

THE ALLURE OF MEZZANINE

Opportunities for drilling oil and gas in the United States have never been better.

BY SCOTT JOHNSON, MANAGING DIRECTOR, GASROCK CAPITAL LLC

Most established oil and gas companies are generating profits and cash flow at record levels, and for smaller companies, financing is more readily available than at any time in memory.

Mezzanine financing is frequently a most attractive alternative for early-stage companies, both public and private.

Applied broadly, mezzanine financing generally is taken to mean “stretch” debt, such as debt that has advanced beyond normal senior debt levels, provided by a traditional bank loan with a higher target return required than for senior debt, often with an element of equity participation. Debt that is fully convertible into equity is not considered mezzanine.

The term mezzanine is an analogy to the levels in a commercial building, where the mezzanine level is located between the ground floor, which equates to equity, and the upper floor(s), which equate to senior debt.

Outside the oil and gas sector, mezzanine finance most typically refers to subordinated debt, which may or may not include equity participation.

In the oil and gas world, mezzanine usually refers to senior first-lien debt that finances specific project assets, usually with an overriding royalty, net profits interest, and/or warrants as equity participation. Second-lien mezzanine debt, which is junior to bank debt, is also available for larger transactions.

ALTERNATIVES FOR SMALLER COMPANIES

Despite the abundance of available capital today, not every combination of management and business plan will attract financing. There are two primary financing routes to rapid growth for early-stage companies. These are first, the combination of a small amount of equity with a larger amount of mezzanine debt financing and second, a large amount of equity, along with some bank debt financing.

Other alternatives are available, but usually do not result in as rapid growth. For example, “bootstrapping” with a small amount of equity, together with bank debt, often results in constrained growth because increased bank funding must await a full engineering assessment of new proved producing wells. The alternative of putting drilling prospects

together and bringing in a larger oil company as a joint venture partner to provide drilling money generally results in a smaller participation percentage, so that it may take a number of years to build critical mass, unless the projects turn out to be home runs.

The combination of a large amount of private equity plus some bank debt is often an especially attractive choice for managements with “superstar” track records and business plans that will require between \$50- and \$100 million initially and likely more within about a year. If exploration is a substantial portion of the business plan, then an equity investor may be the only potential source of funding from the financial sector. With this kind of backing, a management can build a substantial company in a relatively short period of time. The downside is that the equity investor will typically take about 80% of the equity and control when and how to exit the investment through a sale of the company or other action.

Most start-up management teams do not have the superstar track record private equity firms seek, especially a history of having built and sold a company at a large profit. In addition, managements often strongly resist giving up a majority of their company and control to an investor. For these reasons, the combination of a small amount of equity, derived from the managers or individual investors, together with a large amount of mezzanine financing, often offers compelling advantages.

Oil and gas mezzanine finance is in its golden age. With higher prices, today it seems nearly every development drilling project offers attractive economics when financed with mezzanine debt. Even areas with long-life reserves and low drilling risk such as Appalachia offer sufficient returns to make mezzanine financing attractive.

In this environment, the amount of equity needed in combination with mezzanine finance is much less than in the past. Often \$2- or \$3 million of equity investment is adequate in combination with between \$25- and \$50 million of mezzanine debt. The focus is on the selection of a quality development project and a management competent to execute the plan, rather than on whether the management has had the opportunity to make a fortune in the past.

With the right capital source, a mezzanine financing deal can begin at a size as little as \$2 million and can grow to as much as \$50- to \$100 million or more. The cost of mezzanine finance is considerably less than equity and allows management to retain a far larger share of the economic return as well as control of their company.

KINDS OF PROJECTS

Oil and gas mezzanine financing is primarily focused on development drilling. Midstream projects such as pipelines, gathering systems, processing facilities and storage are also attractive. For drilling projects, proved undeveloped and behind-pipe reserve targets are the bread and butter of mezzanine finance, but lower risk probable reserve targets may also be included. Acquisitions often include some producing reserves, but a large portion of undeveloped reserves is needed to generate the returns required by mezzanine. Target internal rates of return (IRRs) usually range from the mid-teens to the low 20s. Targeted rate of investment (ROI) is typically in the range of 1.3 to 1.7, substantially lower than the ROI of 3.0 or more that private equity firms typically seek. Since ROI is a measure of the actual future dollars returned to the investor in relation to the investment (and conversely the remaining number of dollars available to management), it is in some respects a more meaningful measure of capital cost than IRR, at least to many manager/owners. Some financial commitment by the E&P company sponsors is required and should be significant to them, but need not be significant relative to the size of the project.

