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Transaction Structures, Capital Sourcing Options Help Operators Close Deals

By Kari Johnson, Special Correspondent

In one bold move, Earthstone Energy Inc.'s Permian Basin holdings went from a nonoperated position in the Midland Basin to operating a 21,000-net acre producing leasehold concentrated in the heart of the Wolfcamp horizontal play.

The first choreographed step in making that move began last year, culminating in November with an agreement to strategically combine the company with Bold Energy III LLC in an all-stock transaction. A private equity-backed private firm, Bold Energy had amassed an operated portfolio that included both producing and undeveloped assets in Texas' Reagan, Upton and Midland counties. The final step was taken in early May when the "up-C" transaction closed with the approval of publicly-held Earthstone's shareholders.

According to Frank Lodzinski, Earthstone's president and chief executive officer, the up-C partnership structure was an ideal solution for both parties. It gave Bold Energy III and its private equity sponsor, EnCap Investments, an opportunity to combine with a public company. Incidentally, EnCap also sponsored the same management team in Bold Energy I (sold to Occidental Petroleum in 2008) and Bold Energy II (divested assets to Petrohawk and Lime Rock Resources in 2012).

At the same, the deal provided Earthstone an effective entry strategy into some of North America's choicest oil and gas real estate, and gives the combined company a solid foundation on which to grow reserves and production in the future in the highly productive Wolfcamp and Spraberry horizontal trends.

"This is a transformative business combination that creates significant growth potential and allows shareholders to enjoy the benefits of a larger company with a clear strategic focus on further building our operated asset base in the Permian Basin," Lodzinski says. "We have integrated the management team, operations and activities of both companies and our primary focus going forward will be to grow our Permian position through trades, direct leasing, development, and additional merger and acquisition activities."

FRANK LODZINSKI
President and CEO
Earthstone Energy

Frank Lodzinski has served as president and CEO of Earthstone Energy Inc. since December 2014, when the company entered into a strategic combination with Oak Valley Resources LLC, which Lodzinski had served as CEO since its formation in 2012. Earthstone's "up-C" transaction with Bold Energy III transitions the company from nonoperated positions to operating a 21,000-net acre leasehold concentrated in the Midland Basin's Wolfcamp play. Lodzinski's 43-year career includes serving in executive leadership roles at a number of successful startup companies that eventually were sold to or merged with larger operators.

EDWARD HERRING
Co-founder and managing partner
Tailwater Capital

Edward Herring is a co-founder and managing partner in Tailwater Capital, a specialized middle-market private equity firm focused exclusively on the energy industry. Founded in 2013, Tailwater manages $1.7 billion in committed capital in the upstream and midstream sectors. Herring has 24 years of investment experience, and his primary responsibilities include deal sourcing, execution and monitoring of the firm's investments. He previously worked in the investment banking division of Goldman, Sachs & Co.

CHRIS ATHERTON
President
EnergyNet.com

Chris Atherton is president of EnergyNet Inc., an oil and gas asset acquisition and divestiture firm specializing in auction sales, sealed bid transactions and government lease sales. He has been part of the EnergyNet team since 2002. He has been actively involved as the firm has completed some $3 billion in transactions, including sell-side mandates from thousands of exploration and production clients. Atherton leads a multidisciplinary team specializing in land, technical, business development, marketing, information technology and administration.

