A TOOL FOR GROWTH:

Fundamentals of Mezzanine Finance

GasRock Capital LLC

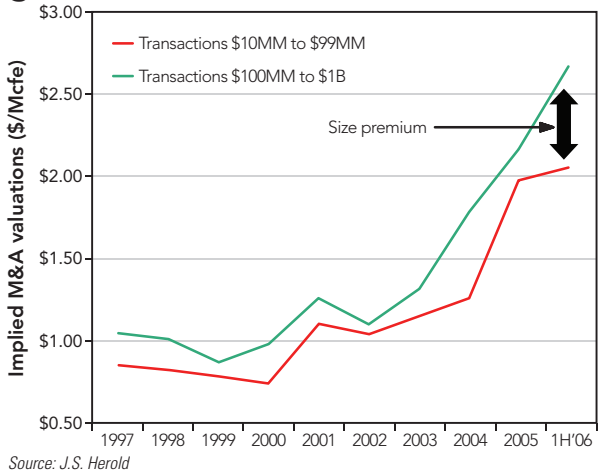
Oil&Gas Financial Journal™

Capital is the lifeblood of the oil and gas industry, since discovering, developing, and purchasing oil and gas reserves requires substantial investment. A fundamental objective of oil and gas company managements is to access capital sources that will accommodate the twin objectives of supporting growth in asset values and permitting retention of value by existing equity holders including the management itself. The questions and trade-offs surrounding various capital sources tend to focus on these two goals.

Size Does Matter

By nature, leaders of E&P companies are driven to grow. Some may ascribe this to ego gratification, but there is plenty of economic justification for this drive. For instance, access to rigs and services is generally better for larger players in a particular basin. Larger companies have better access to capital and they often receive better product prices and transportation terms for their production. The basic concept of value creation in E&P is measured largely by growth in the value of the asset base. One of the most cherished advantages of size is the premium that larger assets or companies receive in the divestiture market. On average, larger transactions receive higher valuations, achieving higher payouts for their owners. The chart here shows that on average, larger deals receive 21% more per Mcfe than smaller deals.

Fig. 1: Value vs. transaction size



Source: J.S. Herold

Achieving Growth

Growth is not easy, however. E&P companies face many impediments to growth, but the right capital structure goes a long way in overcoming many of these issues. Companies with adequate capital can lock-up rigs for longer periods, attract the best talent, and acquire assets at opportune times. Many successful E&P companies have employed mezzanine debt to finance their growth.

What is Mezzanine

Mezzanine financing generally is taken to mean "stretch" debt (i.e. debt advanced beyond normal senior debt levels) with a higher target return than senior debt, often with an element of equity participation. As in department stores which had mezzanine floors in between the ground floor and the second floor, mezzanine debt is in between senior debt and equity in terms of the acceptable risk profile, amounts to be advanced, and rate of return. In the oil and gas world, mezzanine usually refers to senior first lien debt that finances specific project assets, usually with an overriding royalty, net profits interest, and/or warrants as equity participation.

The Attractions of Mezzanine

As with bank financing, the mezzanine advances are based on the proved reserve base. The amount of advance and the nature of the development determine the relative risk profile – more risk than bank debt and less risk than equity. Mezzanine funding supports accelerated growth through development drilling or acquisitions by early-stage companies with advances often two to three times what is available from banks. Importantly, mezzanine finance does not require the sale of any share of the equity ownership in the company, does not involve giving a board seat to a funding source, and does not give control of the company to the funding source. Mezzanine funds will generally put up all the incremental capital for the development phase of a particular project, yet take a minority of the profit from the project. By contrast, bank debt often will not fund all development at the desired pace, while equity may put up a majority if not all the capital for setting up the development including leasing, seismic and first well exploration expense, but expects the majority of the profit in return.

