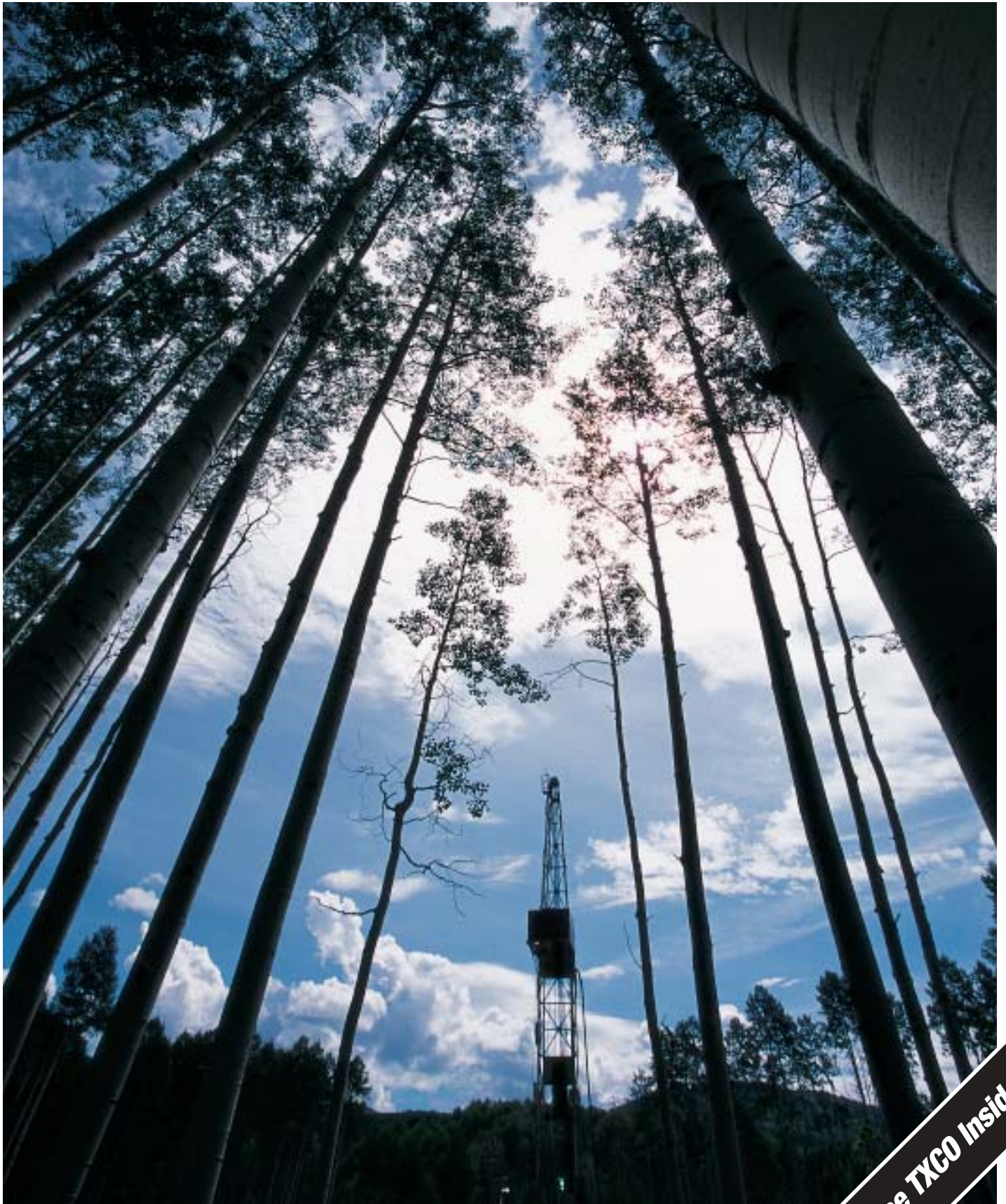


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Small-cap producers are learning to access capital quickly.

