PRIVATE CAPITAL FOR THE TAKING

Today's iteration of private-equity funds has grown from several million to several billion dollars, yet fund managers still strive for small placements to realize maximum returns.

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The price of oil has been on an upward climb for the past six years, and there is no reason to believe it will revert to previous norms anytime soon. Global demand, diminishing supply of easy oil and increasing asset nationalization are just a few of the drivers ensuring high energy prices will continue for at least the next few years.

Meanwhile, so much for the "peak oil" debate. That's so last year. The global energy community is now in the valley of "de-spare"—as in, no more spare capacity.

Recent estimates by the U.S. Department of Energy's Energy Information Administration forecast 2008 global oil production to be 86.48 million barrels per day, and consumption to be 86.40 million, which is cutting it close. For 2009, the agency estimates oil production at 87.72 million barrels per day, with demand at 87.76 million, thus outpacing production. The era of "floating equilibrium" has arrived.

Thus, massive E&P investment is needed to develop resources to meet demand. But it won't be easy, nor cheap.

Working for profit margin off this dynamic, private-equity providers have been raising ever-larger investment funds to support E&Ps in their efforts to bring more oil production to market. While large, $200- to $500-million placements are readily available, private-capital providers are also willing to place small investments, whenever possible, to increase start-up and midcap independents' access to capital. Their strategy is to maximize management-team ownership and investor returns.

Big funds

One such capital provider is Natural Gas Partners (NGP), founded in 1988. NGP provides small placements with big returns, even though its funds are some of the largest in the industry.

"We are very different, because we are the only ones in this market that will continue to do small deals even though our fund size has gotten bigger," says Ken Hersh, chief executive of NGP Energy Capital Management and managing partner of NGP, which places capital in U.S., Canadian and international E&Ps.

"Because we are a very large organization, we are staffed to enable us to do deals as small as $15 million. That's been the hallmark of NGP since we started." NGP currently manages more than $7.2 billion of investments, placing private equity in E&P, midstream and oilfield-service companies.

An affiliate of Irving, Texas-based NGP Energy Capital Management LLC, it is a $9.3-billion energy investment firm. Earlier this year, NGP closed its Natural Gas Partners IX LP private-capital fund with total commitments of $4 billion on February 29, 2008, primarily with existing investors, "although we were able to make room for some new investors," says Hersh. The fund's investors include foundations, endowments and pension funds.

NGP has already committed $1.1 billion of

Opposite, sun shines on the HRM Resources LLC's Box Elder Farms #32-20 gas well in Adams County, Colorado.

"We don't drown out the company's contribution with our equity. The management team should own more of the company," says Ken Hersh, NGP Energy Capital Management's chief executive.

Jonathan Farber, Lime Rock Partners' managing director, says, "We look at every deal with a clean sheet of paper, which leads us to be more creative and a little contrarian."

NGP IX to 18 companies. Five of them are Canada-based, two are European and the rest are U.S.-based. About 40% of the portfolio companies were backed in a prior NGP fund.

"That's one of our hallmarks—that we do a lot of repeat business," says Hersh. "It seems we are so well regarded in the way we work with management teams, and how successful our partnership is, that once the initial company is sold, the team starts a new company and again works with us."

When the ninth fund is fully committed, Hersh expects it to be spread over 30 to 35 companies, half of which have been prior NGP clients.

"We had to cap this fund at $4 billion," he says. "That's a factor of what we think our profile is, on how many companies we can start small, and how many companies we are backing for the second or third time that can take larger amounts of money. Also, many of those come back for follow-on investments because they find bigger deals along the way."

NGP's ninth fund is significantly larger than its eighth, which was capped at $1.3 billion in 2005. Its funds I through V are exited, Fund VI has a few positions left, and funds VII and VIII are just starting to see exits.

The firm boasts an impressive track record of compounded capital, some 33% through realized returns, for 20 years. "It's been a lot of work, and a lot of fun, and there has been a lot of volatility in this sector. Sometimes we've had the wind at our back, and sometimes it has been squarely in our face," Hersh says.

