

THE MEZZANINE MALL

Increasingly, more mezzanine-capital providers are pouring into the E&P space to help smaller operators climb the growth curve.

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**Laminar Direct
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Overbergen, a
Laminar director.**

With so many upstream start-ups being spawned these days by seasoned management teams coming out of larger consolidated E&P companies, a growing number of mezzanine-capital providers are popping up all over the oil patch to help these entrepreneurial managements move up the growth curve.

The opportunity these capital providers see: in a world of \$80 oil and \$6 to \$7 gas, once uneconomic oil and gas plays have now become wildly economic for seasoned E&P managements that understand how to enhance discarded niche plays, yet lack the aggressive, but affordable, funding needed to rejuvenate those plays.

Sure, these cycle-tested upstream management teams could tap available bank credit. But the advance ratios traditional lenders offer—mainly tied to proved developed producing (PDP) reserves—just aren't enough to accelerate drilling programs and rapid production growth. On the other hand, the private-equity markets, although wide open, often demand too great a participation in an operator's equity stake.

The middle ground that's thus becoming more attractive to smaller operators is mezzanine money—loans with equity kickers—where the returns being sought by such capital providers generally tend to fall more in the mid- to high teens.

Among the relatively newer players in this niche financing arena are Laminar Direct Capital LP, the West Coast Opportunity Fund LLC and Petrobridge Investment Management LLC.

Deep pockets

The D.E. Shaw group, a New York-based global investment firm with about \$33 billion in aggregate investment capital as of October, first became involved in direct mezzanine and equity investments in the middle-market space in early 2004—with no small part of that asset allocation to the energy sector.

“With the 2001-03 shakeout of so many energy merchant-banking companies, the D.E. Shaw group saw a real opportunity to start a direct investment group—Laminar Direct Capital

LP (LDC)—to fill a void in both the mezzanine and private-equity space, not only for energy companies but across all industries,” explains Todd A. Overbergen, a senior vice president of D.E. Shaw & Co. LP and a director of LDC.

Houston-based Laminar Direct Capital is a member of the D.E. Shaw group focused on providing direct debt and equity capital to businesses across all industry sectors globally.

Since inception, within the energy sector, it has invested more than \$675 million in 31 companies in the E&P and oil-service industries—72% of that amount in the form of debt, mainly mezzanine; the balance, in equity.

Today, LDC has more than \$2.5 billion in assets under management, about 30% of that focused on energy overall, including the midstream and alternative sources of supply. “However, the majority of our energy investments are focused on E&P and service companies,” says Overbergen.

Although its energy deal flow has ranged anywhere from \$5- to \$250 million, its sweet spot for investment tends to be in the \$20- to \$70-million range. The structure of those deals? “It's really quite flexible,” says Overbergen, a former Duke Capital executive. “We'll look at stretch senior-type loans, something more aggressive than a commercial bank would do.

“We'll also look at the mezzanine market, which includes second-lien loans, loans with equity kickers, and unsecured debt including bridge loans; in addition, we'll look at pure equity, which could be in the form of preferred-equity investments or just investing in the common stock of a company.”

A traditional form of mezzanine financing is the \$50-million deal LDC completed in the spring of 2006 for Bonanza Creek Energy Op-



erating Co. LLC, a private Bakersfield, California-based operator.

"The company was very focused on moving quickly on acquisitions with proven reserves onshore California and in the Rockies—which had development upside and value in production—plus it was looking to recapitalize debt on more favorable terms," says Overbergen. "This fit very well with the hybrid debt/equity structure we wanted to put into Bonanza since proven reserves can be financed with debt."

The deal ultimately took the form of a subordinated-debt component with a current-pay coupon and equity in the form of warrants. Says the mezzanine provider, "By being able to stretch the debt part of the financing—applying aggressive advance ratios—we were able to save Bonanza equity for its owners and management. Had they taken this deal out to the private-equity market, they probably would have needed to give up a lot more equity to raise that \$50 million."

More recently, the financial giant raised Bonanza's mezzanine facility beyond the \$50-million mark so the operator could move ahead on a current acquisition opportunity. Says Overbergen, "We're interested in building relationships that will lead to multiple opportunities with the same management team." (For more on Bonanza Creek, see "Southern California," *Oil and Gas Investor*, September 2007.)

