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Financial Options Boost Industry Operations

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Flexible Capital

Stuart Rexrode is president and managing partner of BlueRock Energy Partners, which specializes in providing flexible nonrecourse capital structures to finance independent producers' growth strategies. Before joining BlueRock, he served in executive roles in finance, mergers and acquisitions, and business development at Just Energy. Prior to that, Rexrode held positions in oil and gas producer financing at Enron Corp. He has a B.S. in aerospace engineering and an M.B.A. from the University of Texas at Austin.

Editor's Note: *With an end-of-2018 oil price swoon and commitments by operators to generate investment returns and maintain capital discipline in 2019, Barclays' annual upstream survey projects that the growth rate for total North American upstream spending will slow this year compared with last, but it still is on pace to rise 9% on an annual basis to an estimated $128 billion. That would represent a $10 billion increase compared with last year and a nearly $29 billion increase over 2017.*

In a marketplace in which analysts estimate upwards of $10 trillion ultimately will be spent to fully develop the currently identified North American unconventional resource base and build out the associated infrastructure, $128 billion may sound like relatively small change. Nevertheless a stack of 128 billion $1 bills would extend further than 8,000 miles high. That is a lot of green!

Where is all that capital originating? On what capital sources are operators relying to meet their financial needs? How are they partnering with private equity firms, mezzanine lenders and banks to meet their long-term business objectives? To find out, AOGR presented a series of questions to a panel of financial experts. The panelist featured in this e-print is BlueRock Energy's Stuart Rexrode.

Questions are in italics, followed by Mr. Rexrode's responses.

Flexible Capital Structures

***Q:** At a time when much of the impetus in onshore U.S. activity is on consolidation and right-sizing in unconventional resource plays, what are the finance challenges for smaller oil and gas operators? What are the main trends you see in oil and gas producer financing? How are those trends impacting the smaller producer's ability to aggregate sufficient capital to meet their needs?*

REXRODE: It's no secret that conventional reserves-based bank financing has pulled back significantly in recent years, given the commodity price downturn and resulting changes in bank regulations. This has particularly hit the smaller producers, where many banks have simply stopped lending to producers in the $1 million-$20 million space. Having said that, we have seen a number of alternative private capital shops open up that are helping to fill that void through higher capital cost structures.

So the capital is there; it just will likely take a different form and likely be at a higher cost than traditional reserves-based lending. The typical alternative structure likely will be more of a uni-tranche piece of paper priced in the teens, with fewer or no financial covenants and guarantees, and likely will be an amortizing structure versus interest only. Most will be nonrecourse asset-specific financings. A healthy proved, developed and producing reserves base also will be a requirement.

***Q:** Traditionally, BlueRock has focused on smaller-sized, reserves-based lending for property acquisitions and upside development. How has BlueRock's strategy evolved in step with the capital needs of smaller independents looking to acquire and develop acreage? What is a typical deal size today?*

REXRODE: We remain committed to the small-to-medium-sized producers as we see very healthy deal flow in that space. We have seen more of our business shift to acquisition financing, with many smaller players looking to grow by buying legacy conventional fields from larger independents that are shifting focus to unconventional resource plays.

With this in mind, we have structured our transactions to maximize the front-end advance rate to assist clients getting the deal done. Having said that, we always hold back development capital to ensure that the first phase of the upside work plan is implemented. At the end of the day, acquisition financing is only as good as the price paid versus the value of the property, primarily supported by PDP value. Because so many of our clients acquire properties, and through growth, either sell or refinance the asset, we make sure there are terms that protect both of us in case of an early payoff. We are particularly interested in deals in the $5 million-$25 million range.

***Q:** What types of projects will BlueRock finance? What percentage of deals are for unconventional versus conventional assets? What do you look for when evaluating a potential deal? What advice do you have for operators seeking to fund an acquisition opportunity?*

REXRODE: We will look at any project in the lower-48 states. Typically, our projects are conventional onshore assets in most cases. We do have exceptions to this rule in certain circumstances. Due to the relatively large size of drilling capital expenditures, our unconventional clients tend to be smaller working interest owners, but certainly experienced operators or nonoperators underneath proven operators.

For acquisitions, we strictly look for opportunities where the client has experience in the play. We do not support buyers in a bid situation looking to "simply do a deal," see what we can finance, and then bid that amount. Usually, this means the client has a negotiated deal with the seller. We absolutely want to see the client's own engineering evaluation and how it thinks about the opportunity before we do any work. The first meeting is critical in establishing technical credibility in the client. The client will also need to have skin in the game and bring a modest level of equity to the transaction, whether in cash or contributed production from other assets.

***Q:** Let's look at BlueRock's deal structure. Can you explain in general terms how a typical deal works? What are the producing company's contractual obligations? How do terms differ based on the nature of a deal? What can an operator do to ensure the most favorable terms in a reserve-based financial transaction?*

REXRODE: Our typical structure is a financial production payment, whereby we advance capital, and in return, we carve out a temporary override in the PDP and upside production. We will continue to sweep cash directly from the commodity buyer from the fixed percentage of net revenue interest (NRI) until a contractual rate of return is met. The percentage override is agreed to upfront, taking into account the expense burden on the client, and leaving enough percentage NRI to the client for expense coverage.

Price hedging for the client's share is encouraged, but not required. The cost of capital will be driven by reservoir mechanical risk, well concentration, decline rates, quality of upside development, and whether the transaction is acquisition financing versus assets already owned by the client. The client must adhere to an agreed-upon upside development work plan, post-acquisition or already-owned. Most favorable terms are provided for operators who can show a proven track record in the play, and present and support the opportunity with a thorough technical/engineering evaluation. We will only consider opportunities with experienced technical personnel within the client's team, and not a third party.

***Q:** How do the features of reserves-based lending compare with other types of financing? Will you discuss the advantages a reserves-based deal offers the operator? How can the producer determine whether the reserves-based financing approach is the best option for a particular growth opportunity?*

REXRODE: On the whole, traditional bank reserve-based lending will generally have the lowest cost of capital available to producers. Advance rates will be a percentage of primarily PDP value, and strict financial covenants must be met. Alternative reserve-based structures typically will provide for a greater advance honoring more upside value, higher cost of capital and few, if any, covenants.

Clearly, if operators secure reserve-based lending with reasonable terms, they keep more of the upside than if they sell down equity in the project. On the flip side, interest-only and equity structures may preserve more cash flow for the client leading up to an exit event. So it very much depends on the cash needs of the client during the term of the transaction. In general, a capital provider that specializes in reserve-based financing will likely optimize a producer's needs because it understands the challenges and opportunities in the industry. Financing generalists typically do not get there. ❐