CAPITAL OPTIONS

PUTTING MONEY TO WORK

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PRIVATE DEBT

Tailoring Credit For Best Fit

As access to traditional capital sources is less certain, private credit has an increasing role to play.

By Chris Sheehan, CFA

Even as some companies move up in scale, helped by "manufacturing mode" operations and easy access to public market financing, the reality is that not all E&Ps are so fortunate. To achieve their operational and strategic goals, many energy companies face specific challenges that go beyond the scope of conventional financial instruments. Where cookie-cutter plans won't suffice, customized strategies and solutions might.

Private credit has become a more important source of funds for a variety of sectors in North America. According to a Preqin report released in February, funds raised by North America's largest private debt fund managers (as measured by total capital raised during the past 10 years) came to more than $200 billion. This very broad survey includes all economic sectors, including infrastructure, noted one observer.

But the trend also indicates where private credit is being deployed in energy companies both large and small. Fund managers and other private equity-providers of energy are delivering an increasingly broad array of financial instruments such as debt (first- and second-lien, subordinated notes, etc.),

EXAMPLES OF A DRILLCO

PRE-REVERSION STRUCTURE	
Operator	Capital Provider
0%-25% D&C	75%-100% D&C
10%-45% WI	55%-90% WI
AMI 15-30 wells	
POST-REVERSION STRUCTURE	
Operator	Capital Provider
75%-90% WI	10%-25% WI
AMI 15-30 wells	

Source: Benefit Street Partners

preferred issues (straight and convertible), mezzanine debt and other financial vehicles, such as DrillCos.

"Private credit is no longer viewed as an 'alternative' source of capital for the energy industry," said Robert Horn, co-head of GSO Capital Partners LP, the credit investment arm of The Blackstone Group. "It has become a core vehicle for energy markets to fund their operations, which is a big change over the last 10 years."

GSO has committed more than $10 billion to the private credit energy market since its inception in 2005, placing it among the most active providers of private credit in its space. With offices in Houston and New York, GSO's energy business is led by co-heads Horn and Michael Zawadzki.

"A lot of our business is financing entrepreneurs and private companies to help fill the gap between equity and bank debt," said Robert Horn, co-head of GSO's energy business.

Private capital trends

The capital needs of today's energy markets "in many cases don't fit the cookie-cutter approach that the traditional public markets are looking for," observed Zawadzki. "As a result, private capital has built an increasingly relevant place in the energy market, especially if you can commit capital in scale and in flexible structures, as we have at GSO."

The growing role of private credit reflects in part the changing trends in current energy capital markets.

"Traditional sources of capital are generally pulling back from the sector," Horn said. "Common equity and initial public offering [IPO] issuance for the E&P and master limited partnership [MLP] sectors have recently been significantly less active. In addition, banks and public credit markets are cautious."

These trends are magnified given the "highly capital-intensive" character of the energy sector, Zawadzki said. With fewer traditional capital sources, E&Ps have elected to streamline their portfolios, paring back non-core assets to fund development of key assets. Simultaneously, capital is required to fund companies seeking to grow through acquisitions and more aggressive development of upstream assets, as well as infrastructure projects to transport new sources of hydrocarbons to market.

The upshot has been a demand for new sources of capital that go beyond conventional equity and traditional commercial bank loans on an E&P's balance sheet.

Filling the gap

"A lot of our business is financing entrepreneurs and private companies to help fill the gap between equity and bank debt, and GSO's capital solutions can be complementary to other sources of capital in the market," Horn said.

Historically, the energy business was funded with private or public equity and conforming bank loans. "But with the unconventional business being capital-intensive, the basic liquidity needs of a rapidly growing unconventional asset routinely exceed what banks are seeking to provide," Horn said.

The extent to which current financial trends in banking reflect changes to tighten guidelines issued in 2016 by the Office of the Comptroller of the Currency depends on whom one asks.

"It's not as big a factor as you might think," Horn said. "In our case, GSO provides financing solutions that would not be a fit under a borrowing base revolver model. We may finance undeveloped acreage, for example, or high-growth businesses, or assist a company in improving its credit profile.

"What we have observed today is that the banks are reducing their non-conforming loan exposure and that they will often encourage clients with non-conforming loans to raise alternative capital. This allows the banks to manage their exposure down, providing clients with additional flexibility."