This past August, Laminar Direct Capital was also the lead investor in a \$50-million, second-lien loan to Aurora Oil & Gas Corp. (Amex: AOG), a Traverse City, Michigan-based operator looking to refinance debt so that it could more aggressively develop its Antrim shale assets in Michigan and pursue New Albany shale opportunities in Illinois.

"While this was a coupon-only transaction and hence, different than a traditional mezzanine deal, it was nonetheless on the higher end of the risk spectrum than a conventional loan since we were in second position behind the senior bank," says Overbergen.

And indeed, the pricing on the second-lien financing reflected this risk, even though the capital provider would have been ahead of any unsecured creditors.

The cost of second-lien financing today? The LDC executive points out that while a typical first-lien, senior-bank loan might be priced anywhere from Libor plus 200 to 400 basis points, a second-lien deal—depending on how much debt is involved and how leveraged a company is—could range anywhere from Libor plus 600 to as high as Libor plus 1,100 basis points.

The outlook for mezzanine deal flow in 2008? "With the recent shakeup in the credit markets, mezzanine-type-risk opportunities that in early 2007 were being syndicated on Wall Street at very low pricing have slowed, and we're now starting to see intermediaries and E&P companies coming back to traditional pri-

vate-capital providers to underwrite more traditional mezzanine transactions," says Overbergen.

"Also, we foresee a high level of deal activity being driven by bullish views on long-term natural gas prices and the near-term oil-price environment—so that should also help provide a nice pipeline of opportunities for both mezzanine and private-equity capital."

Bullish outlook

A money-management firm with assets under management today of about \$500 million, Ventura, California-based West Coast Asset Management Inc. decided in early 2006 to take advantage of mezzanine-oriented financings within the energy space. The reason: the risk/reward ratio was compelling.

The result: West Coast Opportunity Fund LLC, a then-\$35-million mezzanine-oriented fund focused on a variety of industries. Today, that fund is approaching \$100 million, with 75% if its assets invested in the energy sector.

"Simply due to supply and demand fundamentals—we're very bullish on oil prices and are comfortable that natural gas prices will stay much higher than they have historically—a lot of previously economic upstream projects have now become very economic," says Atticus Lowe, chief investment officer and a principal of West Coast Asset Management.

This has created the opportunity for a lot of small producers with proven management teams to complete attractive acquisitions and pursue growth opportunities, he notes.

"We're thus working closely with small producers that are either private or soon to be public and in need of \$5- to \$15 million of capital—a range not efficiently available from the capital markets—to fund those growth opportunities."

Lowe says the firm's mezzanine fund is willing to provide capital in the form of debt or convertible preferred stock, with significant equity kickers in the form of warrants and common stock.

Typically, he says, the coupon on the debt component will range from 5% to 15%—depending on the safety of the investment and an energy client's willingness to compromise on the equity kicker. "Thus, the greater the equity-kicker component, the lower the coupon in the mezzanine transaction and vice versa."

Case in point: Canadian Superior Energy (Toronto, Amex: SNG). Although the Calgary-based producer has significant assets in Western Canada and a good amount of cash flow, the operator in early 2006 still needed a small amount of capital to pursue drilling three very high-impact gas wells offshore Trinidad—the multitrillion-cubic-foot variety.

Enter West Coast Opportunity Fund. In February 2006, the fund proposed to Canadian Superior a \$15-million convertible preferred-stock financing with warrants. Specifically, the

convertible was just like a bond with a five-year maturity date, convertible at \$2.50 per share at the option of West Coast. In addition, the fund received as part of the financing 1.2 million warrants, good for three years, with a strike price of \$3.

Says Lowe, "If the company is successful in Trinidad, we potentially could make 10 times our investment; on the other hand, if it isn't successful, we would get back our money and still earn 5.75% interest."

Another example: PRB Energy Inc. (Amex: PRB). Founded as a midstream company with pipeline operations in Wyoming's Powder River Basin, PRB decided near the end of 2006 to enter the E&P sector through Anadarko's divestment of upstream assets in Colorado's Denver-Julesburg Basin, which included 380,000 undeveloped acres and 200 identified drilling locations. The cost to PRB, after a 10% down payment: \$11.7 million.