See TXCO Inside

SMALL-CAP CAPITAL

For many public small-cap producers and private start-ups, quick access to capital is often just as important as the cost of it—maybe even more so.

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Below left, Delta's Roger A. Parker says quick access to capital was critical when the company decided to accelerate its Rockies drilling program. Sterne, Agee & Leach's Michael D. Bodino explains that his firm saw a PIPE financing as a fast way for Delta to get that capital.

All too often, publicly traded small-cap producers and emerging private E&P companies have a remarkable upstream opportunity presented to them but find it difficult to quickly access the capital they need to act on it.

Sometimes relatively low-cost bank debt isn't an option. Maybe an operator doesn't have enough independently verified, proved developed producing (PDP) reserves to approach a lender for the quick credit needed—or they've already reached the limit of their borrowing-base facility.

In other cases, a producer with few PDPs on its books but plenty of proved undeveloped (PUD) reserves may not know which provider or intermediary of higher-priced capital—mezzanine debt or private equity—would be willing to step up to the plate in very short order.

Indeed, there are far fewer major mezzanine players around today than a few years ago. And, while it may be true there's now a virtual flood tide of private-equity dollars available from specialized funds, those funds are increasing in size and so are their threshold levels for making upstream investments.

Says one intermediary of private equity, "It used to be that private operators could access equity capital in amounts less than \$10 million; today, it's difficult to raise private equity in amounts less than \$15 million. And for those start-ups seeking equity in the \$1- to \$5 million range, there's almost no source for that capital."

In the case of small-cap public E&P companies with a good growth story to tell, access to the public capital markets is hardly an issue—even for those with market caps under \$500

million. Given the market performance of upstream stocks during the past 12 months, investors are anxious to snap up shares in that sector.

The only problem is that it usually takes months to complete a secondary offering of equity or debt in the public markets. So for small, growth-oriented companies looking to rapidly seize the day on an acquisition, that avenue isn't really a viable option.

There is, however, good news for these producers and emerging private operators that may fall under the radar screens of many private-equity funds. Today, there's an ever-widening array of financial institutions and capital-raising tools available that allow such independents to not only move rapidly on near-term opportunities, but also to move up the line quickly to cheaper forms of capital.

PIPE money

Between 1999 and early 2003, Denver's Delta Petroleum Corp. (Nasdaq: DPTR) was focused almost entirely on buying undeveloped producing properties in the Gulf Coast, Alabama's Black Warrior Basin, the Midcontinent and the Rockies.

But later in 2003, with proved reserves of about 90 billion cubic feet equivalent (Bcfe) of gas and daily production of 18 million cubic feet equivalent, it decided to focus on rapid growth through accelerated development and exploratory drilling in the Rockies—particularly in Wyoming's Wind River Basin and Colorado's Denver-Julesburg Basin where it holds a 260,000-gross-acre position.

To move ahead quickly with this new strategy, it needed an immediate capital infusion.

"Time was a critical factor for us," says Roger A. Parker, Delta president and chief executive officer. "We considered doing a secondary equity offering but soon realized it would be very time consuming."

Enter Sterne, Agee & Leach Inc., a regional brokerage, investment-banking and research firm based in Birmingham, Alabama, with offices throughout the southeastern U.S.

"Going into 2004, Delta had a growth story that made economic sense, given its large inventory of properties which could be easily infill drilled," says Michael D. Bodino, the firm's senior E&P research analyst based in New Orleans. "Notably, we saw several great plays in the Rockies where Delta could create a trillion-



cubic-foot-equivalent (Tcfe) company with moderate risk.”

Bodino notes many larger-cap E&P companies have shelf registrations that enable them to do overnight issuances of freely tradable, unrestricted common stock. “Without that, however, an operator needs to go through an SEC registration process that can take up to 90 days.”

To solve Delta’s capital-timing issue, W. Barry McRae, who heads Sterne, Agee’s energy investment-banking group out of Birmingham, advanced the idea of Delta doing a “private investment in public equity” (PIPE) offering.

Simply put, a PIPE is the private placement of restricted, illiquid shares of a company’s common stock, usually sold to institutional investors or qualified high-net-worth individuals within a matter of days or a week, typically at a 10% to 15% discount to the current market price of that stock.

