Friday, November 14, 2008 | Volume 1, No. 12

PLS CAPITALMARKETS

MARKET ALERT

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Current economics and the future of Mezz Money

Has the turmoil on Wall Street affected the appetite for mezzanine funding in E&P?

*–Interview by Bertie Taylor (**btaylor@plsx.com**)*

Historically, mezzanine funding in the oil and gas space has been viewed as an expensive and inflexible financing option for producers. It carries a higher price tag than secured debt or senior debt, and it may also involve greater overall leverage levels than issuers in the High Yield market. Also, mezzanine debt holders will often require higher returns for their investment than secured or other more senior lenders.

Over time, the perception of mezz money has changed for the better. A growing number of smaller E&P companies have employed such funding as a way to "bridge the gap" between other financing sources and completing specific projects. Today, mezzanine facilities often range from $5- to $100 million, provide for cash paid interest in the 10% to 13% range, and range in maturity from two to five years. Mezzanine lenders make up the difference between the stated interest rate and the overall 18% to 20% return they seek through the equity kicker.

However, as the country's economy struggles to recover from financial turmoil, have the pricier financial alternatives for smaller producers lost some appeal?

The Houston-based direct capital unit of the D. E. Shaw group focuses on providing debt and equity capital to small and mid-sized businesses in all industry sectors, including E&P companies. The D. E. Shaw group has a significant presence in public and private markets across most major asset classes, and the firm invests in a wide range of companies and financial instruments within both the major industrialized nations and a number of emerging markets.

Todd Overbergen, head of the direct capital unit's energy group and a senior vice president of D. E. Shaw & Co., L.P., recently shared his take on the current appetite for mezz money in E&P, the best uses of such funding and what current economics have done—if anything—to the mezzanine financing niche.

PLS: ***How would you describe the current appetite for mezzanine funding in E&P?***

Overbergen: In our view, the appetite for mezzanine capital is currently growing. We've seen a contraction in the number of commercial banks providing senior credit facilities to oil and gas companies, and also in the aggressiveness of the borrowing bases of those senior facility providers that are still active. Additionally, with the financial turmoil on Wall Street, we've seen buyers of second lien term loans -- previously underwritten by the senior banks and investment banks -- virtually disappear. As a result, the industry has renewed its interest in utilizing mezzanine capital to fill this gap.

PLS: ***What kinds of oil/gas projects are a match for mezzanine funding?***

Overbergen: Mezzanine capital is well suited for development-stage and acquisitive companies. Companies with a large percentage of proved undeveloped reserves, looking to accelerate the development of these reserves, are ideal recipients of mezzanine capital. Other companies well suited for mezzanine capital include those that are both interested in acquiring assets with proved reserves and also seeking to stretch their equity dollars or lacking a large private equity backing. Mezzanine capital is not well suited for acreage companies or acreage acquisitions which lack proved reserves. Finally, mezzanine capital is development capital and should not be used for exploration.

PLS: ***Have recent economics and general market conditions affected the mezzanine finance niche?***

Overbergen: The senior bank markets are beginning to pull back as many of the banks are being forced to raise capital in order to offset losses in mortgage-related investments. As a result, senior bank debt is slightly more expensive but still available for E&P companies with producing reserves. Very large, syndicated bank financings are struggling somewhat as banks' hold sizes are coming down and the number of oil and gas banks actively lending to E&P companies is shrinking. Also, as mentioned previously, the second lien market has gone away for the time being, which creates great opportunities for mezzanine providers. Some mezzanine providers associated with senior banks, investment banks, and certain hedge funds may have limited access to capital in the current environment and will likely drop out of the market for awhile. But mezzanine providers who have a dedicated fund are on solid footing and have the capital available in the current environment to invest in energy companies. The D. E. Shaw group's large, flexible capital base provides us with a stable source of capital that we can deploy to attract new projects, even in tumultuous financial times.

PLS: ***Can you describe a few of your firm's recent transactions in E&P?***

Overbergen: Earlier this year, we closed a follow-on investment with an existing portfolio where we upsized the existing mezzanine facility, from $70mm to $100mm, in order to partially fund an attractive acquisition in the Ark-La-Tex region that the management team sourced on a proprietary basis. It was a good fit for us because we knew the management team and the Company had unused leverage capacity on its existing proved reserves as well as the proved reserves associated with the acquisition itself.

In late 2007, we provided a $70mm credit facility and a $10mm equity investment to a company pursuing an oil-focused resource play in West Texas. The management team had invested substantial capital in accumulating a large acreage position and drilling some successful wells, which provided some proved reserves as collateral. Our capital was used to accelerate the drilling program and to make select additional acreage purchases with proved reserves. During 2008, we provided some additional equity capital to this company in order to complete a larger acreage purchase and we also committed the full amount of the credit facility based on the continued positive results of the drilling program.

We've made several other investments this year, but these two are prime examples of the various types of flexible funding we provide and the opportunities in which we like to invest.

PLS: ***How has the perception of mezz money evolved during the past few years? Also, how has your firm stayed ahead of the pack in attracting clients?***

Overbergen: I think mezzanine capital has historically been perceived as inflexible, project-based capital that replaces private equity for company owners who don't want to give up control. I'm not sure this view has changed a whole lot today, but it's why we try to get the word out that we are not a pure-play mezzanine shop. We view ourselves as providers of flexible capital; we can provide not only mezzanine debt but also equity capital. We weigh the risks and potential rewards of each investment opportunity to determine the appropriate capital solution for the situation. This may mean putting some equity capital in a minority position of a project early on to help "de-risk" the project, and then following up by providing debt capital as appropriate without overleveraging the company. We work with quality management teams and don't mind providing minority equity, and we don't have to control the board. But we can also provide control equity in earlier stage opportunities.

PLS: ***How do you see energy finance evolving as we move into 2009?***

Overbergen: We think senior bank debt will probably continue to pull back if commodity prices stay where they are as of late October 2008, or continue to decline. We also think the industry will probably see some borrowing base reductions coming soon. We expect to see many acquisition opportunities come out of this market as larger companies shed assets to delever or fund drilling programs on their core assets. The financial market crisis is forcing numerous companies to drill out of cash flow versus using outside debt or equity capital. Often, that means divesting non-core assets.

Combine that with lower commodity prices, and we think you'll see some assets changing hands at attractive prices. Capital has become a precious commodity in this environment, and the days of easy access to financing are gone for the time being. We plan to be active but prudent during this time, and to continue our investment theme of providing flexible debt and equity capital for great management teams who have projects that stand up to the current commodity markets and can effectively use capital in these volatile markets. We believe great opportunity lies ahead for those who can take advantage of it in 2009.

Excerpted from:
CapitalMarkets
November 2008

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