

# FINANCING THE MICROCAPS

A growing number of financiers are making a specialty of connecting publicly traded, microcap E&P companies with growth capital.

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Though the stigma that shadows smaller, oftentimes unknown, publicly traded oil and gas microcaps hasn't completely disappeared, financiers and potential investors are warming up to those with interesting stories, quality management and quality projects.

"The marketplace has dramatically improved for them, their ability to raise capital and the options available to them," says Alex Montano, managing director of Irvine, California-based investment-banking firm C.K. Cooper & Co., which has long arranged capital for micro- and small-size oil and gas companies.

"The window has closed some, with the recent pullback in commodity prices, but the environment is better now than it was two years ago. They still have hurdles and that makes financing harder to do for this group. But there's a larger audience of investors that want exposure to E&P and they're more willing to look at

companies that are more on the fringe than they used to be."

The U.S. microcaps tend to trade on the OTC Bulletin Board or Pink Sheets. In the past two years, several have graduated to larger exchanges—Nasdaq and Amex—as their enterprise values have improved with growth capital and higher commodity prices. (For more on many of these graduates, see "The OTCBBs," *Oil and Gas Investor*, June 2005.)

Cliff Adams, division director and co-head, global oil and gas group, of Houston-based investment banker Macquarie Securities (USA) Inc., says a microcap's management team and its assets are key to attracting capital. "If those two things check out, there's really no distinction between them as a Bulletin Board or Pink Sheets company, Amex traded or privately owned. The capital is out there whether it's from development-capital sources, hedge funds or private-equity funds."

For financiers, matching microcaps with funding can be work-intensive. Montano says more evaluation, more storytelling and more effort is needed to portray the potential reward. A microcap financing also requires additional investor education. "On average, they take a longer time to close. Investors are also a lot more price-sensitive due to the risk associated with microcaps," Montano adds.

Lynn Bass, co-founder of Houston-based microcap financier GasRock Capital LLC, says it is easier today for microcaps to raise \$50 million or more, but the stigma that clings to some Pink Sheets and Bulletin Board-listed stocks exists for a real reason—scams are still out there.

"There also isn't the kind of liquidity in that kind of stock versus what you would find in a New York Stock Exchange stock. However, hedge funds are playing an increasing role in energy finance and, while they recognize those liquidity issues, they generally find microcap stocks more attractive than your standard mutual fund would.

"Also, energy is in the limelight right now, so individual investors are accepting that risk a little more openly. If they didn't invest a few years ago they missed the latest run-up—so the

**Things have gotten a lot easier for microcaps that want to raise \$50 million or more, but the stigma that clings to some Bulletin Board-listed stocks still exists, says Lynn Bass, co-founder of Houston-based GasRock Capital LLC.**





**Cliff Adams, division director and co-head, global oil and gas group, of Macquarie Securities (USA) Inc., says, "There isn't anything that we wouldn't ask of a microcap company that we wouldn't ask of larger, more established ones."**



**Alex Montano, managing director of C.K. Cooper & Co., says matching microcaps with funding requires more evaluation, more storytelling and more effort to portray the potential reward.**

new way to play is to invest in undiscovered companies. If things work out, they could have a pretty big pop. And once that happens, you get growth and liquidity."

Bass says that coalbed methane and shale plays are some of the most popular with microcap E&P companies. "Also, more microcaps are getting financing for exploration, which is a sign of the openness of the financial markets. A few years ago these efforts would have been much harder to finance."

Paul Beck, executive director of commercial banker Macquarie Bank Ltd.'s Houston office, says many attractive microcaps are boasting strategic acreage positions. "They have the ability to turn the acreage potentially into something fruitful for their investor base. That wasn't necessarily the case years ago. I assume it's easier for them to attract capital today because we're seeing more of these opportunities than we did five or six years ago."

Technological advances are also helping the little E&P companies turn old basins into new opportunities, another plus to investors. "There can be some very attractive investments in these stocks for several reasons," Bass says. "First, bigger companies left behind many U.S. basins and the smaller guys are left playing with two big factors on their side: land and local expertise.

"Second, these basins were developed on \$2.50 gas, but now that gas is in a higher realm, it really opens new growth possibilities. Microcaps can grow quickly organically at \$5 or \$6 gas. Finally, they're takeover candidates. These new realities are the source of the true value in these companies. It's not just some hyped-up market."

Successful microcaps often have a distinct first-mover advantage and a knack for cultivating growth opportunities.

Montano says, "We're seeing so many broad-based plays coming to the forefront, and these small companies, either by skill, luck or happenstance, end up putting together something in the core or just outside of it. Smart investors are saying that these companies may have something that other companies don't. There are a lot of opportunities out there and the microcaps tend to be in the mix of it."

In February, C.K. Cooper & Co. did a \$9-million private placement for San Antonio-based Baseline Oil & Gas Corp. that was almost 2.5 times oversubscribed. Baseline is an independent with a 50% interest in New Albany-Indiana LLC, which holds working interests in leases covering some 100,000 acres in the New Albany Shale area of the Illinois Basin in southern Indiana.

"We're seeing a lot of investor interest in unconventional plays," Montano says. "Where you have repeatability and fragmented ownership, you see a lot of microcap interest and investor willingness to invest in those deals. They

have a first-mover advantage and put together a respectable acreage block that requires capital for development."

In May 2005, the firm also did a \$6-million financing for Calgary-based Cheetah Oil & Gas Ltd., an exploration pure-play with a focus on Papua New Guinea. "We garnered a lot of interest for that company, and it shocked me a bit to see how many people were willing to hear the story. In the past, a small company with international operations was a non-event, but now the market has accepted that international is the place where you're going to find new reserves and smaller companies can compete."