Capital Options and Fit

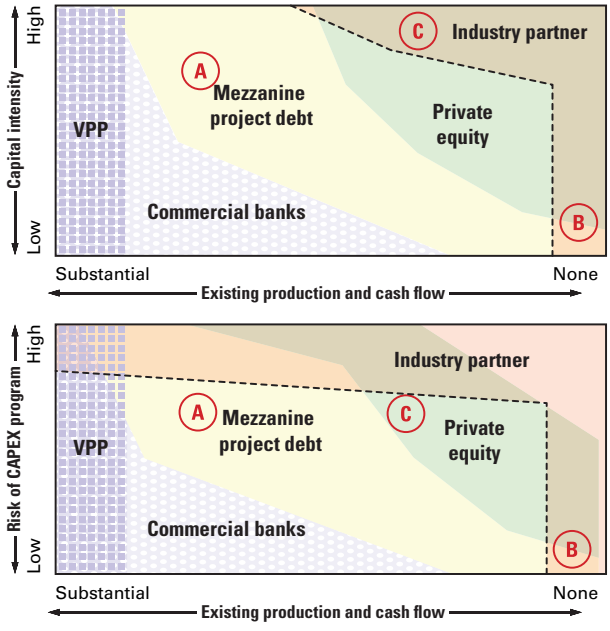
For perspective we'll compare mezzanine with the most common types of capital available to small E&P's; private equity, bank debt, volumetric production payments (VPP's) and industry partners. Most companies have more than one of these options to choose from, but applying the capital structure that fits best can make a big difference. Capital is merely a tool, and the type of capital you employ must be capable of accomplishing what you need from it. Some aspects of an E&P project that drive the capital fit are its risk, the amount of existing production, and the capital intensity of the project.

Capital intensity describes the amount of investment needed before surety of a return of that capital is achieved. A capital intensive project is one where a substantial amount of capital is needed before increased cash flow (or at least relative surety of increased cash flow) is achieved. Examples are expensive offshore wells, or fields that require a large upfront investment in geoscience or in a gathering system before any production can get to market.

Risk can be described as the likelihood that the investment (well, workover, etc.) will return the capital invested.

Figure 2 provides guidance as to the optimal financing source for a specific project based upon its capital intensity, risk, and cash flow. The letters placed on the chart are

Fig. 2: Capital fit



three hypothetical examples to help us visualize what types of financing best fit the nature of the project. The three examples are:

Company "A" drills wells in the Gulf of Mexico. "A" has nine wells to drill, each costing $5 million ($3.5 million dry hole). The wells have been evaluated as PUD by a 3rd party engineer, and also have a significant Probable component. "A" has two PDP wells with PV10% of $9 million.

Company "B" has several thousand acres in the Barnett Shale very near existing, successful production. The acreage has room for 24 wells, which cost $2 million each. Because of the offsetting production "B" has a 3rd party engineering report with eight PUDs. "B" has no PDP.

Company "C" owns an old oilfield which they wish to waterflood. The field has never been waterflooded, but there is an analogous field that was successfully waterflooded in the same productive interval nine miles to the east. "C" needs $15 million to install the flood and expects a response from the injection in six to eighteen months. The waterflood has been evaluated by a third party, and Probable reserves have been assigned. "C" has PDP PV10% of $7 million.

Looking at where each of the hypothetical deals falls on the charts, mezzanine would be an excellent fit for "A" and may be a good fit for "B". While "A's" wells are moderately capital intensive, the success of the well is relatively easy to ascertain after production is achieved, and payouts are quick. And while "B" cannot bring any production to the deal, the nearby production and PUD reserves of this widely understood play provide reasonable certainty of a return of capital.

Company "C's" most optimal financing options are private equity or an industry partner because of the amount of capital relative to the PDP PV10 and because all the capital must be spent before understanding the timing and profitability of the field after waterflood.

