THE DRILLCO

Potential industry partners may be struggling to invest in their own drilling inventory, but capital providers see an opportunity to own direct interest in new wells.

By Nissa Darbonne

Skipping the overhead of funding management teams, several new E&P capital providers are increasingly joining producers directly to fund drilling. “We want to put as many dollars as we can into the ground,” Will McMullen, founder and managing partner of Bayou City Energy Management LLC, said at *Oil and Gas Investor*’s annual Energy Capital Conference recently.

IOG Capital LP also is doing this. It was founded in September 2014 to directly invest in producing acreage as well. In an *Investor* interview this past fall, before WTI fell to as little as $27 a barrel, Marc Rowland, IOG’s founder and senior managing director, had warned producers, “Maybe don’t believe all that is said about what prices are going to do.”

At the time, IOG had done three deals; as of mid-April, it had closed three more. “We started to see a change in inquiries in January,” Rowland said. “Cash flow, hedging, lower prices, bank pressures and the private-equity market froze up quite a bit, and I still think it’s chilly.

“More people are in the ‘lower for longer’ camp now in oil and particularly for gas. It’s a sort of ‘tsunami of bad’ out there happening in the industry.”

These structures—the DrillCos—have attributes that are taken from traditional industry joint ventures and farm-outs. The arrangement more closely resembles that of a JV in which two parties—but, in this case, an E&P and a capital provider rather than two E&Ps—pay for their working-interest

SELECT DRILLCO DEALS

Operator	Investor	Date	WTI	12-Mo. Strip	Play	Investor WI	Trigger	Post-reversionary WI
Linn Energy	GSO	Jan. ’15	$53	> $58	NA	85.0%	15%	5.0%
Rex Energy	ArcLight	Mar. ’15	$48	> $57	Marcellus	35.0%	NA	17.5%
Legacy Reserves	TPG	July ’15	$53	> $56	Permian	87.5%	1.0x ROI then 15.0% IRR	63% on ROI then 15% on IRR
LoneStar Resources	IOG	July ’15	$47	> $50	Eagle Ford	90.0%	NA	10.0%
Seneca Resources	IOG	Dec. ’15	$40	> $48	Marcellus	80.0%	15.0%	15.0%
Alta Mesa Holdings	Bayou City	Jan. ’16	$29	> $33	Stack	80.0%	15%/25%	20%/7.5%
Rex Energy	BSP	Mar. ’16	$31	> $40	Marcellus/ Utica	15% in 1st 16 wells; 65% in rest	None	N/A

N/A = Not applicable. NA = Not available. Source: Oil and Gas Investor

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percentage of the wells' cost in defined acreage. In most of these new DrillCo structures, the E&P regains some of the financial partner's working interest after the latter has gained a stated level of return.

A JV-type deal was struck by Benefit Street Partners LLC (BSP) earlier this year with Rex Energy Corp., involving some 48,000 acres in Ohio and Pennsylvania. It's a DrillCo structure, but a first of its kind, said Tim Murray, BSP managing director and head of energy origination in Houston.

BSP is an affiliate of Providence Equity Partners LLC and has $11 billion under management.

"Most DrillCos have you paying for acreage upfront," Murray said. "This deal does not include either cash or carry for acreage contributed."

The partnership involves up to 58 wells, of which 15 were already completed, but not yet flowing into sales. BSP pays 15% of the first 16 wells' cost in Rex's 42,000-acre Moraine East area of the Marcellus and 65% of six wells in a 6,300-acre area, Warrior North, in the Utica. In an option to participate in 36 additional wells, BSP's working interest will be 65% for $138 million, bringing its total contribution in the JV to $175 million.

With the funding, Rex expects to be able to complete 15 additional wells this year. BSP will receive an acreage assignment of 15% in the Marcellus area and 20% in the Utica area.

Murray is often asked how he won such a deal. BSP's arrangement is simple, he said. "It's like an industry deal, only without any carry. Rex appreciates that we're a financial partner and we don't want to own it forever.

"I want it to be successful and to sell it back to the company. They know that, eventually, we will go away, whereas an industry partner might hold it forever."

Other new DrillCo structures include an eventual reversion, such as 75% working interest declining to 25% upon the financial partner receiving, for example, a 15% internal rate of return (IRR). In that structure, Murray said, "basically, you're making 15% plus whatever the value of that 25% residual working interest is.

"We have no reversion, so we're coming in heads up. We're paying our share of the well and not paying for any of theirs. We're basically an industry partner."

Also traditional as in an industry JV, if BSP plans to sell, Rex has the right of first refusal. "We are very relationship-focused, so our druthers would be to sell it back to the company." Meanwhile, if the E&P operator's ownership changed hands, "it doesn't impact us. That's pretty key for capital providers in this environment to basically have a nonrecourse deal not affected by what's going on with the company," Murray said.