In addition, Horn said, if companies want to tap the high-yield market, they will need to demonstrate a number of factors: assets in a top-tier basin, low leverage, an acceptable free-cash-flow profile and a large high-yield issue—typically $500 million or greater—in order to appeal to public market investors. That's where private credit can step in to fill the gap.

Some examples of past deals Horn cited where private credit was able to offer funding are: a high-growth E&P without much cash flow initially, but the E&P is acquiring an undeveloped asset and developing it; project financing for construction of a midstream asset, where the coupon would be "paid in kind" rather than in cash for the first two years; a delayed draw facility, where a company doesn't need the full facility upfront, but can draw down capital in stages over time to hold down costs; and acquisition financings, where GSO's

capital is committed and financing costs are known, providing certainty to buyer and seller.

In addition, existing GSO portfolios include a large component of what is called "structured equity." This involves "hybrid securities that straddle the fixed income and equity markets," Horn said, and are designed to manage the impact of what otherwise would be an adverse increase in leverage or in equity dilution on a firm's balance sheet following an acquisition.

Competing goals of stakeholders

Using the example of a firm wanting to grow through a transformative acquisition, Horn laid out two competing goals of stakeholders. On the one hand, E&P issuers want to avoid significant traditional leverage, risking existing bank lines if leverage exceeds 3x to 3.5x debt/EBITDA. And on the other hand, issuers are careful to avoid heavy equity dilution by issuing shares, particularly when energy stocks are trading near lows. "We are focused on delivering solutions that offer flexibility and favorable balance sheet treatment similar to equity, with fixed income benefits of credit," Horn said.

As an example, in mid-2017, GSO arranged a $250 million preferred stock issue that enabled an E&P to make an acquisition of almost $650 million, adding a new growth asset. The preferred stock paid dividends of 8.875% per annum, with an option to pay part of the dividend in common stock for three years. The E&P's stock was close to a 52-week low. Its leverage was roughly 3x debt/EBITDA.

"They were looking for ways to complete the acquisition in a manner that managed dilution and managed leverage, and we structured a preferred security to achieve these objectives," Horn recalled.

In setting terms on a transaction, "we don't go into a deal saying we've got to make a certain return," Zawadzki said. "Every situation is different. We look at each individual deal and try to work out what is the best bespoke solution for a company's objectives and the financing they're trying to raise. Then we determine what the appropriate return is for the given risk profile."

Historically, financings by GSO span a range from $100 million to $1 billion. It works "very collaboratively" with both commercial banks and investment banks, according to Horn.

"We work together to develop favorable capital structures for our partners. These often include a bank revolver, offering efficient revolving liquidity, as well as GSO's solution, offering additional capital with customized flexibility," Horn said. "We've always viewed ourselves as partners rather than lenders. We want to partner with great companies and great people."

"The capital needs of today's energy markets in many cases don't fit the cookie-cutter approach that the traditional public markets are looking for," observed Michael Zawadzki, co-head of GSO's energy business.

Shaping solutions, not products

Tailoring solutions to meet specific capital needs is an undertaking with a long history at Prudential Capital Group. As of June 30, its energy finance group had invested more than $18 billion during the past 22 years. Its "new investment appetite" is approximately $1 billion per year, having funded average investments in excess of $1 billion across some 23 companies in each of the last six years.

"Our biggest advantage is our ability to go into companies, almost on a consultative basis, and work with them and give them options," said Brian Thomas, a managing director in Prudential's energy finance group. "Whether it's senior debt, junior, structured preferred, etc., doesn't matter—I'm agnostic. I just need to know that it makes sense for the company as a borrower and for Prudential Capital as an investor.

"We don't sell a product. When we walk into a company, we sit down, we talk about the company's business plan, and how they plan on developing and exploiting their assets," he continued. "Then we sketch out not just a single option based on a single product, but tailor a financing strategy that gives the company the ability to execute its plan without compromising its future."

In addition to being able to draw upon industry knowledge gleaned over decades of experience, being able to speak to more than one form of capital is an advantage in that "it allows you to be objective in your feedback to companies," according to Thomas. After all, he commented, "to a guy with only a hammer, everything looks like a nail, doesn't it?"

Prudential Capital has the capacity and appetite to invest in all levels of the capital structure, according to its recent presentation to the IPAA Private Capital Conference. By using the parent's balance sheet, Thomas said, the energy finance group has the "latitude to craft attractive investments, on a risk adjusted-to-return basis, that are tailored to the specific needs of a company."