And there is risk as well. "Geology doesn't care about commodity prices. A dry hole is still a dry hole, whether it's at high or low prices. Service companies now have even more pressure to do things better, faster, cheaper. There are unique challenges working in a high-price environment," Hersh says, adding that NGP ensures its projects can work at $70 oil and $7 gas.

Also, it's important for capital providers to be able to distinguish between "who are the winners and who are just playing the game," he says. NGP identifies up-and-coming industry executives looking for early equity backing.

"We don't drown out the company's contribution with our equity. The management team should own more of the company. We've found that small deals with great people tend to do well. The equity incentive is more powerful than just 'having a job,'" says Hersh. "If someone owns at least 10% of the company, he thinks like an owner—acts like an owner—and that's the best measure we have for success."

Also, as management teams find larger transactions that need further capital, NGP is ultimately able to get more capital to work. NGP can do deals as large as $500 million, but always strives to align its interests with owners and managers.

"This is a formula that we have developed over 20 years. We've had top-percentile returns and outperformance in all sectors of private equity, and the fact that it is being copied by others gives us affirmation as well."

Creative deal-making

Lime Rock Partners, founded in 1998, prides itself on being different as well.

"We are a little different in that we don't have a formulaic approach to investing," says Jonathan Farber, managing director.

"We look at every deal with a clean sheet of paper, which leads us to be more creative and a little contrarian."

Lime Rock, based in Connecticut, has $3.5 billion under management.

In 2007, Lime Rock Partners' Aberdeen-based investment team was named "Deal-Making Team of the Year" in a Scottish Business Insider's "Deals & Dealmakers" awards program. At the ceremony, a judge highlighted the Lime Rock Partners team's "very entrepreneurial and creative deal-making" and noted the significant equity stakes taken by its decision against charging transaction fees.

Above, a sign on gas compression equipment warns of hot pipes. Opposite, a new gas compressor arrives for installation at HRM Resources' Kallsen #1-10 & 14-10X well location in Adams County, Colorado.

Lime Rock only invests in energy, and mostly in smaller enterprises. Its investment portfolio is split between E&Ps and energy-service technology companies, making $25- to $150-million growth-equity investments.

While the company is not into alternative energy in any substantial way, it did invest in Acteon Group, a U.K.-based company with a segment that provides engineering services to offshore wind farms.

Also in the U.K., Lime Rock and its partners acquired PSL, which at the time was in receivership, and formed PSL Energy Services, a provider of innovative solutions for wells, process and pipeline services to the global oil and gas industry. Lime Rock helped Aberdeen-based PSL management grow the company rapidly. PSL both captured opportunities in its core North Sea market and aggressively expanded operations in the Caspian, Middle East, North Africa, U.S. and Asia-Pacific. Lime Rock Partners made two follow-on investments in PSL and sourced another undisclosed, but key, acquisition for the company. PSL became a leading oilfield-service provider with more than 1,100 employees. Last year, Lime Rock sold it to Houston-based Halliburton Co. in an all-cash transaction for an undisclosed price.

In May, Lime Rock closed its latest fund, Lime Rock Partners V LP, at $1.4 billion, funded by endowments, foundations, public and state pension funds and high-net-worth individuals.

"The vast majority of our investments are in private companies," he says. "We do have the ability to invest in or buy public companies, but we find that the best opportunities have typically been in private companies."

Small placements

Another private-equity provider with small-placement opportunities is Dallas-based CIC Partners LP, with some $350 million under management.

CIC purposefully places smaller amounts of capital with each producer. "For the explorationist who really wants to feel that it is his company, he owns a bigger piece of the pie with us having a smaller amount of capital invested, than he might with a larger fund that needs to put $50 million to work in an individual transaction," says Marshall Payne, head of CIC's energy-investment practice.

"We have to work a lot harder to grow a smaller capital base, but the returns can be spectacular for us and our producer partner. There is a cornucopia of funding opportunity out there for these management teams, from one end of the spectrum to the other."