The restricted shares are later registered by the issuer with the SEC, usually within a month or so, at which time they become freely tradable in the market. The advantages of a PIPE: the issuer gets *immediate* access to equity; the buyers, discounted shares that are soon liquid paper in the market.

In February 2004, Delta moved ahead with a \$32-million PIPE at \$8 per share—a very narrow 5% discount to its stock’s then-prevailing market price of \$8.40.

“Investors liked Delta’s use of proceeds, so they were willing to accept a smaller-than-usual discount,” explains McRae. “Moreover, our institutional sales force sold them to the market in about four hours. Overall, from the time the trigger was pulled on the deal to the time money was in Delta’s drawer, the process took about a week.”

In June this year, Delta did a second, \$72-million PIPE offering to support the time-sensitive acquisition of southeast Texas producing properties from Alpine Resources, a private Houston-based company.

The overall \$122-million purchase was consummated with a \$50-million increase in Delta’s credit facility led by the Denver office of Bank of Oklahoma, US Bank in Denver and Hibernia Bank in New Orleans.

“We wanted to enlarge our producing position in southeast Texas and found it attractive that Alpine operated virtually all its properties there and, in most cases, owned a 100% working interest in its wells,” says Parker. He also saw this acquisition of high-volume, high-decline-rate properties as a good complement to Delta’s lower-volume, but long-life-production properties in the Rockies.

The PIPE portion of the funding was priced at \$12 per share—again a narrow 5% discount to Delta’s then-market price of \$12.60 per share. “This didn’t surprise us, given our earlier growth in the year,” Parker adds.

Growth, indeed. The producer’s proved reserves have climbed this year to 170 billion

cubic feet equivalent (Bcfe); daily production, to 43 million cubic feet equivalent. To boot, the \$372-million market-cap company’s stock price moved up from a January 2004 level of \$6.20 per share—before the first PIPE offering—to just under \$13 at the time of the second PIPE deal.

Sweetened PIPE

Focused primarily in the Maverick Basin in southwest Texas where it has 550,000 gross acres under lease, San Antonio’s **The Exploration Co.** (Nasdaq: TXCO) also recently tapped the PIPE market.

With the help of First Albany Capital Inc. in Houston, the \$106-million market-cap operator in late May raised \$16 million of gross proceeds through this financing vehicle, netting a little more than \$15 million.

Again, quick access to capital was a critical issue.

“This spring, we saw an opportunity in the Maverick Basin to bring in a 50/50 partner to drill a portion of our existing acreage—a lease that had prospective potential in the 5,000-foot Glen Rose formation which we had successfully drilled elsewhere in the basin,” says James E. Sigmon, the company’s president and chief executive officer.

However, after closer analysis, Sigmon’s group concluded the field’s potential reserves were so low-risk and high-impact that it would be far more accretive to the company and its shareholders to retain a 100% interest in the property.

“We had to make a choice very quickly—keep 100% of the prospective field or sell 50% of it to a buyer that we might lose if we waited,” Sigmon explains. “There was also another timing issue facing us. We felt if we could begin drilling this property right away, we had the potential to double the total reserves of the company within the calendar year.”

Roberto R. Thomae, The Exploration Co.’s vice president of capital markets and corporate secretary, says First Albany Capital felt a PIPE deal was the best solution and could get done quickly. It did. The producer was able to get more than \$15 million of equity capital within a week.

The PIPE shares were sold to institutional investors at \$3.75 each—a 6% discount to the company’s then-prevailing stock price of \$4. A sweetener to the deal was that investors were offered a 25% warrant coverage, that is, the opportunity to buy, on a proportionate basis, 25% more TXCO shares in the future at a fixed price of \$4.25 each.

Says Thomae, “It was an incentive for them because they got the chance to lock in a further profit opportunity; for us, it means that if we are successful, the warrants will be exercised and we’ll have even more capital to grow.”