Typical investment size varies with asset type. For example, investments in senior secured or unsecured fixed-rate debt may fall into a range of $10 million to $400 million and carry a coupon of 3.5% to 7%. Second lien fixed-rate or floating-rate debt is typically made in investments of $10 million to $100 million and carries a coupon of 7% to 12%.

Mezzanine and equity investments are typically made in a $10 million to $50 million range. Targeted returns for mezzanine are in the "mid- to high teens," comprised of a contractual coupon (8% to 11%) coupled with a kicker in the form of a warrant, overriding royalty interest (ORRI) or net profits interest (NPI).

Equity investments are made assuming a long hold period and an on-control position. "We're not a control-oriented investor," Thomas said. "That is probably the biggest point of separation between our investment interests and those of traditional private equity."

Buy and hold

Overall, Prudential Capital maintains debt and equity relationships with more than 1,000 companies worldwide. Upstream and midstream investments came to around $7 billion as of Dec. 31, 2017.

"Our ability to tailor these types of structures is what many operators find attractive and is why people reach out to us directly," Thomas said. "We don't syndicate. We buy and hold, often for five to 10 years, or longer."

In many cases, Prudential Capital may be more aligned with "second stage" funding, at the junior capital level, rather than an initial round of funding. To illustrate, Thomas said an E&P may be seeking some form of "transitional financing" to meet a specific funding need, but didn't want to be burdened with that cost of capital beyond the transformative period.

"Assume an E&P has 5,000 to 10,000 acres and has drilled four to eight development wells. They've begun to solve the science experiment and are honing in on proper completion methodologies, etc. Now they want to drop the clutch and accelerate their drilling program. But the cost of the wells and the pace of the drilling program preclude them from relying on traditional conforming senior bank debt.

"Private capital can offer a more patient mindset, tailored solutions and the ability to lean into the wind when others might be retrenching," said Brian Thomas, managing director of Prudential Capital's energy finance group.

"We can come in and structure junior capital that can fund the E&P at an accelerated pace and at a much higher advance rate relative to PDP [proved developed producing] and PUD [proved undeveloped] than would be the case with traditional senior bank financing. Doing so allows the E&P to minimize its need to raise new equity, which can be particularly dilutive to existing ownership and prospects for independent governance."

In turn, as its production base grows and matures, an E&P may have a wider range of options as to how to proceed.

"While operators can always choose to slow their pace and drill from cash flow, such factors as lease expirations, temporal commodity price environments, and growth objectives often cause management teams to seek solutions that allow for accelerated development drilling," Thomas said.

"Typically, there's a two- to four-year period from when you start actively deploying considerable capital to drill and develop acreage and when you start generating substantial cash flow, and during that period your investment needs greatly outstrip your cash flow from production," Thomas continued. "By year three or so, a junior E&P may have reached an inflection point where it is self-funding or it can migrate to a conforming senior bank facility, or it can choose to sell. My job is to tailor a structure that allows

operators to reach this point, while also preserving this kind of optionality."

Due to action by the bank market to limit the use of second liens, Prudential Capital is increasingly providing a "one-stop shop" service for clients, according to Thomas. "Often commercial banks resist most forms of junior capital other than new equity," he said. "As a result, we're often providing the senior financing alongside the junior debt in order to provide certainty of execution."

In the midstream sector, Prudential Capital plays a key role in both the Lower 48 and north of the border.

"They know if they don't HBP it (acreage investments made in better times), it'll evaporate," according to Tim Murray, managing director with Benefit Street Partners.

Active in Canada

"We're probably one of the largest financiers of midstream assets on the institutional level," Thomas said. "We have been very active in Canada for the last 30 years, working with both upstream and midstream sectors. Canadian firms don't seek the public debt markets as actively as their U.S. counterparts, and are more comfortable working directly with institutional lenders on a senior or junior lending basis."