Founded in April 2004, CIC Partners LP is the successor to an investment practice managed for Cardinal Investment Co.'s private-equity group. Cardinal Investment was a partnership of Payne, one of the four partners of CIC, and Rusty Rose, a well-known industry short-seller.

Above, Marshall Payne, head of CIC Partners' energy-investment practice, says, "There is a cornucopia of funding opportunity out there for these management teams, from one end of the spectrum to the other." Above left, Terry Pape, managing partner of HRM Resources, checks a flow-rate meter at the Tipperary #1 & 34-8 gas well. Opposite, HRM Resources' gas wells in rural residential subdivisions are fenced for safety and to blend into the environment.

(Cardinal Investment was not the only Payne-Rose collaboration. At one time, Payne and Rose co-owned the Texas Rangers baseball team, along with President George W. Bush, who was the Rangers' managing general partner until he was elected governor of Texas in 1994.)

After leaving Cardinal Investment, Payne and his three partners, Mike Rawlings, Drew Johnson and Fouad Bashour, formed CIC Partners and raised its first fund, the $55-million CIC I. In 2006, the firm opened CIC II, a $165-million fund that closed at the beginning of 2007 with 35 investors. To date, about half of the committed investments from that fund are in upstream energy.

"We also have a $115-million sidecar fund we call CIC Flex, which, along with CIC II, allows us to do large transactions as well," says Payne.

"The bulk of our capital is from high-net-worth individuals. But we look for more than just net worth. All of these guys are also successful operators and have earned their net worth on their own."

Notable limited partners include T. Boone Pickens, Casey McManemin (chief executive of Dorchester Minerals) and George Kaiser (founder of BOK Financial, Kaiser-Francis Oil Co. and Bank of Oklahoma).

"Our firm's partners represent about 20% of the fund, which is unusual in our business," says Payne. "We are highly invested in our own activities."

CIC's goal is to get back three to four times investment capital within a five-year window, and get an internal rate of return of 40%. CIC views fund exits as opportunities and will hold an investment longer than five years if it continues to grow.

"We focus on great explorationists for our placements—those who have proven track

Kyle Miller, Energy Spectrum vice president, says that, from the outset, Energy Trust Partners has been focused on funding drilling-oriented growth strategies for small independents.

"We embarked on a specific strategy in Canada when the Canadians changed their tax laws related to income trusts on October 31, 2006," says Carl Tricoli, managing partner for Denham Capital Management.

records of finding low-cost energy reserves through the drillbit," says Payne. "Also, we look for smaller transactions because that's where we find good returns."

CIC recently placed a total of $25 million among Dale Gas Partners II LP and Schuepbach Energy, both based in Dallas, and Castex Energy based in Houston, all of which "have that track record," says Payne.

Dale Gas Partners, one of the early pioneers of the Barnett shale in eastern Tarrant County, Texas, has grown from $5 million in invested capital to more than $100 million in distributions to CIC, Dale Gas and its partners.

Third fund

Since 1996, Dallas-based Energy Spectrum Capital has raised five midstream and oilfield-service investment funds. In 2002, the firm joined Energy Trust LLC in New York to form Energy Trust Partners, a fund devoted exclusively to E&P.

From the outset, Energy Trust Partners has focused on funding drilling-oriented growth strategies for small independents. The firm invests in both start-ups and existing independents that grow oil and gas reserves in areas in which management has both prior experience and proven expertise.

"We just finished raising our third E&P fund, called ETP III, from mostly institutional investors, including several large corporate pension funds. We closed the fund at $450 million," says Kyle Miller, vice president. "Our strategy is to invest anywhere from $25- to $75-plus million in eight to 12 private E&Ps with an emphasis on growth through the drillbit."

Energy Trust Partners I (ETP I) was formed in 2002 with $112 million of equity capital, followed by ETP II in 2005 with $303 million and ETP III this year. Commitments are typically placed over a three- to five-year period and the average lifespan of each fund ranges up to nine years.

The majority of the investments in ETP I have been successfully monetized and the investments in ETP II are in various stages of development. One investment in ETP II is Keystone Petroleum LP, located in Dallas.

