PRIVCAP CONVERSATIONS/

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Power Partnerships

Insight into private equity's investments in energy operating companies and entrepreneurs

With Expert Commentary From:

- RSM LLP
- EnCap Investments
- PennEnergy Resources

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–Richard Weber, PennEnergy Resources

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Oil and Gas in Their DNA

Entrepreneurs who have found success in the oil and gas sector continue to invest in the space, because they understand the process, says **RSM** tax partner **Charles Clines.** But they have had to adapt to shifting capital structures.

Charles Clines, RSM

Those who successfully invested in the oil and gas sectors early on are using their personal capital to fund new opportunities.

This is according to Charles Clines, a tax partner in RSM LLP's Houston office, with 30 years of experience in the investment services industry. "The longer the family history is in oil and gas, the more they believe in the industry," he says. "They understand oil and gas. It's part of their DNA."

Clines says that RSM has worked with clients on deals where an E&P company will approach the client to negotiate a drilling program on their land. In the past, the landowner would take only a royalty interest, and now more clients are willing to participate with the E&P company on a working interest basis. The third-party capital will be used for the first portion of exploration and production activity, for example, and then the landowner will "put his capital to work on a side-by-side basis.

The capital structures used for these sorts of investments have shifted in recent years. In the past, Clines says, if a company was coming in to work a deal, the promoter or operator received the financial benefits along with the owner of the property where the minerals were produced. There weren't a lot of management fees and if the play on the property did well, everyone did well on a side-by-side basis.

Now, Clines says, those structures are more private equity-like, with participation on the upside along with management fees and other financial benefits to the promoter.

The main question he fields questions about from oil and gas entrepreneurs is about management teams. "That is what investors are really looking for," Clines says. "Entrepreneurs are asking, time and time again, 'Who is the management? Who is driving the show?' They want to know if the team has a track record."

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Generally, in a private equity deal, a firm will invest in a business and bring in a management team they have worked with in the past, but Clines says this traditionally hasn't happened in the exploration side of oil and gas investment. Now, in areas such as the Eagle Ford shale formation in south Texas, the size of the opportunity, and therefore amount of capital committed there, means "we are seeing a lot of people focus on the quality of management."

The deal market has become incredibly competitive, he says, and there's increasingly significant capital at work. In addition to this, dealing with landowners has become trickier for those management teams.

"Small missteps can have big consequences," Clines says. "Landowners are a lot more savvy about the deals they're entering into. They're not as quick to cede all control to the driller." ■

Videos

1. How EnCap Partnered with PennEnergy
2. How Energy GPs Build Platforms

Drilling Down into Energy Partnerships

Leaders from shale development company **PennEnergy Resources** and its backer **EnCap Investments** tell Privcap about how they partnered to build a business

RIchard Weber
Chairman, CEO
PennEnergy Resources

Bio

Richard Weber is chairman and CEO of PennEnergy and was previously president and CEO of Atlas Energy until the company was sold to Chevron in 2011. Prior to joining Atlas in 2006, he worked at McDonald & Company Securities for 14 years. He has also worked for First Chicago Venture Capital and NBD Bancorp. He received a degree from Ohio's Miami University and an MBA from Tulane University.

Jason DeLorenzo
Partner
EnCap Investments

Bio

Jason DeLorenzo is a partner at EnCap, joining the firm in 1999 after spending four years at ING Barings' corporate finance business, focusing on energy. He previously worked as an associate at Wells Fargo Bank's energy group. He received a degree from the University of Texas at Austin.

Privcap: We're here to learn about the relationship that exists between private equity firms and the energy operating companies they invest in. Rich, can you tell us about the relationship between PennEnergy and EnCap?

Richard Weber, PennEnergy Resources: EnCap is our lead equity sponsor. It really has provided the financial backing that allows our company to exist. We're a company focused primarily in the Marcellus shale opportunity in Pennsylvania, as well as the Upper Devonian shale opportunities and, to a lesser extent, the Utica.

And it's roughly a $300M commitment?

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—Jason DeLorenzo, EnCap Investments

Jason DeLorenzo, EnCap Investments: That's accurate. Rich and I go back to 1996; he was in banking for about 18 years before he became president of Atlas Energy, which was a publicly traded company focused on the Marcellus shale that sold to Chevron for about $4.2B.

We watched Rich and his leadership of the company and the team he assembled in that play and the success they had. EnCap looks for guys who have a lot of industry experience, a lot of great relationships in the industry where they can put together a comprehensive team that covers all the disciplines from the engineering, geology, land, finance side, and put together a comprehensive team and business plan that we believe will succeed over the long term.

From your firm's point of view, what does deal flow look like? When you're meeting with teams of potential partners, what are the important characteristics that they need to show in order for your firm to agree to give them financial backing?

