard, since that's a key part of the component that's important to us. Certain plays have reputations that speak for themselves.”

Petrobridge has a wide fairway with respect to the way it prices deals. “But some components are standard: we're always senior secured; we have a coupon, and there's equity participation. Our returns tend to be around 15%-plus, but it really depends on where we think we are in the risk spectrum.”

Though most of the firm's financings have



Rob Lindermanis, co-founder of Houston-based Petrobridge Investment Management LLC, says that, despite the influx of new energy mezzanine players, the core group is still made up of veterans.

been drillbit transactions, Lindermanis says his efforts have “been more to feed the acquisition appetite rather than support it. Half the companies have decided to sell and half have recapitalized and moved forward with a longer-term business plan. But the drillbit is where we’ve spent most of our time.”

While mezzanine transactions are growing in popularity with producers, it’s not the right option for all of them.

“The primary driver for mezzanine at the end of the day is how much ownership a team wants to retain in their entity. Based on the last few years, the best uses for mezzanine are in large, statistical drilling programs, to enhance the exploitation of existing assets, and for acquisitions, recapitalization and monetization.”

Mezzanine money is a strong supporter of the build-it-up-then-sell-it strategy. “It can get good returns for the capital providers while building value for the management and ownership of these companies. Most of these guys aren’t trying to build kingdoms. They’re in this industry to build value.”

Expanding the universe

Post Oak Energy Capital was formed in late 2006 to pursue direct-equity and equity-related debt investments in companies and projects across the energy spectrum.

Managing directors are Clint S. Wetmore, Frost W. Cochran, Robert H. Walls Jr. and Philip A. Davidson. Ryan Mathews recently joined the firm as vice president. Wetmore was with Royal Dutch Shell’s global M&A group; Cochran was chief executive of Appalachian E&P company Belden & Blake; Walls was a member of Enron’s post-bankruptcy office of the chief executive and general counsel; Davidson was a managing director of Rice, Sangalis, Toole and Wilson (formerly Rice Capital, a private-equity firm); and Mathews was an energy lawyer with Thompson and Knight.

Post Oak isn’t the first financier to go from offering strictly equity to some form of debt. Why include mezzanine as an additional financing option now?

“It’s a nice playground if you’re interested in energy investing, where you’re not taking true open-equity risk but you can earn a better return than what commercial banks are squeaking out,” Cochran says.

“We are active in and prefer equity investments, but we’ve found that many customers are seeking a combination of mezzanine and equity or interim equity and then mezz, or interim mezz then equity. Just being an equity guy can really limit your financing universe. You can do mezz these days without doing equity, but it’s getting harder to be an equity guy and not look at doing mezzanine deals.”

To date, the firm has completed three equity deals and is actively reviewing several mezzanine-financing proposals.

One is for an unconventional exploration project for a private company. The total pro-

posed facility is \$100 million. Cochran says, “It’s a bit of a tougher mezzanine deal than what most folks in the business would look at, because it’s primarily an exploration company, and the loan relative to the value of the proved reserves is a real stretch.”

Although the deal involves assets that are largely unproved, the surrounding acreage is well established, Cochran says.

“The deal would probably price in the range of Libor plus 650 to 850 or so. It’s designed to be a fairly flexible facility. It would have an expected payoff in the four to four-and-a-half-year range.”

The firm is also evaluating a financing for an E&P company with existing proved reserves. “The deal will price a little tighter, close to Libor plus 650. It’s likely to have warrants attached instead of a fee, but a similar payoff period for amortization.”

Commodity prices began softening during the summer of 2006, which pushed out some of the fast money, Cochran says. “It brought a little more discipline back to the market for debt and equity, but it didn’t scare off enough people to create a cash shortage. The sophisticated money that focuses on structure, hedging and marrying the debt terms closely to the asset base stayed.

“I’ll be shocked if we don’t see additional mezz players going forward, as there’s still room in the space for folks with experience in structured finance to make it worth the effort.”

Post Oak favors producing deals but still considers pure drilling plays. “The drillbit side is attractive to us, although it’s harder to evaluate and risk appropriately. Incrementally, it’s not much more difficult to structure than a production deal, but it’s harder for some of the more conventional financiers. The science effort required to do a proper risk evaluation is a step beyond hiring a third-party engineering firm to do a quick fly-over and produce a report.”

Wetmore says producers can structure mezzanine in a variety of ways—but they have to be careful not to overlever themselves.

“It’s a matter of relative risk versus the kind of capital that you’re using. If you’re not hedging your commodity-price risk, you can destroy equity value and hurt management’s incentive quickly. Hedged mezz is a great deal, but only if you can structure it right.”

The pair expects the future of mezzanine financings to be largely driven by volatility. A stabilized commodity market this year could set records in terms of the number of closed financings, Wetmore adds.

Cochran says, “There’s nothing that scares the mezz market in any industry more than volatility, since they’re always the lender at the margin being squeezed. It’s not about low or high prices—it’s about the volatility for someone who’s a fixed-margin investor. Being in this business when you’re not used to waiting out cycles is a scary place to be.” □



Post Oak Energy Capital managing directors Clint Wetmore (top) and Frost Cochran expect energy mezzanine financings to be largely driven by volatility.