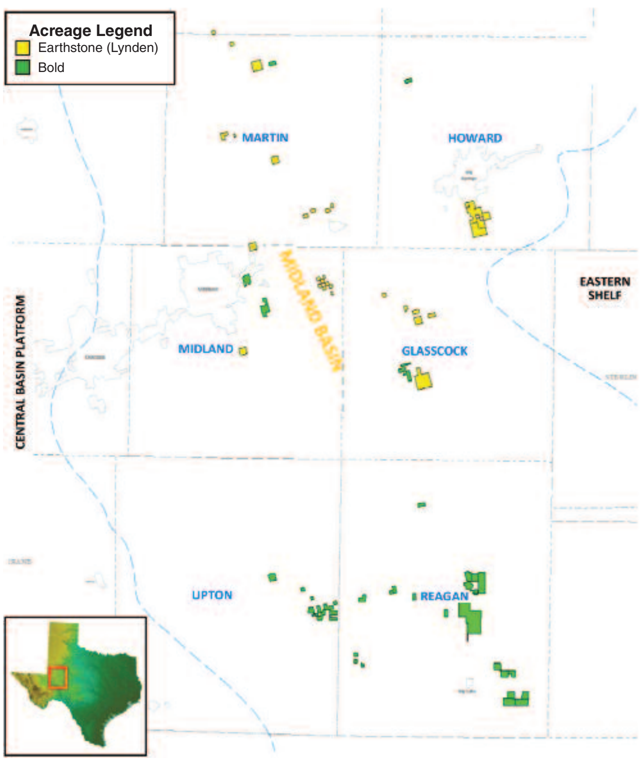
Continuing To Grow

The Bold III combination was the third transaction that Earthstone has closed successfully since Lodzinski joined the company in late 2014–the start of a prolonged down cycle in commodity prices that did not deter Earthstone from executing its growth strategy. In fact, Lodzinski came to The Woodlands, Tx.-based company through another strategic combination with Oak Valley Resources, which he had led from its formation in December 2012 until the closing of its combination with Earthstone in December 2014.

"We have continued to increase our production, reserves and drilling inventories," comments Lodzinski, noting that the latest deal adds more than 500 gross operated "high-potential" proved and probable locations to inventory.

"We expect the number of locations to increase with further derisking of Spraberry and Wolfcamp intervals. Additionally, we are excited about the upside in reserves and returns being realized from our 'Gen IV' optimized completion design," he reports. "We believe we will continue to see well productivity and reserve increases from ongoing improvements in completion techniques."

According to Lodzinski, the company brought on line seven gross horizontal Wolfcamp A, Upper B and Lower B wells with Gen IV completions during the first four months of 2017. On average, the wells had 8,251-foot laterals and were completed with 51 stages (166-foot stage spacing) and 2,267 pounds of proppant per foot. The peak 30-day initial production rates of its newest wells averaged 992 barrels of oil equivalent a day, or 120 boe/d per 1,000 feet of completed lateral.



Earthstone Energy began its move into the Midland Basin in 2016 with the all-stock acquisition of Lynden Energy and its non-operated position in 5,883 net acres in Texas's Howard, Glasscock, Martin and Midland counties. In May, Earthstone completed an all-stock "up-C" transaction to strategically combine with private equity-backed Bold Energy III and its 21,000-net acre operated leasehold in the heart of the Wolfcamp horizontal play in Texas's Reagan, Upton and Midland counties.

Earthstone Energy began its move into the core of the Midland Basin by establishing a nonoperated position with the acquisition of Lynden Energy in 2016, giving it 5,883 net acres in Texas's Howard, Glasscock, Martin and Midland counties operated by a leading Permian producer. Following that deal, Lodzinski says, Earthstone worked diligently to secure and close a significant operated property. That objective was achieved with the up-C transaction, giving Earthstone an operating position in the red-hot Midland Basin to add to its existing operated position in the Eagle Ford and its nonoperated positions in the Permian and Bakken.

"We always have been rabid about operations," he comments. "Historically we have operated 75-80 percent of our assets. The Bold III combination brought us back up to the mark and we will continue to focus on operated acreage going forward."

Record Of Success

In addition to establishing Oak Valley and managing Earthstone, Lodzinski's 43-year career includes serving in executive leadership roles at a number of successful startup oil and gas companies that eventually were sold to or merged with larger operators. "Our strategy historically has been to build and sell," he offers. "Our exit strategy is to sell the company at a significant premium and give shareholders liquidity in the public markets so that they can take profits."

He says the strategy he and his team follow is simple. "Do not get overleveraged and control your operating costs," Lodzinski states. "When commodity prices turn, if you continue to control your cost structure, everything you have done in the past lifts the entire boat."