"We formed Keystone in 2006 with Dick Frazier, Earl Krieg, John McRae and several private investors," says Miller. "Keystone's primary drilling activity is focused in the Wolfberry play in West Texas, where it has assembled a significant leasehold position. To date, results have been very encouraging."

Meanwhile, Miller and partners have made three investments from ETP III so far this year.

The first was with Lake Ronel Oil Co. based in Tyler, Texas. The company develops and drills seismically generated prospects along the Texas Gulf Coast. It has acquired a significant 3-D seismic database and considerable drilling expertise in the area.

As part of its deal with ETP, Lake Ronel contributed an inventory of primarily Hackberry and Yegua prospects into a new entity co-owned with ETP III called Lake Ronel Energy Partners LLC.

Another investment was a partnership with Bill Bergman of Chi Energy Inc. of Midland, Texas. "Chi has been around since 1983," says Miller. "They have been very active in southeastern New Mexico and more recently in the Texas Panhandle, and have developed a solid reputation as an operator in both areas."

The company historically funded its development through industry partners, but was looking for an equity partner to expand its operations, he says.

ETP and Bergman formed Chi Partners in July. ETP chose Bergman and his management team because of their strong track record, industry reputation and ability to identify and execute low- to medium-risk drilling opportunities in multiple basins. For the deal, Chi contributed existing production and leaseholds associated with drilling prospects in eight project areas. ETP contributed an initial $26 million to provide drilling capital for existing projects and new prospects to be generated during the next two years. The existing projects include several multi-well developments.

The third ETP III investment is a San Antonio-based independent. Formed in July, it focuses on operated gas plays in South Texas.

Canadian strategy

Denham Capital Management LP, a global private-equity firm focused on the energy sector, recently closed its Denham Commodity Partners Fund V LP at $2 billion, exceeding its $1.75-billion targeted commitment. The limited partners of Denham Capital's Fund V, over 90% of which participated in its previous funds, include primarily well-established endowments, foundations and similar institutions as well as high-net-worth individuals. This fund brings the amount of capital under Denham management to some $4.3 billion.

Denham Capital usually places $50- to $200 million per investment in E&Ps, midstream and oilfield services.

"Denham has significant investments and commitments in the oil and gas sector," says Carl Tricoli, managing partner in the Houston office. "We have four E&Ps and eight midstream and services companies in our portfolio." The E&P group includes Fairborne Energy Ltd. and MEG Energy, an oil-sands developer, both based in Calgary.

Fairborne was formed in December 2007 when Fairborne Energy Trust was converted into a growth-oriented E&P company by issuing 13.4 million common shares to Denham Commodity Partners Fund IV LP. At a subscription price of C$7.45 per share, Denham invested about $120 million, and Fairborne listed on the Toronto Stock Exchange as FEL. (All figures in this article are in U.S. dollars unless otherwise noted.)

A rural Colorado mailbox mounted on an old plow near a gas pipeline stands ready to receive a check from private capital providers.

Fairborne now has production across central and western Alberta and in southeastern Saskatchewan, including two operated rigs in the Harlech area, one in Brazeau Belly River Unit, and is participating in one nonoperated well in the Deep Basin. In addition, completion operations are under way on two wells in Harlech—one well in the Peace River Arch and one in Deep Basin. At the end of 2007, its production was approximately 13,250 barrels of oil equivalent per day.

"We embarked on a specific strategy in Canada when the Canadians changed their tax laws related to income trusts in 2006," says Tricoli. The Canadian government proposal, which would later be adopted by the legislature, was issued in a frightful surprise on Halloween Day that year.

"We had a specific investment thesis that the Halloween surprise would create opportunities as certain pools of capital were no longer available to the trusts. We spent nine months talking to Canadian producers and chose Fairborne because its objectives, such as growing through the drillbit, are closely aligned with ours."

Privately held MEG Energy Corp., also based in Calgary, is focused on developing oil sands in the southern Athabasca region of Alberta. Denham is also invested in two Houston-based oilfield-service companies—Greene's Energy Group and Tanner Cos.