COMPARATIVE ANALYSIS

Let's look at financing options relating to an actual field and the impact different types of financing would have on the value created and retained by the management. This example is based on a real situation, but the company is called by the fictitious name of Mythos Inc. Mythos owns a largely undeveloped field with the following characteristics:

Type Well		Field	
Net Reserves	572 MMcf	Producing Wells	3
Cost to drill	\$650,000	PDP PV10	\$4.4 million
R/P ratio	8.5	Production	400 Mcf/day
Life	25+ years	Drilling locations	72
		Total drilling cost	\$47 million
		IRR (drill & hold)	37%
		Potential sale price	\$78 million (30 months)

Mythos can choose from bank debt, industry joint venture, institutional private equity and mezzanine debt.

Bank debt—We assume a 7% interest rate and an advance rate equal to 60% of the PDP PV10 value (proved developed reserves). Semiannual borrowing base redeterminations lead to additional advances during time, but because of the lower advance rate, a lower commodity price forecast and slower value redeterminations, the desired pace of drilling is constrained by the bank's will-

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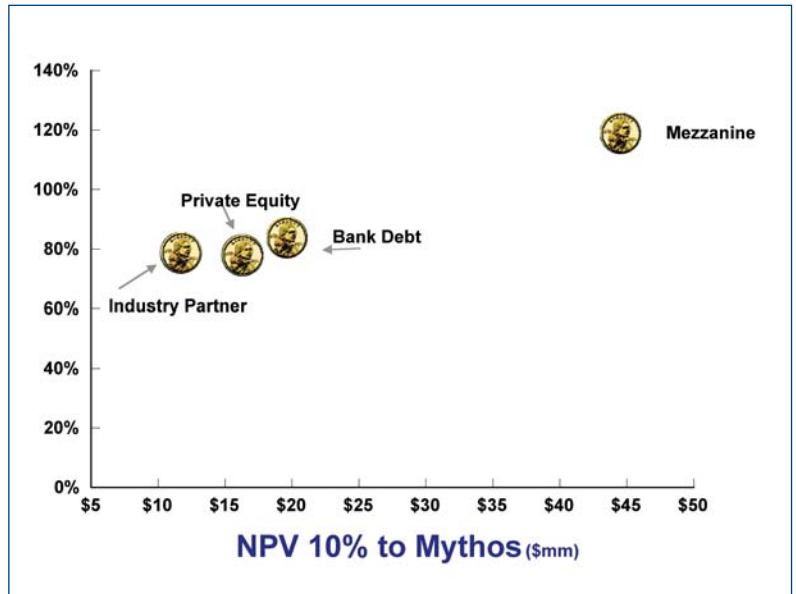
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Industry partner—We assumed a promote equal to a one-eighth carry through all 72 wells. Alternatively, we could have assumed a third for a quarter promote through several wells, followed by a requirement that Mythos finance future wells. Under such a scenario, however, results are heavily dependent on the terms of the later financing, so that the simpler assumption seemed preferable. We did assume Mythos is carried on all of its capital expenditures “to the tanks.” The pace of drilling is not constrained, and the resulting joint venture partner’s IRR is calculated at 31%. This relatively modest figure demonstrates that, if anything, the partner might demand more attractive terms, which would have made this alternative appear less attractive than under our assumptions.

Private equity—We assume this investor will contribute \$28 million to Mythos. In addition, the company uses a



Internal rates of return and net present value management for Mythos.

modest amount of bank debt. The company initially receives 14% of the equity for its contribution of the field assets. At that level, the equity investor’s valuation equals about \$2.34 per thousand cubic feet of reserves and \$8,000 per thousand cubic feet per day of production. Through options, the management can claw back to 34% of the equity. In other words, the “promote” to the private equity partner is about 20%. After an assumed sale, the equity investor’s IRR is calculated at 50% with an ROI of 3.4. These assumptions are realistic.

Mezzanine financing—Mythos receives a \$47 million facility with a 10% coupon rate. The overriding royalty interest is 5% commencing immediately. There is a 2% advance fee paid as funds are advanced. The cash flow is split 90% to repay principal and interest with 10% to cover the overhead of Mythos until the debt is repaid, at which point only the royalty remains. The mezzanine provider earns an 18.5% IRR. The ROI is 1.5 over 4.5 years without a sale. In the event of a sale in 2.5 years, the mezzanine provider would earn 23%.

SPLITTING THE PROFITS

With each of these assumptions, we can look at results of a model and see how the various players make out under different circumstances. In the chart below, Mythos management’s achieved IRR and net present value (NPV) are shown. Because the amount of Mythos equity value contributed at the outset was moderate, the IRRs to management are high in all the cases.

It is clear, however, that mezzanine finance generates a dramatically higher NPV to management—it is more than double that with any of the alternatives.