Earthstone's management team historically has acquired acreage for equity where possible, or acquired acreage by raising equity where needed, Lodzinski goes on. "We are careful to use debt appropriately to develop assets and increase cash flow without overleveraging," he notes. "We do not like to complicate our balance sheet with too much high-yield and preferred stock. By managing operations and costs, we have positioned ourselves for accretive acquisitions."

Both the Bold III and Lynden acquisitions were common stock transactions. "If we can build our market capitalization through these transactions and show that we have a clear path to propel double-digit growth, we can raise the development capital to drill and complete wells efficiently," he explains. "The Permian Basin has proven to be the primo basin for profitable operations during the downturn."

As Earthstone attracts additional shareholders, institutional investors and increases float and volume in shares, it expects additional liquidity in its shares. "If we perform and add economic production and good gross margins, our share price should respond," notes Lodzinski.

He indicates the majority of the Earthstone management team has been together for more than a decade, and the experience of the individual team members dates to the 1970s and drilling deep, highly deviated Gulf Coast wells. They also were early practitioners of horizontal drilling and multistage hydraulic fracturing though their involvement in the Austin Chalk, Vicksburg and other plays. "In the Austin Chalk, we were lucky to go out a few thousand feet laterally. Now we are routinely extending out several miles," reports Lodzinski. "Certainly all this experience has helped us develop our current horizontal drilling techniques."

In addition to the management team, Lodzinski estimates that at least 35 percent of Earthstone's support staff has been on the team before. "The accounting, land, regulatory and other staff members are a highly important ingredient in our success," he says. "We have production superintendents who have been with the management team for 15-20 years through multiple entities, and many also are investors."

Exceeding Expectations

The majority of Earthstone's 21,000 operated acres in the Permian basin has a net 85 percent working interest. "When we were looking for opportunities, we focused not on where the market was at the time, but where it was going," says Lodzinski. When Earthstone initiated discussions with Bold Energy III, he says, there were not a lot of horizontals producing in Reagan County with new frac designs, but the early wells indicated the presence of oil within the thicker Wolfcamp sections, namely the B zone.

"We felt pretty good going in that direction, and have identified 500-plus drilling locations in the Wolfcamp," he adds.

The type curves associated with the producing wells show dramatic improvement moving from the first generation of completion design to the current fourth generation, Lodzinski says, and a Gen V design is in the works. The generation-to-generation enhancements generally include larger frac sand volumes, increased pump rates and denser stage spacing throughout longer lateral sections. "The last 14 wells placed on production are exceeding our type curve expectations. All of them have used the Gen IV completion design," he states.

Earthstone is running a one-rig program in the Midland Basin this summer, but plans to deploy a second rig later in the year, according to Lodzinski. "In general, our acreage is held by production, so there are minimal outstanding drilling obligations," he details. "However, we intend to maintain an active program to accelerate drilling and completion activities. We expect to drill a minimum of three wells per pad whenever possible to maximize the value of our assets."

Role Of Private Equity

Tailwater Capital actively manages four pools of private equity capital, including two midstream funds that back gathering, processing, treating and compression projects. "We also focus on downstream bottlenecks and are in the business of trying to help make the delivery of hydrocarbons and products to the downstream sector more efficient as well," says Edward Herring, Tailwater Capital's co-founder and managing partner. "We really play across the full midstream spectrum."

Tailwater's two upstream funds are focused on nonoperated working interests in upstream opportunities that can take many forms. "We can be more creative with private capital than with public currency," explains Herring. "We may lease smaller chunks of acreage that have been delineated, or five to 150-acre unleased positions where the operator in the area would be a high-quality partner for our capital."

"Our investments can take the form of wellbore assignments, where someone owns nonoperated interests but does not have the capital or the ability to finance it," adds Herring. "It also can take the form of drilling companies or joint ventures that are set up to accelerate drilling in an area behind a single operator."