DeLorenzo: We see a lot of management teams; we are very selective and probably back two to three per year. In this environment, to get into plays with attractive economics, it comes down to being able to evaluate an area that you want to get into, then having the deal and skill set to actually get into that play in an economic way. It can be through acquisition; it could be through partnering in a JV with an existing operator.

These days it's all about execution, which means turning this land into producing reserves and cash flow. We're at the beginning stages of that with PennEnergy. Other guys are drilling wells and hooking up wet gas and dry gas into the pipeline systems and creating revenue and cash flow. So it's really about the team with a strong leader.

Rich, can you talk a bit more about why private equity made sense as a partner, and why EnCap?

Weber: Private equity is long-term focused, and when you're starting a company, you need to have a plan, a vision. This is a process that takes a few years to realize. My partner and I said there's still room for us to build another company, particularly in the Marcellus shale, and we started thinking about who we would partner with. I heard from EnCap quickly. We talked to several other big private equity providers, and we had some criteria. Size mattered.

This is a business that takes a lot of capital, so we needed scale. We wanted a firm that had expertise and experience. It's more than just the money. We also wanted people that shared our same values. Greg [Muse, PennEnergy president and COO]and I were very deliberate about establishing a value set for this company. We wanted people that share those.

And as a portfolio company, you really take a leap of faith that your equity sponsor is going to follow through with the commitments they make to you.

How important is the plan and the target assets when a proposal is presented to your firm? How much time do you spend looking at the land and even the science behind the plan to get the energy turned into cash flow?

DeLorenzo: We're trying to be in a top-tier economic area. In today's world, on the gas side, that's the Marcellus and the Utica shale. PennEnergy is trying to create an opportunity set that one day somebody larger—a public company, usually—will want to buy. Or alternatively, we could take the company public. So in order to achieve those goals, you need to be in an area that produces top economic returns regardless of the commodity price cycle. Oil and gas are volatile commodities; prices will go up and down.

What are some important aspects to get right in structuring a long-term partnership with an operating group?

Weber: The arrangement we have with EnCap really does align us along the same interests. That's one thing we were attracted to. Greg and I wanted to build a company to sell. It's not impossible that we could go public, but our real focus is to sell the company. The arrangement that we have requires Greg and I to put up our own capital, which we understand and are glad to do. It also aligns us, in that if we are able to generate attractive returns to EnCap and its partners, we can share in some of that upside. That's highly motivating.

Can you talk about how the capital initially gets deployed, and the communications that both of you have as you decide to deploy further capital?

DeLorenzo: The $300M commitment initially went towards covering overhead and building up the staff of the company to succeed in the future while they went out and found transactions to acquire and/or lease. So as they come to the board, and as they have opportunities to deploy capital that fits with the business plan we've

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Richard Weber, PennEnergy Resources, Jason DeLorenzo, EnCap Investments

all agreed on, we advance the capital.

PennEnergy came up with a pretty sizable transaction in the first year. So we went out and acquired some land, and it was roughly a $100M transaction. We're still in a position where we have a lot of capital left on the $300M commitment to support a drilling program.

Rich, can you talk about the kind of communication that takes place between you and EnCap as you're building your business?

Weber: We try to be as transparent as possible with what's going on with the business, where we're planning to take the business. We believe that transparency ensures we get the best advice and coaching from the guys at EnCap, and we set up expectations so there's an anticipation of how we're building the business. We have formal board meetings, but there are many more conversations in person and over the phone.

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And what are some of the key metrics?

DeLorenzo: You buy something and have a pre-drill estimate of what the rates of return will look like—in other words, what it'll cost to drill a well, what kind of reserves will come out of the ground, and what kind of cash flow it will generate. Then, as we drill wells and see the actual performance versus the pre-drill estimate, we make decisions to potentially deploy more capital. Alternatively, there are situations where the rates of return or the drilling program present some challenges. In those instances, which we have not had at PennEnergy, you try to bring in a partner; you try to bring in some alternative source of capital to diversify risk. You deploy capital elsewhere in a known area.

For a well or a project that is generating revenue, what do you do with that capital? Is it put back into the business?

DeLorenzo: We are growth equity at EnCap. We're starting with a management team and a business plan and no assets, and we're trying to grow an opportunity set that will be attractive one day in the sale market. So in this growth equity phase, you are constantly feeding the company capital early—in later stages, some moderate amount of debt—but you're always reinvesting that cash flow to develop the growth of the business.

Where's PennEnergy as a project now? What percentage of the capital has been deployed, and are there any big milestones that are coming up?

Weber: We're well along the way towards a successful enterprise. We're moving towards our execution phase in terms of development. It's our desire to have an asset that is fairly substantial in scale but where we have de-risked and essentially proven the acreage from a development standpoint and, importantly, built the infrastructure to allow a buyer of a company to accelerate development, which is important in getting value. ■