At midyear, the company’s daily output was



At top, Caza Drilling Inc.’s Rig #31. Above, The Exploration Co.’s Roberto R. Thomae explains that through a PIPE financing, his company was able to get more than \$15 million of equity capital within a week.

17 million cubic feet equivalent of gas, up from an average daily rate of 13 million at year-end 2003. Says Sigmon, "We expect comparable production growth in second-half 2004, especially now that we have seven rigs running compared with as few as two in first-half 2004."

James A. Hansen, Houston-based managing director and head of energy investment banking for First Albany, says that PIPE transactions seem to fit best with early-stage producers that may have tapped out their bank credit line and need a small amount of equity to validate or accelerate their capex program.

"It's almost a tailor-made financial instrument that helps such companies build up their reserves or cash flow to the level where they can then borrow more in the debt market to

fund additional growth."

Earlier this year, First Albany—two-thirds focused on small- and midcap public E&P companies—agented a \$21.5-million upstream PIPE financing for Englewood, Colorado-based Gasco Energy Inc. (Nasdaq: GASE), a small-cap producer operating in the Uinta Basin.

Currently, the investment banker is in the due-diligence phase of exploring the viability of doing PIPE deals for three more domestic E&P companies that have separate core areas in the Gulf Coast, the Rockies and overseas.

But Hansen isn't married to PIPE transactions. "That's just one part of a company's capital structure at any given point in time. Ideally, we want to help operators through the entire spectrum of their financing needs—from raising private equity or debt, to underwriting their IPO, to providing M&A advisory help as well."



At top, The Exploration Co.'s James E. Sigmon says the firm's recent PIPE transaction solved more than one timing issue. First Albany Capital's James A. Hansen notes his company is exploring the same type financing for three more producers.

PARTNERSHIPS PLUS

Now a stand-alone growth business, GE Commercial Finance's energy financial services (EFS) group—headquartered in Stamford, Connecticut—has roughly \$12 billion of assets under management globally, 80% of them in the U.S.

Importantly for small and midsize private and public independents, EFS since February 2003 has—through its upstream acquisition and asset-monetization partnerships—grown its capital commitments to the domestic E&P sector from \$1 billion to \$1.5 billion.

These partnership structures, in which the new GE offshoot is the limited partner, are designed for two purposes—to partner with an independent producer to bid on oil and gas assets for sale, and to provide liquidity to operators wishing to sell some of their assets into a partnership while remaining the general partner.

"We're truly a side-by-side partner with producers to purchase assets or monetize them," says John Schaeffer, Stamford-based managing director, oil and gas group, for EFS.

Schaeffer's group, which has invested roughly \$2.5 billion in the oil and gas sector since 1994, currently has 28 E&P clients, five of them public; the balance, private. Notably, while it continues to make annual upstream investments of \$300- to \$400 million, there's no ceiling on that investment range.

In its niche partnership structure—where the typical financing is around \$50 million—EFS invests 95% of the capital needed for an asset purchase and handles 95% of all ongoing capital expenditures; the operator,

meanwhile, foots 5% of the asset-purchase price and ongoing capital expenditures.

Once the GE group receives its threshold cash-on-cash 11% to 12% pre-tax return, the operator is then able to back in for more than a 35% interest in the partnership while assuming a corresponding share of the costs.

"Although we're not actively marketing other financial products in the upstream, we are capable of executing all types of reserve-based financings—everything from senior-secured debt to mezzanine deals—should our clients need to reshuffle their capital structure," stresses Schaeffer. "In certain cases, we're also capable of providing private equity, if it makes sense."

As part of its broadened financing capabilities, the stand-alone GE group can also arrange equipment leases. Recently, it completed a lease-back transaction related to an offshore production facility, basically purchasing an offshore platform and leasing it back to the client. It also can do oilfield-equipment leases, whether they're for compressors or gas-processing equipment.

Back to bread-and-butter partnership deals, John Cleveland, Denver-based senior vice president in the EFS oil and gas group, points to an \$85-million acquisition-partnership transaction last March whereby the group and a private Midland, Texas-based producer jointly acquired a package of Williston Basin working-interest assets from a private Denver operator.