Looking back at the experience of the past two years, Herring says, 2015 was a year of "dislocation" with a dramatic drop in oil prices. "By our internal estimates, publicly traded U.S. upstream companies overspent their free cash flows by 150 percent on average between 2010 and 2014," he says, adding that much of that overspend was financed by cheap debt and equity that was highly valued.

"Coming off of the volatility of 2015, there is a more capital-constrained upstream market in general today," Herring observes. At the end of 2016, he says, Tailwater assessed that about half of all public exploration, drilling, completion and production companies had debt in excess of three times their cash flows, and 20 percent of those had debt in excess of six times cash flow. "We are talking about balance sheets that may not be terminal, but they require you to live within free cash flow."

Herring says the upstream public company universe is viewed

Earthstone says its strategic combination with Bold Energy III includes 500 (gross) operated proved and probable drilling locations, with that number expected to increase with further derisking of Spraberry and Wolfcamp intervals. Moreover, ongoing completion optimizations are steadily improving horizontal well performance. The last 14 wells placed on production, all of which were completed with the 'Gen IV' design, are exceeding type curve estimates, the company reports.

as under-levered at less than three times debt to cash flow, but not all of those equities trade at a price that will allow them to be the preferred buyer of noncore assets. "There is a big role for private equity in a dislocated market like this," he remarks.

Herring sees continuing opportunities for private equity capital to help publicly traded operating companies develop some of their core acreage at a more accelerated pace. "We also have seen the concept of drilling companies pop up and we will see some companies shedding legacy acreage positions to focus on what they deem to be their core acreage in today's environment."

As an example, he points to some larger independents that have been selling legacy positions in East Texas to private equity during the past nine months to allow them to concentrate capital investments in resource plays such as the Permian's Delaware Basin and the STACK and SCOOP in Oklahoma. "That is a healthy trend for balance sheets to get right-sized on the backside of 2015," Herring offers.

One of the moves Tailwater has found most attractive is acquiring and leasing noncontrolled positions in key areas with active drillers. By default, they essentially are partnering with expert drilling and production companies in those areas. "Our portfolios end up with a lot of effective operators in them, which provides a lot of diversity for us," he says.

Win/Win Opportunities

Tailwater focuses on finding win/win opportunities, according to Herring. "It is hard to put capital to work in the energy business unless there are winners on both sides of a project."

He explains that his team looks for situations where operators can offer a best-in-class set of management experience, operating capabilities and capital as partners, and where someone else can win on the back end as well. "It is such a large and diverse market that anything other than that has a hard time being repeatable," Herring says.

One of the most successful win/win strategies for Tailwater is to partner with independents that control a lot of acreage, but lack drilling capital. "We partner with them to focus on the midstream part of the equation to free up capital for the upstream equation. This creates best-in-class, third party-owned systems that can attract volumes from others to anchor the midstream assets," Herring relates. "That is a real opportunity for a negotiated win/win."

Tailwater's midstream private equity focus complements its investment opportunities in the upstream sector, he goes on. "To be a good midstream investor, one has to understand the rock, particularly if you are doing upstream adjacent midstream investing," Herring states. "There is no better way to understand what is happening in a basin than owning an interest in those basins. We view this strategy as being highly complementary to our midstream franchise. We currently own interests in approximately 500 wellbores across our active basins."

According to Herring, upstream companies get paid on reserve replacement and reserve development. Midstream companies get paid on volume and throughput. Partnering with a specialist that can provide midstream solutions can free capital for the value-driving engine in the area, creating an opportunity to turn a cost center into an asset he explains. "There is nothing like a major correction in oil prices to provide focus on the core value drivers for each segment of our industry. We would encourage people to think about that."

A&D Activity

Recent acquisitions by EQT Corp. and Oxy Oil & Gas are great examples of large deals designed to create a dominant position within a target basin, says Chris Atherton, president of EnergyNet.com. By agreeing in mid-June to acquire Rice Energy for $6.7 billion, EQT was able to greatly expand its core position in the Marcellus and Utica shale plays in the Appalachian Basin. Atherton notes that Rice was originally a private equity-backed company, which later went public to provide liquidity to its private investors.