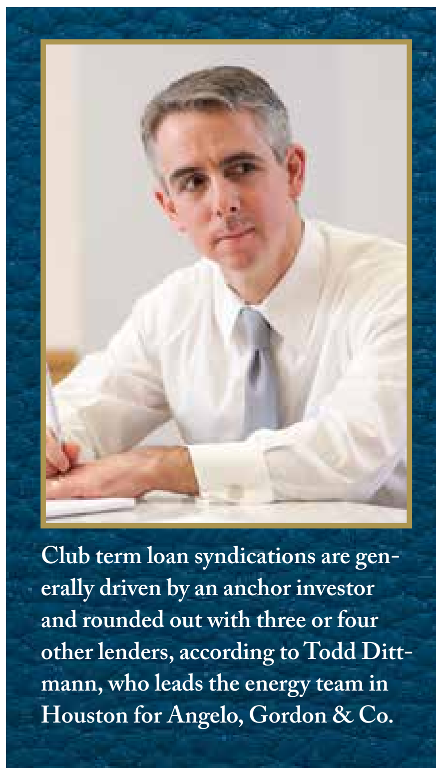
In the upstream sector, Prudential Capital's Canadian clients often include E&Ps that are seeking long-term, fixed-rate financings to augment borrowings from commercial banks. In the midstream sector, Prudential Capital has worked with both smaller operators and with much larger players, such as Enbridge Inc. and TransCanada, for whom it provided financings designed specifically at the asset rather than corporate level, noted Thomas.

He sees an increasing role to be played by providers of private capital at the institutional level.

"Energy companies have a voracious appetite for capital," observed Thomas. "As was increasingly highlighted during the last sector downturn, companies are realizing that access to capital shouldn't be a two-legged stool. Private institutional money can and should be a very valuable third leg to the stool, providing access to a significant amount of long-term, patient capital that can either augment bank financing or obviate the need to go the high-yield market."

Thomas sees benefits from building a stronger institutional leg.

"Private institutional capital tends to demonstrate much greater stability and access, irrespective of where you are in the capital cycle, whereas the broader bank and public capital markets tend to be more of a volatile barometer of lending behavior," Thomas said. "In addition, private capital can offer a more patient mindset, tailored solutions and the ability to lean into the wind when others might be retrenching."



Club term loan syndications are generally driven by an anchor investor and rounded out with three or four other lenders, according to Todd Dittmann, who leads the energy team in Houston for Angelo, Gordon & Co.

Robust deal flow

Adverse conditions in energy capital markets have meant the opportunity set for private credit "had never been wider than it is today," according to Tim Murray, managing director with Benefit Street Partners. Public capital markets will at some point recover, he said, but in the interim Benefit Street Partners "is experiencing robust deal flow."

While Benefit Street Partners can offer a variety of financial options, roughly two-thirds of the deals in its current pipeline are potential DrillCo transactions. Its sweet spot in terms of deal size is $100 million. Targeted returns are in a range of "mid-high teens to low 20s," with several key factors capable of playing a part in helping narrow the range.

Murray pointed to several factors driving the rise in private credit. For one, the tighter guidelines for commercial banks introduced by the OCC "dramatically impacted banks, especially the smaller regional banks," he said. In public equity markets, while the oilfield sector had seen several IPOs this year, the absence of an upstream IPO since the fall of 2016 reflects energy being "out of favor," he added.

In high yield, year-to-date issuance is comprised of more than 20 issuers as of mid-July, but that was predominately to refinance existing debt rather than to finance, for example, A&D activity, noted Murray. Meanwhile, private-equity (PE) funds are active, but larger fund raises have meant sponsors are looking to fund larger deals and are less focused on opportunities of less than $200 million.

Given less resilient traditional funding sources, private credit has emerged as a means of financing a "wide fairway" of activities. Common uses include, drilling to HBP where leases are set to expire, refinancing maturing bank debt and bonds, and refurbishing and expanding oilfield service equipment as firms recover from the downturn.

DrillCos, carries and tails

DrillCos have emerged as a popular solution for companies to develop and HBP their acreage to preserve the significant acreage investments made in better times. Interestingly, clients include some PE-backed companies and public E&Ps, according to Murray.