"The deal catapulted the Midland E&P company from being the eighth-largest producer in North Dakota to among the top six producers in that state," he says.

"Significantly, there are a number of fol-

Bridge to Infinity

Denver-based Infinity Inc. (Nasdaq: IFNY) has a sizeable 180,000-gross-acre position in the Rockies—in the Wamsutter Arch and Labarge areas in Wyoming's Greater Green River Basin and in Colorado's Sand Wash and Piceance basins. It also holds 28,000 gross acres in the Barnett Shale play in the Fort Worth Basin.

But in mid-2003 the \$43.2-million market-cap operator faced some daunting challenges. To meet some debt obligations and complete its planned 2003 Wamsutter drilling program before winter set in, it needed a capital source that could not only act quickly, but be aggressive in terms of giving it credit for both its PDP and PUD reserves.

"Not having even an up-to-date, third-party engineering report to present to any bank, we turned to Petrobridge Investment Management

low-on opportunities for this partnership to acquire other third-party working interests in the area. It's an excellent case where a small producer—about \$50 million in asset size—was able with limited capital access to make an acquisition that would have otherwise been out of its reach."

Emphasizing the group's expanded financing capabilities, Cleveland cites a private West Coast producer for whom EFS completed a \$35-million asset monetization in 2003. Recently, that operator returned to the group with a twofold need: it wanted to refinance a preferred-equity placement that was coming due and to refinance existing bank debt. In all, the company required about \$100 million.

"What our investment committee approved, and what we were prepared to moved forward on, was a \$40-million commitment to refinance the producer's preferred stock, \$50 million to refinance its senior bank-debt facility, and a \$10-million line of credit for drilling," he explains.

The transaction didn't close because the producer ultimately decided to sell a majority interest in the company to a third party, but Cleveland notes EFS was ready to address the producer's capital-structure requirements in a timely fashion.

EFS is currently studying five potential E&P transactions for Rockies-based operators totaling more than \$500 million. They range from a \$300-million financing structure for a small-cap, publicly traded Denver producer looking to complete a large acquisition, to a \$100-million subordinated loan for a private operator in the same city seeking to monetize its PDP reserves.

Says Schaeffer, "At any given time, we're looking at 20 or more potential upstream financings throughout the Lower 48 that have an aggregate value of \$1.5 billion."

LLC in Houston," says Stanton E. Ross, Infinity president. "It reacted quickly with a \$3.85-million bridge loan that did a lot more than solve our near-term financing needs."

Jim Tuell, president of subsidiary Infinity Oil & Gas of Wyoming, says Petrobridge not only responded within a matter of days or weeks, but also brought in a third-party engineering firm to conduct an independent analysis of Infinity's PDP and PUD reserves—something it previously lacked.

The bridge loan had some mezzanine-finance components to it, carrying an 11% coupon plus equity participation.

"This financing fit well with our business plan—helping small private and public independents access the capital they need to graduate to that next level where there are more financing options open to them," says Rob Lindermanis, Petrobridge managing director.

Since it opened its doors early last year, the firm has committed \$196 million of capital to seven private and three public independents. Seven of the 10 transactions have been mezzanine financings; two, bridge loans; and one, a subordinated-debt deal.

"While we have a primary emphasis on mezzanine debt (loans with equity kickers), we have the complete investment toolbox available to us, from convertible debt to volumetric production payments (VPPs)," he notes.

The advantage of mezzanine capital versus straight bank debt is that it's more aggressive in its advance ratios and gives operators credit not only for PDP reserves, but also for proved behind-pipe reserves and PUDs, Lindermanis adds. "This type of capital makes a lot of sense when producers are trying to move forward with aggressive or accelerated development-drilling programs, or trying to make strategic acquisitions."

Currently, Petrobridge, with an annual \$200

John Schaeffer (top) and John Cleveland of GE's energy financial services. Below, a rig hand at work on Encore Coring & Drilling USA's Rig #232, drilling a Delta Petroleum well in eastern Colorado.