"This was a giant deal, one of the largest in a number of years," Atherton observes. "I expect to see more companies growing strategic positions through acquisitions and mergers like this one. There is a lot of land to cover and there is definitely a benefit to having a larger company operating the assets."

Meanwhile, Oxy has been consolidating its San Andreas position for some time, says Atherton, culminating in a recent deal to acquire Hess Corp.-operated carbon dioxide enhanced oil recovery assets in the Permian Basin.

"Oxy is now the dominant player for CO_2 EOR," he says. Oxy has so much acreage in the Permian that there is probably much of it that the company will not be able get to in a timely manner," he notes. "It makes good sense for Oxy to consolidate around its EOR operations with the Hess deal."

Oxy paid $600 million for Hess's EOR assets in the Permian. In a separate deal, Oxy announced, it is divesting of nonstrategic acreage to raise the funds for the Hess deal. "Companies are choosing to high-grade their portfolios, and doing so with a noncash outlay is quite smart," Atherton evaluates.

In another recent deal, Encana reached an agreement to sell its Piceance Basin natural gas assets to Caerus Oil & Gas, which was formed in 2009 to invest in conventional oil and gas properties with private equity backing from Oaktree Capital and Anschutz Investment. The deal makes Caerus the dominant player in the basin, says Atherton, and includes 550,000 net acres of leasehold, more than 4,000 producing wells, and some 7,000 future drilling locations.

"The $735 million cash transaction was one of the largest, particularly for a private-equity backed firm," he adds.

Beyond the mega deals, there are a lot of nonoperated interests trading hands, Atherton reports. "It can be a good strategy to partner with a really strong operator or deploy capital alongside a basin-dominant player," he says.

Laser-Focused Strategy

"Access to capital now really depends on a very specific strategy," Atherton offers. "You cannot just say you are going to buy assets in the Permian Basin. Everyone is trying to do that."

Instead, when management teams meet with private equity sponsors, they describe a laser-focused strategy, such as buying nonoperated working interests in a specific county within a basin with a dominant operator. Once they get operating experience, he says, they may have a chance to buy out the operator or branch out and begin buying operations.

Private equity-sponsored companies and teams "leaned into" the 2014 to 2016 downturn, says Atherton. They were buying assets aggressively to build positions that were distressed or where there was good opportunity. "In the Permian, there has been a mass conversion of private equity-sponsored companies to public companies. From an acquisitions and divestitures perspective, having private equity available during the downturn was very important. If private equity had not been there, it would have been a much scarier downturn because there would have been few buyers," considers Atherton.

As the market recovers, Atherton says the management teams that cashed out and started new companies will have to be mindful of where they want to go next. Do they go back to the Permian or do they go to a different basin? Do they hop right back into the same high-priced neighborhood they exited, or can they replicate it somewhere else?

Brigham Resources, for example, closed in March on the $2.55 billion sale of its Delaware Basin assets to Diamondback Energy. Brigham Resources's predecessor company was a public firm with Gulf Coast operations. "In the downturn of 2009, the share price fell to $2 a share. A few years later, after moving into the Bakken Shale, the company sold to Statoil for $55/share. The team then shifted its strategic focus from the Williston to the Permian Basin. Now it is trying to see if it can reapply its knowledge to yet another basin," Atherton says.

With the recent fluctuations in oil prices, public companies and private equity-backed companies will need to take a hard look at their capital commitments and drilling programs, says Atherton. "If oil prices continue to stay where they are or go down, companies will have to start cutting back on their work and reducing capital programs," he remarks. "Nobody wants to do that.

"We have sold about $500 million of properties through mid-June, which was almost double from the same point in 2016," says Atherton. "A lot of these companies, big or small, have a much more focused strategy going forward. They will continue to divest of assets that no longer meet core criteria or other investment hurdles. There is still a lot of money out there on the buyer side. We see A&D activity remaining relatively robust for the rest of the year." ❐