Energy Finance 101

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

ARTICLE BY T. PRESCOTT KESSEY and WILLIAM E. WEIDNER

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

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

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

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

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

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

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

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

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

The Four Basic Steps

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

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

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

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

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

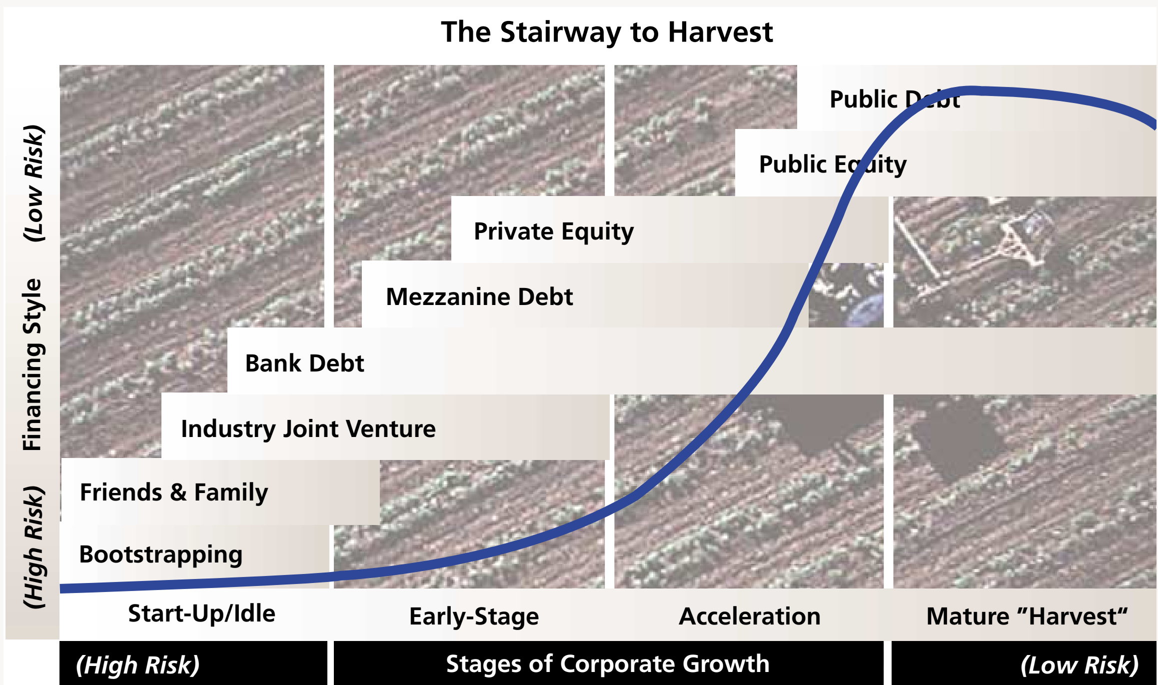
Track record. Everyone has a so-called track record, but very few people have taken the time to

FINANCING STYLES

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

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

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



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

Source: Cosco Capital Management

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

FOUR BASIC STEPS

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