Cost of Capital

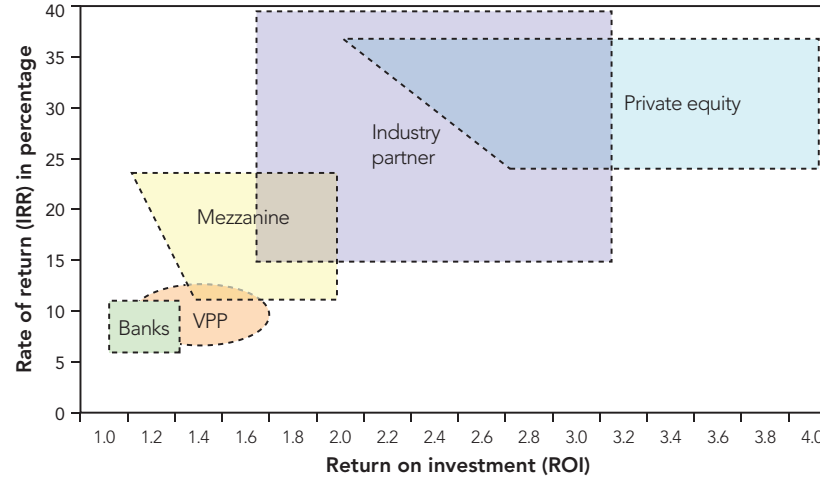
When sourcing capital, many companies elevate cost to the top of the list of priorities. Without doubt, cost is important, but all aspects of cost need to be understood and placed in perspective. Measuring cost is not as intuitive as it may appear. For this discussion we will look at two direct measures of cost, and also touch on some of the indirect costs of capital.

The most common measures of cost are the Internal Rate of Return (IRR) and the Return on Investment (ROI). Both of these measure the return to the investor, and conversely the cost to the receiver of the capital. IRR is defined as the discount rate at which the net present value of a project is zero. It is based upon the timing of when cash is invested and when cash flow is realized, and stated as a percentage. ROI is simply the dollars received from an investment, divided by the dollars invested. An ROI less than one means an unprofitable investment while greater than one is a profitable investment.

Most managers think in terms of IRR when considering financing options. However, an evaluation of cost on one dimension (IRR) doesn't reveal the full picture. Figure 3 shows the returns (measured by both ROI and IRR) typically sought by the different types of capital.

Providers of bank debt, VPPs, and mezzanine are typically driven by IRR. Private equity is perhaps more driven by ROI than IRR, which is related to the way these funds are structured and how their managements' are remunerated. For an equity fund, an investment opportunity with a very high IRR but an ROI of 1.2x is a non-starter. What this means is that for relatively short term capital needs, mezzanine can be a better fit. Many development drilling projects

Fig. 3: Relative cost of financing options



require "stretch" financing for only one to two years before the increase in the value of producing wells will support lower cost bank financing. Both the lower ROI requirement of mezzanine and the ability to pay it off without penalty fit well with shorter term financing needs.

Mezzanine deals are usually structured to return capital to the lender before management receives significant payback. Return of capital to the lender can happen very rapidly, particularly when the project itself has a high rate of cash flow and quick paybacks. This drives the IRR of a mezzanine deal up, but the ROI stays very low. Put another way, mezzanine lenders typically get a relatively high IRR, but a very modest ROI. The following example will reveal how you can make this work to your advantage.

IRR, ROI and the Power of Mezzanine: A Case Study

"ABC", a real company but one whose name we've changed, has identified a bypassed pay in its area of focus. The company has leased considerable acreage and has drilled the first three wells. They are now looking for the best way to finance drilling 72 wells which will cost $47 million, and it intends to sell the assets in 30 months. We'll compare three financing options and examine the impact that each type of financing has on the value which is created and retained by management. The field has the following characteristics:

Type Well	Field Data
Net reserves: 572 MMcf	Producing wells: 3
Cost to drill: $650,000	PDP PV10: $4.4 million
R/P ratio: 8.5	Production: 400 Mcfd
Life: 25+ years	Drilling locations: 72
	Total drilling cost: $47 million
	IRR (drill and hold): 37%
	Potential sale price: $87 million (30 mo)

The financing alternatives considered are bank debt, institutional private equity, and mezzanine debt. For the bank debt case, we assume a 7% interest-rate and an advance rate equal to 60% of the PDP PV10 value. Semiannual borrowing base re-determinations lead to additional advances over time, but because of the lower advance rate and slower value re-determinations, the desired pace of drilling is constrained by the bank's willingness to extend additional funds over time. The bank case is not constrained by rig availability; it is assumed that a rig is available as soon as bank funding is available, which may be unrealistically optimistic.