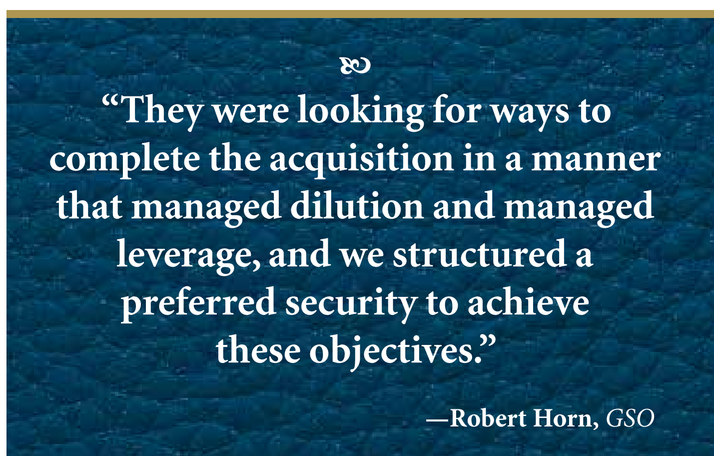
COMMON STRUCTURAL CHARACTERISTICS

Reserves	Structure	Characteristics
Proved Reserves	Probable & Possible Reserves	■ Cash Flow, Covenant Based Lending ■ Yield Range: 3.5% -7% ■ $10-$400 Million Investment
	Second Lien Fixed/Floating Rate Debt	■ Coupon: 7%-12% ■ No royalty or equity linked component ■ $10-$100 Million Investment
	Mezzanine	■ Targeted returns typically in the mid- to high teens ■ Contractual coupon with varying types of yield enhancing features (e.g., warrants, ORRI, NPI) ■ Secured/Unsecured ■ $10-$50 Million Investment
Probable & Possible Reserves	Equity	■ Non-Control Position ■ Long Hold Period ■ $10-$50 Million Investment

Source: Prudential Capital Group, IPAA

"Even though the capital is priced in the mid-teens and above, PE guys and public companies that have accumulated a lot of acreage are now very interested in taking the capital and deploying it to secure their acreage positions," he said. "They know if they don't HBP it, it'll evaporate."

Within the private credit universe, the subset of DrillCo providers is "much more limited," Murray said. "Doing a DrillCo requires knowledge of how the industry operates, some real technical knowhow, and what happens after the ink is dry. We've done quite a few of them now, and our reputation for knowing the business is likely why we see a large number of DrillCo opportunities."



DrillCos are structured in various ways, but the key elements include the capital provider's disproportionate share of the drilling capital ("carry"), the "reversion" or change in economic terms after a pre-agreed hurdle rate has been met, and the residual interest retained by the capital provider after reversion (the "tail").

For example, a pre-reversion structure may call for the capital provider to invest 75% to 100% of drilling and completion (D&C) costs to earn a disproportionate working interest (WI) of 55% to 90%. Meanwhile, the operator pays zero to 25% of the D&C costs to earn a 10% to 45% WI.

Once the targeted hurdle rate is met—typically set in terms of an internal rate of return or return on investment—the carry ceases. At this point both parties' D&C costs and WI are in line with each other.

"Between the carry, the reversion hurdle and the tail, you have the three levers to press to get the right answer," he said. "The carry can be a big factor. If the capital provider is paying 90% of the capital to get 70% of the interest, those 20 points of carry obviously means a lot to the company; but it also raises the return requirements when you're paying 20% of the capital for the other operator."

A DrillCo can be structured at the wellbore level, on a drilling spacing unit basis or on a defined acreage position.

DrillCos are typically structured in a program of 20 or more wells, because "you're trying to make the average" and avoid concentration and single-well risk, Murray said. "We prefer to stay with the better operators in core acreage and avoid areas that are 'fringy,'" he said. "If your wells don't work out, that's all you've got, especially if you do a wellbore deal with an interest just in those wellbores and no acreage participation."

To protect its DrillCo investments, Benefit Street is a strong believer in hedging, according to Murray. "We're not trying to pick a price. We're just concerned about potential downside, so we're always going to look for a floor in a collar structure, or buy puts. We rarely do swaps, apart from basis swaps. Our primary interest is in putting in a floor to protect our investment."

Benefit Street Partners appears to have no shortage of potential opportunities to fund. "We've got enough opportunities that, if a deal has some hair on it, or someone is unwilling to agree to terms that generate an acceptable return, we'll move on to the next transaction," Murray said.

'Club' term loan market

Those seeking credit in smaller sizes than the energy high-yield market typically provides may find other sources with single lenders and in the "club" term loan market, according to Todd Dittmann, who leads the energy team in Houston for Angelo, Gordon & Co.

BIG NEED FOR CAPITAL LOOMS

Since it is becoming more difficult to secure bank credit, and a lot of existing energy loans are still under pressure, new avenues to secure funding need to open up. This is all the more true as producers continue to push the boundary on how many wells they drill on a pad or within a section in the shale plays.