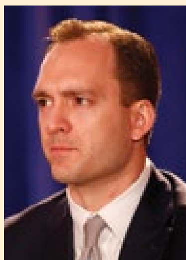
Other deals BSP is working on are also in unconventional resource plays. The greatest appetite is in areas with newbuild infrastructure where producers have minimum volume commitments (MVCs) to midstream operators. "If the volume isn't delivered, there is a financial penalty," Murray noted. "Rex really wanted to fill those volume commitments. There are others in the same situation."

In mature areas, MVCs are less common. "Not so in the Utica and Marcellus. There had to be strong commitments from the E&Ps to build all of those takeaway facilities." There have been some in the Eagle Ford, Bakken and Delaware Basin, but they're primarily in Appalachia and the Haynesville.

"Those transportation commitments can pressure an operator," Murray said. "Get the wells drilled and the volumes online. Almost everyone in the Marcellus and Utica signed up for an MVC. If you didn't, you couldn't get your product to market."

Murray's experience as a long-time financier may have helped him strike the deal with Rex. At one time, Murray operated an E&P asset after a management team walked away. The property, which is in Alabama, had been purchased for $160 million; Murray sold it a year later for $240 million.

"We understand the business," he said. "We don't micro-manage operational details about how you're fracking the wells or how to choke them and who to hire. We understand the operational decisions that have to be made. People without operating experience can't say that."



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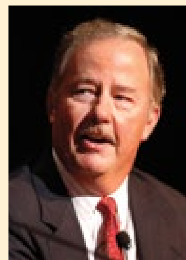
***Will McMullen**, Bayou City Energy Management LLC*



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‘A bridge to somewhere’

Also a veteran E&P financier, IOG’s Rowland founded the firm to buy working interests in exploitation acreage onshore the U.S. as a joint-interest partner. “I call it a bridge to somewhere—to sell out, to refinance, to go public,” he said. “We’re that bridge capital. I think we are a user-friendly product and we’re right here in Dallas.”

Some operators took on more debt in the second quarter of 2015 as oil prices were climbing back up. “They have only dug a deeper hole,” he said in an interview this spring. “It’s time to tighten your belt. Keep your balance sheet in shape.”

Rowland was chief financial officer of Chesapeake Energy Corp. until 2010, when he left to lead its pressure-pumping unit, Frac Tech Services LLC. IOG’s start-up was funded with more than $350 million from institutional investors and private-equity partner Metalmark Capital LLC. Fortress Investment Group LLC joined in May 2015 with $330 million. By this past April, IOG’s total deployable capital was more than $930 million.

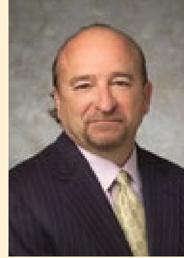
The firm aims to invest in established leasehold with financially sound operators where there is evidence of repeatability, operational quality, rock quality and cost efficiency. “Everyone is focused on costs being down, but, even today, I see examples of wells by Operator A that cost $1 million more than B’s and B’s are better wells,” he said.

IOG’s deals to date have been in the Marcellus, Bakken, Permian, Eagle Ford and the Stack play in the Anadarko Basin. Takers like these DrillCo arrangements for myriad reasons. They may need to HBP their leasehold, fund their share of nonoperated wells, fulfill MVCs, maintain an investment-grade credit rating, keep staff in place, provide bank collateral and/or make distributions.

“It’s a bridge to solve a problem or achieve an objective,” he said.

In December, Rowland announced a deal with Seneca Resources Corp., the unregulated E&P unit of regulated investment-grade utility National Fuel Gas Co., to develop its Marcellus leasehold in Elk, McKean and Cameron counties in north-central Pennsylvania. The arrangement involves up to 80 wells in 10,500 acres.

IOG will have an 80% working interest and is obligated to participate in the first 42 wells; it has an option until July 1 to participate in 38 more. Seneca’s costs will be reduced some $200 million in the first batch and $180 million in the second. It retains its 7.5% royalty interest in addition to 20% working interest in the first. In the second, it will retain 10% royalty interest and 20% working interest. After IOG achieves a 15% IRR, Seneca’s working interest will increase to 85%.



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Marc Rowland, *IOG Capital*

This past summer, Rowland closed three deals for $185 million in drilling-capital commitments. In the Stack play, the commitment is $60 million and involves both operated and nonoperated wells; in the Bakken, $25 million; and in a deal with Lonestar Resources Ltd. in the Eagle Ford, up to $100 million.