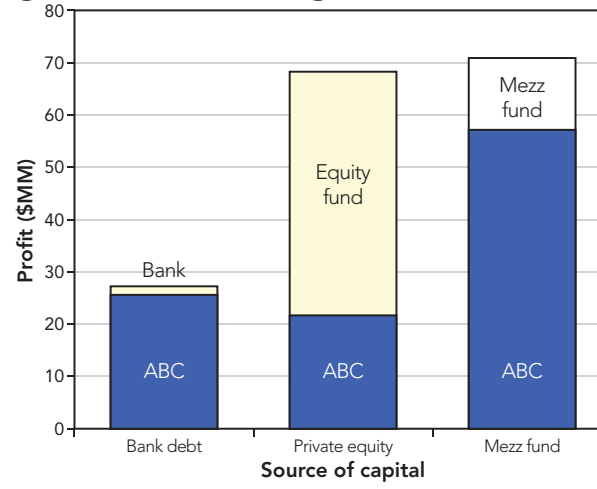
In the equity case, the private equity fund invests $28 million in ABC, which combined with cash flow and a modest amount of bank debt funds the full $47 million CAPEX program. ABC receives 14% of the equity for its contribution of the field assets, based upon a valuation at about $2.34 per Mcf of reserves and $8,000 per Mcfd of production. Through performance-based stock options, management can claw back to 34% of the equity. Over the 30 month life of the investment, the equity fund receives a 50% IRR and 3.4x ROI.

In the case of mezzanine financing, ABC receives a $47 million facility with a 10% coupon rate. The lender receives an overriding royalty interest of 5% as its equity kicker. There is a 2% advance fee paid as funds are advanced. Assuming the sale in 2 1/2 years, the mezzanine provider would earn a 23% IRR and 1.3x ROI under these terms.

Splitting the Profits

Figure 4 shows the profit generated from the project (including the sale) and how it is divided among stakeholders. Notice that in the bank financing case, management retains an extremely high percentage of the profit created, but the aggregate retained value is much lower because constraints on the drilling program slow down project value creation. With private equity, the maximum field potential is achieved, but management retains just under one third of the total value created. By contrast, in the case of mezzanine financing, full field value is created and management retains over 80% of the total profit created in the field, or $58 million.

Fig. 4: Profit sharing



The case study highlights a few points:

- Cheaper isn't necessarily better: Bank debt was the cheapest option, but unfortunately ABC had to slow its growth, and this had a hidden but real cost. The moral of the story is: don't overpay for what you need, but make sure your capital provider can get the job done. In this case, mezzanine was more expensive than bank debt, but its value to ABC far exceeded its higher cost.
- Calculate indirect costs: The mezzanine and equity options allowed ABC to fund a more consistent drilling program. In a tight market for drilling rigs and other services, the bank option could have been even worse since ABC would face even more delays than in this example, since once they released a rig, they would face a substantial wait before getting it back. As well, committing to a larger, more consistent drilling program may allow ABC to get better rates on its rigs and services.

Attracting Mezzanine

Which companies and projects attract mezzanine? The following is a list of some characteristics of the perfect mezzanine deal.