From left to right, Infinity Inc.'s Stanton E. Ross and Jim Tuell, and Petrobridge Investment Management's Rob Linderman, discuss how a quick \$3.85-million bridge loan from Petrobridge opened the door to more financing options for Infinity.

million of capital availability, has two mezzanine transactions in the works: one for a private Arkoma Basin-focused producer and another for a private West Texas and Permian Basin independent.

Back to Infinity. After the assistance extended by Petrobridge, the producer was able in September 2003 to approach a lower cost-of-capital provider, US Bank in Denver. That lender provided Infinity a \$25-million commitment, with an initial \$5.5-million borrowing base, priced at prime plus 1%, or 5.25%. With that, it paid off Petrobridge and used the remainder for Wamsutter drilling.

Not neglecting another core asset—its Labarge coalbed-methane (CBM) unit—the operator last December also entered into a joint value-enhancement agreement (JVEA) with Schlumberger involving the planned drilling of 90 wells.

“Under this JVEA, we fund and equip all the Labarge wells we drill while Schlumberger provides all the logging, cementing, wireline, fracturing and completion services in return for a net profits interest in the wells’ production,” says Tuell.

Ross adds, “We know from a resource study that there’s about 700 billion cubic feet (Bcf) of gas in place in the Labarge unit—roughly 250 Bcf of that recoverable under our portion of the unit.”

To further improve its balance-sheet position and help fund its 2004 drilling program, Infinity last January raised \$4 million through a private placement of its common stock with Wellington Management in Boston.

Infinity’s 2004 upstream growth will also be helped by its ability to draw upon the financial resources of its wholly owned, Kansas-based oilfield-services subsidiary, Consolidated Oil Well Services Inc.

This subsidiary’s Chicago-based lender, La Salle Bank, has agreed to increase Consolidated’s credit facility from \$5- to \$7.5 million, allowing that credit to be upstreamed to Infinity and downstreamed to Infinity Oil & Gas of Wyoming, says Ross. In addition, Infinity recently announced the sale of \$4.1 million of Consolidated’s assets—up to \$2.4 million of which will be available for capex.

All this varied capital infusion should sub-

stantially boost Infinity’s proved reserves and production from year-end 2003 levels of 9 Bcf and 2.8 million cubic feet equivalent per day, respectively.

Charles S. Searle, senior vice president and head of the energy industries division for US Bank in Denver, says, “We routinely back experienced management teams that are involved in upstream situations where we see very significant upside. Both Infinity and Delta fit perfectly with this philosophy.”

Denver-based Berco Resources, a private Denver operator, is also the type of independent the bank targets. “We’ve backed Berco for more than 15 years, banking it when it was very small—with an initial credit facility that was less \$1 million,” says Searle. “Today, it’s one of our largest energy clients.”

Since 1990, US Bank has grown its commitments to the oil and gas industry from \$80 million to \$1.6 billion currently, 70% of that geared toward some 90 private and public E&P customers.

Quick loan execution

Headquartered in Houston, with offices in Dallas and San Antonio, Sterling Bank started its energy-lending initiative in April 2003. Today, the \$3-5-billion asset-sized institution has \$175 million in commitments to 17 energy clients, with outstandings north of \$80 million.

These clients include nine private E&P companies, five small-cap public producers and three private midstream companies. The bank’s range of upstream loans: \$1- to \$20 million.

“Growing this customer base hasn’t been easy, given that the acquisition market—the driver of loan growth for banks—has been slack,” says Dan Steele, Houston-based senior vice president and manager of energy lending for Sterling.

This dampened activity has been caused, in part, by recent high commodity prices where the expectations of buyers and sellers have become increasingly divergent, he notes.

“Also, due to a lack of quality drilling prospects and an inability to be successful in the M&A market, producers are using the cash flows they’re generating to repay existing debt. So banks are getting paid back faster than anticipated and new acquisition deals aren’t coming



Sterling Bank's Dan Steele talks about the energy lender's emphasis on quick credit execution.