Hence, the rise of the "non-bank bank" to serve energy companies hungry for capital.

"There is a looming need for more capital," said Mark Green, president of Madava Financial, speaking to the Houston Energy Finance Group.

"The RBL [reserve-based lending] market remains large, but it is in transition. Mezzanine lenders and credit funds have generally been the next layer of available capital, but another direct lending alternative is needed to fill the gap between these capital alternatives."

Green, formerly with Wells Fargo for 12 years, joined Madava in May 2017. It is a private, energy-focused finance company providing capital alternatives through direct lending to middle market upstream and midstream companies. It is not a credit fund, but rather a specialty finance company that has raised permanent capital. The new entity was founded in early 2017 by Robb Turner, one of the co-founders of ArcLight Capital.

A confluence of trends has led to this opportunity. Green cited the example of several foreign and domestic banks that closed down or significantly reduced their oil and gas portfolios during the downturn, and the exit of industrial-type lenders such as GE Capital. The ability of traditional commercial banks still in the game to engage in stretch lending to energy companies has moderated as well, thanks to the Comptroller of the Currency's revised and stricter lending guidelines.

"The E&P industry's need for capital is still growing," Green said. "For example, companies are increasingly drilling multi-well pads. We recently saw a Delaware Basin company with 24 wells planned in one section, which obviously results in a very large call on capital."

At the same time, just as the OCC narrowed the fairway on what is considered a "pass" RBL or credit, many of the credits extended during the downturn are coming due soon. More than $208.6 billion in upstream debt existed at the end of 2017, and an estimated $76 billion was not in compliance with the new bank guidelines at the end of 2016, he said.

"As these credits mature and roll off, some of them will be renewed—but many will not. We think there is a gap where some companies cannot renew their RBL and thus, will need to explore other sources of capital."

Until 2014, the senior secured RBL was bulletproof and loan recoveries averaged 98%, he said. Through 2015, there was a significant drop-off in the recovery factor, down to 81%, according to Moody's Investors Service, he said, and numerous second-lien facilities and unsecured bonds were "completely wiped out."

Madava looks primarily to provide unitranche facilities in the middle market, well-hedged but relying as heavily on PDP reserves as banks do. "We are targeting middle-market upstream and midstream companies, many of which will be sponsor-backed." Madava seeks to fill a growing gap between first-lien lending provided by the regulated banks and other capital providers that include private equity, hedge funds and energy credit funds. It will advance 70% to 100% of PDP with a typical size of $25 million to $100 million. It also will consider second-lien/Holdco type of structures or preferred equity.

—Leslie Haines

As of mid-July, there were three E&P deals in the high-yield market, ranging from $400 million to $850 million. "But that leaves issuers seeking smaller issues of $200 million to $300 million left to explore other sources," observed Dittmann. "Fortunately, for those good issuers, we've seen a market open up in club term loan syndications."

Club term loan syndications are generally driven by an anchor investor and rounded out with three or four other lenders, according to Dittmann. Examples include Triple Crown Energy LLC (lead placement agent: Wells Fargo), Sundance Energy (Morgan Stanley) and Admiral Permian Resources LLC (UBS). Angelo Gordon participated as an anchor investor in two of these three deals.

"Growing demand for our capital is fortuitous, as at the same time there's a multiple-prong de-risking going on in the E&P sector," Dittmann said. "Higher oil prices mean more revenue, and producers are increasingly spending within cash flow. Average leverage is coming down across the space. E&Ps are hedging more, taking more revenue volatility out of the mix."

In addition, to a growing extent, "E&Ps are now using revolvers as originally intended: unfunded, for short-term capital needs, rather than as a replacement for term debt, simply because it was cheaper," he continued. "The problem is revolvers come with 'sole discretion borrowing bases,' making them a very volatile liability for a long-term asset base.

By contrast, secured, non-reserve-based term debt comes with a degree of insurance given the absence of the sole discretion borrowing base mechanism."

More recently, in a very interesting development, Dittmann observed that "private-equity-backed companies are experiencing an exit problem because both the asset sale and IPO markets have resisted smaller packages.

We are seeing an ever-growing dialog with PE-backed teams to facilitate the next, unanticipated stage of their growth. Structure and use of proceeds vary, but come in the form of delayed draw term loans, dividend recaps and DrillCos." ■