- **Reliable engineering –** a credible engineering evaluation of the acquisition, play or project is key. If you have a third-party report, make that available. Most lenders will need one before you close a deal, but you probably don't need one to begin the discussion. Not all reserves have to be proven to fit the mezzanine structure, so long as the engineering story and risks can be well understood.
- **Operational control –** a company that has a majority interest and operates the development project is in better position to control the development and meet the projected targets than a company that has a non-operated minority interest.
- **Proven operational capabilities –** a team that has all the necessary skills to carry out the proposed plan.
- **Conservative enthusiasm –** use realistic assumptions. Don't assume an LOE that is half of what has historically been true, unless you can prove you can lower it. Don't forget that as you are presenting your project, the lender is also evaluating your character. Being enthusiastic but somewhat conservative is the best way to establish credibility.
- **Skin in the game –** teams that invest in their projects, that have something at risk, attract the most attention of mezzanine lenders. Depending on the size of the project this may be 5% to 15% of the proposed investment, and in any event, should be financially significant to the managers.

- The power of mezzanine to create wealth: After the first three wells were drilled, the mezzanine provider put up all the incremental investment to drill the next 72 wells -- about 90% of the capital for the entire project. For this they took only 19% of the profit, compared to a majority of the profit that a typical equity provider would take. Mezzanine financing allows managements to capture a dramatically larger share of the value that they create.

What To Look for in a Mezzanine Partner

You should consider the following as you seek a mezzanine financial partner.

Industry experience – The E&P business is unique. Choose a fund who understands E&P to ensure that your capital partner won't flee at the first blip in commodity prices or the first time a well doesn't work quite as planned.

In-house engineering skills – A mezzanine lender must understand the reserves and the risks of your project. This is not only true when first making the loan, but also on an on-going basis in order to increase the advance rate and fund the next round of CAPEX. This demands solid understanding of reservoir engineering. Lenders who must reach outside their firm to evaluate your project are more likely to be slower and more unpredictable. Slower because they take more time to evaluate and respond to your requests, and less predictable since they may make offers based upon rough estimates of reserves and risks, and then hire consultants to true-up their picture. This can lead to changes in terms late in the closing process, or to a deal that doesn't close.

Responsiveness – Look for a funding source that listens to your needs and responds quickly. A mezzanine partner that drags its feet will cost you in the future in terms of missed opportunities. Additionally, a slow response may indicate a lack of understanding of your project.

Reasonable cost – The cost of the financing needs to be measured against how much it allows you to achieve. A low cost facility that doesn't give you enough capital may not be a bargain if it doesn't allow you to grow.

Scale – Look for a lender that can grow to a much larger size. You never know how successful your project will be, or when you will find that perfect acquisition and need more capital quickly. If you are chained to a lender who only wants to make loans up to $20 million and your project needs $40 million because of success, then those constraints could cost you your growth. Yes, you can refinance, but it is usually very disruptive to your business and can be expensive.

Flexibility – It is difficult to predict exactly how a field development will play out. The geologic picture of a field or the understanding of the productive capabilities of the reservoir will often change as a field is developed. Your lender should expect this, and as you change your capital program to reflect your better understanding, the lender should be able to quickly adapt. (This relates to the lender's industry experience and in-house technical capabilities.)

People fit – A mezzanine lender is your partner for a period of time, and as such you should pick someone you can live with. Are they accessible? Are they excited about your project and your success? Do you like them? Do you trust them? Talk to other companies they have financed and see what they say about the style of the lender after the deal closed. Most E&P managers accept that they will have their backgrounds checked – but they rarely think to check out their financial partner.

Conclusion

Although no one type of financing is the best choice for all companies or all strategies, mezzanine financing is in most cases a great fit for companies and projects that are heavy on development drilling, especially where there is a small amount of existing production at the outset. Advantages include its ability to fund rapid growth from a small base, the large majority of value retained by the managers and other equity holders, and retention of outright control by the existing owners. Where the risk is moderate and well defined, the wells financed can often extend well beyond the proved undeveloped category. Typically, after project values have increased substantially in one to three years, the mezzanine financing can be paid off without penalty and refinanced with cheaper bank debt, leaving equity owners with as much as 70% to 90% of the profit derived from developing the project.