At top, eastern Colorado's prairie with Caza Drilling's Rig #31 on the horizon. Weisser, Johnson's Frank Weisser talks about his company's formation of a private-equity fund aimed at helping start-up or undercapitalized E&P companies access private equity in amounts up to \$5 million.

into the credit market as quickly as before.”

Despite this deal-flow malaise, Sterling has managed to successfully court energy clients with its speed of execution on credit facilities.

While each of its three energy lenders has 20 years of industry experience and an extensive network of contacts, this group also enjoys significant technical support from a third-party engineering and reserve-evaluation firm—W.D. Von Gonten in Houston.

Says Steele, “We put a premium on the timely execution of credit facilities, and between our own staff and W.D. Von Gonten, we’re able to complete due diligence and reserve evaluations in as short as a day; in other cases, two or three days.”

In June 2003, the bank originated a \$4-million, three-year revolver, priced at prime, for a private Austin-based E&P limited partnership. The partnership had acquired small royalty interests in more than 3,000 producing properties scattered throughout the Gulf Coast and Mid-continent and wanted to build on that.

By January 2004, Sterling upped this commitment to \$6 million. The overall facility enabled the client to expand and diversify its royalty-interest positions in areas where it already had a foothold, says Steele.

“Then this June, it sold all its royalty interests—for an amount exceeding eight times its annual cash flow or \$15-plus million; the initial worth of the partnership’s royalty interests before it approached us was little more than \$5 million.”

Private-equity caveats

An intermediary of private equity and mezzanine capital for small-cap E&P companies, Houston-based Weisser, Johnson & Co. sees an ironic pitfall ahead for upstream start-ups as the result of so much private-equity capital being available to the industry.

“With so many private-equity funds raising larger and larger amounts of capital from institutions, they’re tending to gravitate toward much bigger equity investments in much fewer upstream companies,” observes Frank Weisser, managing director for the energy investment-

banking boutique.

It used to be that private operators could access equity capital in amounts less than \$10 million; today, it’s difficult to raise private equity in size ranges less than \$15 million, he says. And for those start-ups seeking equity in the \$1- to \$5 million range, there’s almost no source for that capital.

Compounding this problem is the fact that energy equity-fund managers—mainly focused on acquire-and-exploit investment strategies—don’t want to pay up for reserves in the current high commodity-price environment. As a result, these risk-averse funds are being forced to look more and more at drilling deals.

How do start-ups cope with this? “They might present potential equity partners with acquisition opportunities that have plenty of PUD-reserve potential that those partners wouldn’t have to pay for up front—or present them properties with unengineered reserve potential that an acquirer with special skill sets can exploit.”

This past May, Weisser, Johnson intermediated on behalf of Centurion Exploration Co., a private Houston operator, a \$40-million private-equity commitment from Yorktown Energy Partners. Centurion has access to a large 3-D seismic database across South Louisiana and intends to acquire existing fields on which it will do further exploration drilling based on reprocessed 3-D surveys.

The firm is also trying to arrange \$50 million of equity funding to support a private Gulf Coast producer which similarly has access to a large 3-D seismic database—along the Texas and Louisiana coasts.

Still, for those acquire-and-exploit start-ups in need of small amounts of private equity under \$10 million, a capital void exists.

To address this, Weisser, Johnson has created SPARK, a private-equity fund capitalized by energy-knowledgeable investors who collectively have the money, time and skill sets appropriate to the energy business to evaluate the merits of E&P projects and provide up to \$5 million of equity to start-ups or undercapitalized producers.

This small equity infusion would allow those operators to then move forward with upstream projects, sometimes in combination with additional debt or mezzanine financing, explains Weisser.

He notes that mezzanine lenders like Wells Fargo, Petrobridge Investment Management and Trust Co. of the West (TCW) may like a particular E&P project, but will want to see some small amount of equity in the project as well.

Currently, the special private-equity fund, which is studying a half-dozen small upstream equity deals, has members in Houston, Denver and Kansas City. Says Weisser, “Ultimately, we hope to have at least two or three members in every major energy city in the U.S. in order to service geographically dispersed operators.” □