The chart shows the economic comparison even more clearly. In the bank financing case,

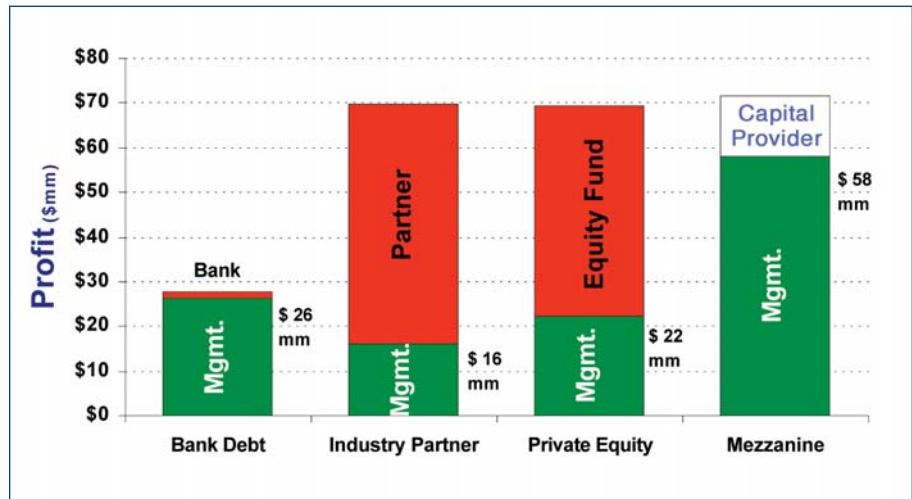
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management retains a high percentage of the value created, but the aggregate field value is lower because of constraints on the drilling program. With an industry partner or private equity, the maximum field potential is achieved, but management retains only a minority percentage of the total value created, perhaps in the 20% to 30% range.

By contrast, in the case of mezzanine financing, full field value is created and management retains more than 80% of the total profit created in the field. In terms of the aggregate future value, management retains \$58 million in the case of mezzanine finance, while the next best management result is with bank debt, where management retains \$26 million of profits.

Results under various future commodity price assumptions and different degrees of project success render similar results. As gas price ratchets up or down, the mezzanine finance case dramatically outperforms the other alternatives under a range of prices. Retained management profits vary more significantly with production results, but in all cases where production is at least 50% of the projected level, management still fares better with mezzanine than under the other alternatives.



An economic comparison of various financing groups.

company to a third party. Mezzanine financing also allows managements to capture and retain a larger share of the value that they create.

GasRock Capital LLC is an energy mezzanine investment firm formed in 2005. Scott Johnson is also managing director of Weisser, Johnson & Co., which is the manager of GasRock Capital. He co-founded Weisser, Johnson in 1991 with Frank Weisser. ■

CONCLUSION

Mezzanine is an attractive alternative for financing of development projects by smaller and early-stage companies. In some cases, even larger companies that do not wish to utilize their equity funds or full recourse debt may find mezzanine appealing. Mezzanine funding supports accelerated growth of development projects by early-stage companies with advances often two to three times what is available from the banks. Although the cost is significantly higher than bank funding, it remains substantially lower than the cost of equity financing and applies to only the specific project or assets, which are financed. Importantly, mezzanine finance does not require the sale of any share of the equity ownership in the company, does not involve giving a board seat to a funding source and does not give control of the

Mezzanine Investment Structure	
Limited Recourse Project Financing	<ul style="list-style-type: none"> • Non-recourse to sponsors or other company assets not being financed • Often first lien on project assets • Second lien, junior to the banks, on larger deals with debt in excess of \$50 million
Coupon	<ul style="list-style-type: none"> • Usually 9% to 12% • May be higher of fixed-rate or floating rate (LIBOR +)
Overriding Royalty	<ul style="list-style-type: none"> • Royalty sized as required to meet target return • Sizing based on economic model • May begin immediately or after loan repaid • Could be between 2% to 10%+ depending on economics
Alternative Equity Kickers	<ul style="list-style-type: none"> • Net profits interest and/or warrants may be used instead of royalty or in addition to a royalty
Advances	<ul style="list-style-type: none"> • Based largely on PDP value • May equal or exceed PV10 • Low risk drilling may not require any PDP • Typically a sponsor pays for leases and seismic • Proceeds applied to approved development plan • Initial commitment is often two to three times the amount available from banks • Additional advances for batches of wells based on early success
Repayment	<ul style="list-style-type: none"> • Sweep of cash flow to pay interest and principal • Typically 80% to 90% • Structured to accommodate overhead • Three to 4 year maturity • Early repayment allowed without penalty