In this case, the West Coast Opportunity Fund, along with another mezzanine player, completed a \$15-million financing that involved a senior, secured debt component, secured by the majority of PRB's existing assets and those it was acquiring. The debt has a term of 18 months and a 13% coupon. The equity kicker: \$4.5 million of PRB's common stock.

More recently, this past June, EnerJex Resources Inc. (OTCBB: EJXR), a small Kansas City-based producer, availed itself of a smaller West Coast financing. Seeking to extract oil from old, once uneconomic, oil fields throughout Kansas by means of secondary recovery efforts, the operator entered a transaction with the West Coast fund and four other investors.

The overall financing totaled \$9 million, of which West Coast put up \$5 million. The deal's structure: senior debt, secured by all the assets of EnerJex, with a 10% coupon. The equity kicker: 9 million shares of the producer's stock. (For more on EnerJex, see "Upstream Microcaps," *Oil and Gas Investor*, October 2007.)

Says Lowe, "We believe there are hundreds of millions of barrels of oil that can be economically extracted from old fields like these through secondary recovery efforts, particularly with oil prices where they are today—and even at \$40 to \$50 oil."

He adds, "There are more opportunities out there than capital in the mezzanine space."

Broad appetite

Started in April 2003, Houston-based Petrobridge Investment Management LLC has completed more than \$825 million worth of capital commitments through 28 transactions, 90% of them mezzanine financings for 25 E&P companies and one oilfield-service provider.

"We felt in 2003, primarily because of the merchant-energy meltdown, that there was a void in the capital markets, in terms of the availability of mezzanine financing, and thought we could fill that gap to some extent," says Rob Lindermanis, Petrobridge co-founder

and managing director. Previously, he had been with Mirant Energy Capital; the firm's other co-founder and managing director, Mike Keener, had been with Shell Capital.

While Petrobridge employs a wide array of financing structures—stretch senior and subordinated debt, converts, production payments, bridge financing and project equity—its principal investment tool is clearly the mezzanine structure—that is, loans with equity kickers.

"In our mezzanine deals—which have ranged in size from \$4- to \$120 million with our sweet spot right around \$30 million—the coupon on the loan component can range anywhere from 10% to 12%, with the equity kicker typically taking the form of overriding royalty interests (ORRIs), warrants or a combination," says Lindermanis.

"So we're willing to start out transactions at a rather small size, assuming we see growth potential, with the aim of achieving for our institutional investors returns in the mid-teens."

In April, the capital provider assisted Baseline Oil & Gas Corp. (OTCBB: BOGA), another Houston-based producer, with \$33 million of senior secured debt that carried an 11% coupon and an equity kicker in the form of warrants.

"This supported three needs for the company: the acquisition of a North Texas oil and gas asset, the drilling of some wells on that asset, and bridge dollars toward a very sizeable subsequent acquisition, which helped the producer lock up that asset," says Lindermanis.

Earlier this year, Petrobridge provided Petro Resources Corp. (Amex: PRC), a Houston-based producer focused on the Williston Basin, with about \$32 million of mezzanine funding—senior secured debt with a 10% coupon and warrants—that supported the operator's efforts to step up acquisition and development-drilling activities.

Easily the largest series of financings the mezzanine player has done to date has been its backing of Llano Royalty Co., a private Amarillo, Texas-based operator, which allowed that company to accelerate the development of its Barnett shale assets.

"Our support of this company began in July 2005 with \$7 million of senior secured debt that carried an 11% coupon and equity participation in the form of ORRIs and warrants," Lindermanis says. "Today, that mezzanine commitment has grown to \$120 million."

Currently, the mezzanine provider has 25 transactions in its upstream deal-flow pipeline—five of which are actively being worked toward closing—that have an aggregate value of around \$500 million.

Says Lindermanis, "These are niche players that understand their assets geologically and geographically, have worked them before, and can come in and operate those assets and create value with our capital, whether that be through development drilling, recompletions, enhancements/exploitations or acquisitions." □

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On July 1, 2008, many of the business activities previously conducted under the name Laminar Direct Capital, L.P. were assumed by the direct capital unit of the D. E. Shaw group. Please visit www.deshawdirectcapital.com for current and additional information about the D. E. Shaw group's direct capital unit.