Denham is expanding globally by opening offices in London and São Paulo, Brazil. "Anyone in the energy business looking for capital outside the U.S. is generally going to do that in London," says Tricoli. "Latin America is also a big focus for us. We have investments in Trinidad, Colombia and Brazil. We've been spending a lot of time evaluating opportunities there."

Close-knit group

Kayne Anderson Capital Advisors LP, based in Los Angeles, is managed by a close-knit group of professionals who have known each other for years. It manages more than $9 billion in assets.

"One of the unique things about us is that, while we have 10 people in this energy group and are going to add two more, we've never hired anyone off a resume," says Danny Weingeist, co-managing partner of Kayne Anderson Energy Funds and based in Houston. "We've all either known each other or worked with each other, and we've never had anyone leave."

Of the $9 billion Kayne Anderson manages, roughly 75% is energy related. It raised its first private-equity fund in 1998.

KA Energy Funds, a division of Kayne Anderson, is based in Los Angeles and Houston. It manages more than $1.85 billion in private-equity energy investments. Its investors include endowments, foundations, public funds and pension plans, and high-net-worth individuals.

Target investment size is generally $25- to $150 million, and its investment professionals typically take a majority position on the portfolio company's board. Although this range rep-

Far left: Danny Weingeist, co-managing partner for Kayne Anderson Energy Funds, says, "It's difficult for a private-equity firm to get into some of the resource shale plays." As equity continues to flow unabated into energy, there has been an opportunity-shift in the industry, notes S. Wil VanLoh, center, co-founder and managing partner of Quantum Energy Partners. "Capital will flow to energy as long as energy prices stay robust and investors continue to see positive rates of return," says Jeffrey Harris, above right, managing director of energy for Warburg Pincus LLC.

resents KA Energy Funds' typical deal size, it is not restricted from making larger investments. About 80% to 90% of each fund is invested in upstream companies, with the remainder invested in midstream and oilfield services.

"The placements are larger than they have been in the past because, five years ago, a 1,000-barrel-per-day E&P might have been worth $30- to $40 million. Now, it may be worth $100 million due to commodity prices," he says.

KA Energy funds typically have a 10-year maturity. The strategy is to pursue investments for the first three to five years, grow those investments and then start exiting during the next seven years.

Recently, KA Energy invested in Denver-based HRM Resources. The E&P, formed less than a year ago, has some 27,000 acres with gas production and reserves."The management team has been successful before in the same area and recently acquired about $8 million of undermanaged property from a publicly traded E&P. We expect them to double production and reserves during the next six months," says Weingeist.

This past February, KA Energy invested in the service sector through its commitment to Energy Contractors LLC, a Bridgeport, West Virginia, company focused in the Appalachian Basin. The company provides rig mobilization, fluid management, tank rentals and well services to drillers.

"This transaction represents a great opportunity, in that it not only allows us to back an impressive management team in the service sector, but also provides exposure to the Marcellus shale play without incurring high leasehold prices," he says.

"It's difficult for a private-equity firm to get into some of the resource shale plays. It is hard to justify leasehold costs of $25,000 an acre for firms in our position. So, a different way to gain exposure to these resource plays is to invest in service and midstream companies that operate in these areas."

Future capital sources

Going forward, there continues to be a tremendous amount of equity capital lined up from a number of funds that are looking for a home in the energy business.

"From the private side, there is ample equity and mezzanine capital, ready to be put to work," says S. Wil VanLoh Jr., president and chief executive of Houston-based Quantum Energy Partners, which this year marks its 10th anniversary.

Quantum seeks U.S. and Canadian E&Ps that target reserve growth through acquisition, exploitation and exploration, as well as midstream and oilfield-service companies. With $4.7 billion of capital under management, Quantum places investments in $50- to $500-million increments, prefers to have a 51%- to 95%-ownership position and requires board representation. Its average investment duration is three to seven years.