The Lonestar deal has IOG paying up to 90% of the wells’ cost and, after IOG achieves an undisclosed IRR, Lonestar’s interest becomes 90%. With its spare cash flow, Lonestar plans to do more farm-ins with its neighbors.

In early April, Rowland was closing a sixth deal—a second involving nonop wells in the Bakken. A fifth deal was in the Permian Basin; the first well in that one had already been drilled. Areas that have piqued IOG’s interest were the five in which it has done deals to date, plus the Scoop play, which is also in the Anadarko Basin and south of Stack.

Capital for acquiring acreage and for start-up management G&A “is not completely gone,” Rowland said, “but it certainly is reduced.” At an investment conference recently, an energy private equity manager with a large firm told him that, within its portfolio, only one rig was running.

“We wanted to get away from the PE market. It’s well-served and was, basically, ‘Write me a check.’ We wanted to be a direct property owner and not be affected by the balance sheet of our partner.”

Five of IOG’s six deals are in oil plays. IOG did the Seneca deal in part because it was able to get a good hedge at the time, the production is dry gas and Seneca owns the property, so there is no royalty dilution. Seneca also owns the midstream assets.

Otherwise, Rowland said, he can’t remember one recent gas deal he looked at that came close to being economic. Not the Haynesville, Fayetteville, Woodford or Barnett. And gas plays that had NGL uplift in 2014 have dived with oil, he noted.

“It still has to get back to the economics,” he said. “Something that doesn’t generate north of 20% IRR at the wellbore isn’t a project an operator would want to drill anyway.”

Instead of 'tuition dollars'

Formed in the second quarter of 2015, Bayou City Energy Management LLC also invests directly into existing operations and drilling rather than underwriting management teams.

"We're not going to partner with someone who doesn't already have an asset," McMullen said in an interview. "We can work with someone who is circling an asset as well, but we won't support a G&A budget until that asset is acquired.

The capital is used to buy more acreage or accelerate development.

"We're not giving teams hunting licenses. Not to say a strategy is better or worse. We just don't have the time and capacity to fund what I call 'tuition dollars.' We want to go into geologically derisked situations with drilling inventory and cash-flowing reserves already in place."

Like Rowland's, McMullen's office has also become busier this year. "Back in 2015, the head fake we saw in the spring gave a lot of producers hope that we were out of the woods and were going to jump right back to $80 oil.

"Now, down to $27 and back to $40, everyone is slowing down, trying to hunker down and eliminate all unnecessary costs, while also seeking to strengthen balance sheets. Drilling partnerships are credit accretive to producers with the right kind of asset."

To date, Bayou City has done deals in the Stack play with Alta Mesa Holdings LP, in conventional oil drilling with TXon-SCZ LLC in the nearly century-old KMA Field in North Texas, and with White Knight Resources LLC in three septuagenarian fields in the San Joaquin Basin of California.

The latter two are balance-sheet investments in what McMullen calls "platform companies." The difference is that each operates only in that area; the partnership with Alta Mesa is a DrillCo in that it is specific to Alta Mesa's leasehold in Kingfisher County, Oklahoma.

A drilling partnership has to work at a better than 20% IRR single-well type curve or it isn't a good tool for an operator, McMullen said.

"You have reversionary interest to the operator. The majority of the cash flow is going first to the financial sponsor and that threshold is in the mid-to-low teens and then reverts back to the operator. The operator gets to claw back some of the interest in the wells.

"If you never get to that first threshold in terms of returns, they're not a good DrillCo candidate. The quality of the asset in a DrillCo matters a lot."

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The deal came about in part through McMullen's familiarity with the operator, gained while he was with Denham Capital Management LP. Alta Mesa is a portfolio company. Also, Bayou City partner Mark Stoner was Alta Mesa's vice president of finance.

"So we both knew the company well and understood its position in Kingfisher very well. Relationships' importance can't be overstated. There are a lot of nuances that go into decisions when you're drilling a well. Having a partner you trust enables you to actually put in practice what you put on paper."

In the two platform investments, a sound balance sheet was critical, and the candidates were too small for large private-equity firms. Bayou City's investments are between $5 million and $50 million. "The niche we sought to serve was the smaller end of the market."

For the balance of 2016, McMullen expects to enter more DrillCo arrangements, rather than platform investments. "The drilling partnership is a solution when you have large bid-ask spreads. In balance-sheet deals, the word 'valuation' pops up often, and there can be a large discrepancy between the sponsor's valuation and the operator's valuation."

In a DrillCo, the question is primarily of whether the acreage can generate sufficient production. "We've seen that as an easier path in terms of getting more interesting opportunities in this market," he said. "As prices stabilize—if they do—and the bid-ask stabilizes, you might see more platform-company investments by us." ■