At Macquarie Bank, Beck says the microcaps' international stories are mixed. "Even though some of these companies are in well-established areas, some of them are not, and they haven't done enough drilling to prove it up yet. From a financing perspective, you can dip your toe into those areas, but it's hard to get a lot of attention until more drilling gets done. The more conventional opportunities are easier to define and you can have a little more confidence in what the end-game will be."

In microcap stories, Montano looks for repeatability, reduced risk at the field level and a business plan that directs some of the capital toward developing reserves. The firm considers deals as small as \$2.5 million.

"The one criterion that we have, in addition to the standard ones, is that the capital beneficiary's primary listing be on a U.S. exchange," Montano says. "Also, we expect a level of corporate governance associated with a listed stock, even though it's not required at a Bulletin Board level. Some companies get shy about the potential costs associated with that, but I have never met a microcap that hasn't had the goal of getting off the Bulletin Board as quickly as possible."

Macquarie Securities' Adams adds, "There is so much capital in the energy business that there always seems to be a shortage of opportunities that hedge funds can invest in. So it's simply supply and demand. Pink Sheet and Bulletin Board companies allow hedge funds to meet their requirements of putting money with publicly listed entities, despite the fact that they might be small, illiquid and have limited trading volume."

In May, Macquarie Bank completed a US\$40-million senior first-lien secured credit facility for Denver-based Admiral Bay Resources Inc. to develop its unconventional gas projects in the Cherokee Basin in southeastern Kansas and the Appalachian Basin in Pennsylvania. To date, Admiral has drilled and/or reactivated more than 120 wells, with the first 65 now selling gas. As of early May, its gas production was 1.5 million cubic feet per day.

Its 2006 drilling program calls for 200 new wells across four projects and 300 producing by year-end. It has more than 200,000 acres under lease. (For more on Admiral Bay, see "CBM Review," *Oil and Gas Investor*, June 2006.)

Macquarie Bank also signed a \$50-million credit facility with TrueStar Petroleum Corp. subsidiary Trinity Barnett LLC, Toronto, to finance drilling and development of leases in the Barnett Shale play in northeastern Texas. Macquarie Securities also invested \$1 million in a private placement of Trinity units. Proceeds are funding lease acquisitions and working capital.

Beck says, "TrueStar and Admiral Bay are both unconventional gas development plays where the lion's share of our money is going into the ground for development. The unique thing about the Admiral Bay financing is that the style of it allows for the company to access much more aggressive capital. It's more mezzanine and project-looking, but it can seamlessly evolve into a traditional corporate senior loan."

"As they develop their acreage, high-grading non-PDP (proved developed producing) reserves in that category, they'll look more like a traditional company. They had good acreage positions, just not a lot of drilling money...Later, we'll play the role of traditional banker to them."

Adams says, "There isn't anything that we would ask of a microcap that we wouldn't ask of larger, more established ones. It's about the team and the assets. On the agency side of our business, we generally don't work with a company unless it wants to raise more than \$5 million. However, if it needs a smaller amount of capital and it has a good project, Macquarie's investment-banking side can invest smaller amounts of capital with a company to help meet its financing needs."

Beck adds that Macquarie Bank has no high-end loan range because the assets determine how much money a company will need, though he wouldn't do anything less than \$10 million.

In April, GasRock closed a \$30-million credit facility to EnDevCo Eureka, a subsidiary of Houston-based EnDevCo Inc., to finance the acquisition and development of Short Junction Field in Oklahoma. The 12,000-acre field includes 270 wellbores and rights to a gas pipeline and gathering system. In April, the field was producing from 19 wells with daily production of 100 barrels of oil from the Hunton limestone reservoir and 300,000 cubic

feet of gas from the Red Fork Sand reservoir.

Bass says, "EnDevCo had arranged for the acquisition and had gone down a path with another financial institution that ended up not being able to close. When we got involved, there were really two points that mattered most to the company—surety and rapidity of close. They had to put down more money to hold the deal so they really wanted to know that this was going to happen. We closed it in about two weeks."

GasRock's investment criteria are highly asset-focused and it considers loans of \$5- to \$100 million for microcaps. Bass says, "We almost always want some production and we're open to technological risk. Whether the company is public, private, small or large, none of these factors matter like the assets do."

Though the initial deal terms may call for smaller financings, as the company grows, the financings should ideally grow with it. "As the story develops, we have the wherewithal to communicate that story," Montano says. "If Baseline graduates to the Amex, it's likely that we would initiate research coverage on them. We can be a relationship that takes them from a microcap to a small- to medium-cap level so they can stay in one shop."

**B**ob Brooks, division director, co-head, global oil and gas group, Macquarie Securities (USA) Inc., says flexibility in offering both investment-banking and commercial-banking services is an advantage. "It's not just that we can both help people raise money and put our own in. Sometimes when you get the right management team and the right project, there just isn't a box that the financing fits in—but some capital providers would have you do just that. We'll look at investing in direct working interests, royalties and all forms of securities—everything from equity to subordinated capital to senior capital."

GasRock's Bass says, "We're focused. All we do is energy and we're not going to leave during the next downturn." GasRock is run by long-time capital advisory firm Weisser Johnson & Co.

"We can start financings at \$5 million or less, but we can grow to over \$100 million on any transaction. There are some small funds and a number of large ones out there, but nobody to really span the difference. Many large funds won't touch a deal that isn't at least \$20- to \$30 million on Day One. And while the smaller funds are happy to chase the \$5-million deals, they can cap out at \$10 million. We see a lot of attractive opportunities that start small but grow much larger."

While there is plenty of capital available to producers today, investment standards still have to be met. "From a presentation standpoint," Adams says, "if a team walks into a meeting and doesn't have their story well-crafted, knowing their assets backwards and forwards, they're going to lose folks who have a very limited time to hear what they have to say." □



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