Jeffrey Harris, New York-based managing director of energy for Warburg Pincus LLC, agrees. Warburg Pincus, a private-capital provider with more than 40 years experience, has invested almost $30 billion in more than 600 companies in 30 countries around the world. In 2005, the firm launched its 100th IPO from among its portfolio companies.

At left and facing page: Dave Gammel, a swabbing rig operator for Brighton, Colorado-based D.J. R Well Service, shows American pride as he works on HRM Resources' Wagner #41-10 well in Adams County.

"There is no reason but to believe that private capital will continue to increase in dollar amounts and expand in number of funds or sources," says Cameron O. Smith, New York-based senior managing director of The Rodman Energy Group.

"There is an abundance of all types of capital available to the energy industry. I think it will only get bigger as long as hydrocarbon prices stay robust and as long as investors continue to see positive rates of return from their prior investments," says Harris. The capital will come from mutual funds, insurance companies, pension and endowment funds, and the vehicles through which they invest, including hedge funds, which have made a lot of money in this asset class during the past few years, he says.

While energy capital, in the past decade, has progressively come from private-equity funds, there "is no reason but to believe that will continue to increase in dollar amounts and expand in number of funds or sources," says Cameron O. Smith, New York-based senior managing director of The Rodman Energy Group.

"We are also seeing increasing interest from institutions looking to invest directly in the energy business as a hedge against their energy costs, as well as individuals and home offices looking to add energy to their portfolios," he says.

Meanwhile, it's no secret that investment-transaction sizes are getting larger because capital funds are growing in size. "A $5-billion fund's smallest deal is probably no less than $300 million," says Smith.

Also, a look at where the money is going now gives an indication of where it will go in the next few years. Some fund managers will continue to keep their investments close to home, while others look to international playgrounds.

Warburg Pincus, for example, deliberately maintains global energy investments.

"We have investments in Canada, such as in MEG Energy Corp., a Calgary-based private oil-sands company first brought to us by Cameron Smith and in which we've been involved now for four years," says Harris. MEG has interests in the Christina Lake and Surmont oil-sands projects and in the Access and Edmonton diluent pipelines.

Recently, Warburg led a $500-million syndicated private investment in Kosmos Energy LLC, based in Dallas, which will use the equity to finance ongoing oil and gas exploration, appraisal and development activities for its West Africa assets, including the first-phase development of its Jubilee Field. Jubilee is a significant oil discovery offshore Ghana. (For more on this, see "Kosmos and Jubilee Field" in this issue.)

Warburg Pincus also has a substantial investment in Fairfield Energy Ltd., a London-based E&P focused on blocks in the Maureen and Crawford fields in the central and northern North Sea.

Alternatives investments are still in play as well. Warburg Pincus invests in solar, wind and others such as Ceres Inc. Ceres, a plant-genomics biotechnology company, based in Thousand Oaks, California, develops proprietary seeds for energy crops to be used as feedstock in cellulosic ethanol production. Warburg Pincus plans to continue to invest in energy-focused technologies.

Quantum's VanLoh says, "Historically, private-equity investors invest in hard assets like producing properties, midstream assets or a service company, where there is an existing revenue stream. It takes a venture-capital fund manager's different skillset to invest in this kind of risk profile and analyze these new types of technologies."

Most of Quantum's funds shy away from alternatives, with the possible exception of wind energy, he says.

VanLoh says that, as equity continues to flow unabated into energy, there has been an opportunity shift in the industry. In the past, many private-equity groups backed acquire-and-exploit companies from which the cash flow was known and the risks were smaller. Now, capital is backing more leasing and drilling business models.

"The number of teams looking for capital has never been greater, while on the whole, the qualifications of these teams have never been less," says VanLoh. "So while we are very excited about the opportunities to put capital to work with some of the exceptional teams seeking financing, we are also very cautious."

Also, start-ups are getting a lot of capital, he says. "That's a model that many private-equity funds have used very successfully. They back a team that they may have backed in the past.

"Because energy assets are so liquid, it is very easy to get some capital, buy some assets, drill some assets, build up a company and sell those assets, and then start over. A lot of private capital will continue to be available for start-up companies." □