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CAPITAL SOURCES

THE MEZZANINE MALL

Increasingly, more mezzanine-capital providers are pouring into the E&P space to help smaller operators climb the growth curve.

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With so many upstream start-ups being spawned these days by seasoned management teams coming out of larger consolidated E&P companies, a growing number of mezzanine-capital providers are popping up all over the oil patch to help these entrepreneurial managements move up the growth curve.

The opportunity these capital providers see: in a world of \$80 oil and \$6 to \$7 gas, once uneconomic oil and gas plays have now become wildly economic for seasoned E&P managements that understand how to enhance discarded niche plays, yet lack the aggressive, but affordable, funding needed to rejuvenate those plays.

Sure, these cycle-tested upstream management teams could tap available bank credit. But the advance ratios traditional lenders offer—mainly tied to proved developed producing (PDP) reserves—just aren't enough to accelerate drilling programs and rapid production growth. On the other hand, the private-equity markets, although wide open, often demand too great a participation in an operator's equity stake.

The middle ground that's thus becoming more attractive to smaller operators is mezzanine money—loans with equity kickers—where the returns being sought by such capital providers generally tend to fall more in the mid- to high teens.

Among the relatively newer players in this niche financing arena is the West Coast Opportunity Fund LLC.

Bullish outlook

A money-management firm with assets under management today of about \$500 million, Ventura, California-based West Coast

Asset Management Inc. decided in early 2006 to take advantage of mezzanine-oriented financings within the energy space. The reason: the risk/reward ratio was compelling.

The result: West Coast Opportunity Fund LLC, a then-\$35-million mezzanine-oriented fund focused on a variety of industries. Today, that fund is approaching \$100 million, with 75% if its assets invested in the energy sector.

"Simply due to supply and demand fundamentals—we're very bullish on oil prices and are comfortable that natural gas prices will stay much higher than they have historically—a lot of previously economic upstream projects have now become very economic," says Atticus Lowe, chief investment officer and a principal of West Coast Asset Management.

This has created the opportunity for a lot of small producers with proven management teams to complete attractive acquisitions and pursue growth opportunities, he notes.

"We're thus working closely with small producers that are either public or soon to be public and in need of \$5- to \$15 million of capital—a range not efficiently available from the capital markets—to fund those growth opportunities."

Lowe says the firm's mezzanine fund is willing to provide capital in the form of debt or convertible preferred stock, with significant equity kickers in the form of warrants and common stock.

Typically, he says, the coupon on the debt component will range from 5% to 15%—depending on the safety of the investment and an energy client's willingness to compromise on the equity kicker. "Thus, the greater the equity-kicker component, the lower the coupon in the mezzanine transaction and vice versa."



West Coast Asset Management's Atticus Lowe says the firm's mezzanine-oriented West Coast Opportunity Fund LLC has grown from \$35 million in 2006 to nearly \$100 million, with 10 private investments structured to date.

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Case in point: Canadian Superior Energy (Toronto, Amex: SNG). Although the Calgary-based producer has significant assets in Western Canada and a good amount of cash flow, the operator in early 2006 still needed a small amount of capital to pursue drilling three very high-impact gas wells offshore Trinidad—the multitrillion-cubic-foot variety.

Enter West Coast Opportunity Fund. In February 2006, the fund proposed to Canadian Superior a \$15-million convertible preferred-stock financing with warrants. Specifically, the convertible was just like a bond with a five-year maturity date, convertible at \$2.50 per share at the option of West Coast. In addition, the fund received as part of the financing 1.2 million warrants, good for three years, with a strike price of \$3.

Says Lowe, “If the company is successful in Trinidad, we potentially could make 10 times our investment; on the other hand, if it isn’t successful, we would get back our money and still earn 5.75% interest.”

Another example: PRB Energy Inc. (Amex: PRB). Founded as a midstream company with pipeline operations in Wyoming’s Powder River Basin, PRB decided near the end of 2006 to enter the E&P sector through Anadarko’s divestment of upstream assets in Colorado’s Denver-Julesburg Basin, which included 380,000 undeveloped acres and 200 identified drilling

locations. The cost to PRB, after a 10% down payment: \$11.7 million.

In this case, the West Coast Opportunity Fund, along with another mezzanine player, completed a \$15-million financing that involved a senior, secured debt component, secured by the majority of PRB’s existing assets and those it was acquiring. The debt has a term of 18 months and a 13% coupon. The equity kicker: \$4.5 million of PRB’s common stock.

More recently, this past June, EnerJex Resources Inc. (OTCBB: EJXR), a small Kansas City-based producer, availed itself of a smaller West Coast financing. Seeking to extract oil from old, once uneconomic, oil fields throughout Kansas by means of secondary recovery efforts, the operator entered a transaction with the West Coast fund and four other investors.

The overall financing totaled \$9 million, of which West Coast put up \$5 million. The deal’s structure: senior debt, secured by all the assets of EnerJex, with a 10% coupon. The equity kicker: 9 million shares of the producer’s stock. (For more on EnerJex, see “Upstream Microcaps,” *Oil and Gas Investor*, October 2007.)

Says Lowe, “We believe there are hundreds of millions of barrels of oil that can be economically extracted from old fields like these through secondary recovery efforts, particularly with oil prices where they are today—and even at \$40 to \$50 oil.”

He adds, “There are more opportunities out there than capital in the mezzanine space.”