GasRock Capital LLC

GasRock Capital LLC is an energy industry mezzanine investment firm. It was founded in mid-2005 to invest in oil and gas development drilling projects and property acquisitions as well as mid-stream natural gas projects such as pipelines, gathering systems, and storage and processing facilities. GasRock targets investments of $5 to $100 million or more in the form of mezzanine debt or project equity in companies or projects managed by both newly formed and long established companies.

Investments are usually structured as non-recourse to the sponsors, with royalty or other equity kickers. GasRock will consider either senior or subordinated debt investments.

A GasRock financing supports a much faster pace of development, and allows the owners of the project to keep a much higher percentage of the profits they create than they would with equity or industry partner funding – often 80% or more. GasRock aims to be especially responsive to transaction requirements such as short time fuses and to gain a reputation for closing investment transactions relatively quickly and without changes from the initially agreed upon terms.

Typical projects financed by GasRock:

- Company or property acquisitions
- Development and exploitation drilling
- Gas gathering and processing
- Gas storage
- Pipeline acquisition or construction

Our people:

In 2005 the principals of Weisser, Johnson & Co. formed GasRock Capital with funding commitments from financial institutions that together manage approximately $8 billion. Weisser Johnson, which manages GasRock Capital, is an investment banking advisor and agent for oil and gas producers and other energy companies in private placements of equity financing and in acquisitions and property or company sales. The firm has completed transactions ranging in size from about $5 million to over $400 million. The four founders of GasRock have completed over $12 billion of energy financing or M&A transactions in their careers. Below are brief biographical descriptions of the four founders.

Frank M. Weisser, Managing Director, has over 30 years of energy transactional experience. He spent 17 years with major investment banking firms in New York City, focused primarily on energy. He was with Merrill Lynch and Morgan Stanley, and led the Energy Group of Bear Stearns. In 1991 he co-founded Weisser Johnson.

Mr. Weisser received a bachelor's degree in chemical engineering from The University of Texas and master's degrees in both chemical engineering and business administration from the University of Michigan. He worked as an engineer with Shell Chemical in Houston and Shell Oil in New Orleans and served as an officer in the U.S. Navy Civil Engineers Corps in Yokosuka, Japan.

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Scott Johnson is a Managing Director of GasRock and brings a total of 28 years of investment banking experience focused in the energy industry. He began his career at Goldman Sachs in New York, where he worked thirteen years primarily in the Energy Group with responsibility for the execution of transactions totaling several billion dollars for oil and gas, oil service, utility, and pipeline companies.

Scott co-founded Weisser Johnson in 1991 where he is a Managing Director. He holds an undergraduate degree from Harvard College magna cum laude and an MBA from Stanford University. He is a director of Blast Energy Services, Inc.

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David Taylor, Principal, has over thirty years experience in the oil and gas industry with a focus on evaluation of exploration and development projects. He began his career with Exxon, working in the Gulf of Mexico and Gulf Coast areas. He next joined Transco and later Aquila, working in the E&P subsidiary of each company. He then joined Halliburton, where he was responsible for sourcing, evaluating, and closing new business ventures as the company expanded into the role of a risk sharing partner.

David is also a Principal of Weisser Johnson, the manager of GasRock Capital. He earned a degree in Chemical Engineering from Oklahoma State University.

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Marshall Lynn Bass, Principal, has over thirteen years of transactional and consulting experience. He began his career in consulting, working for DLB Associates and in the Energy groups of Arthur D. Little and Ray & Berndtson.

Lynn joined Weisser Johnson in 1998, where he is a Principal. He has experience in upstream and midstream sectors of the energy industry.

He earned a bachelor of science in Honors Economics from Purdue University, and a masters degree in business administration from Rice University. He is a director of Dune Energy Inc.

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Recent Transactions

Miller Energy LLC

$30,000,000

Advancing credit facility to Miller Petroleum Partners, L.P. to refinance acquired North Texas assets and fund accelerated exploitation.

Provided by:

GasRock Capital LLC

October 2005

Westside Energy Corp.

$45,000,000

Advancing credit facility to subsidiaries of Westside Energy Corporation to develop North Texas Barnett Shale assets.

Provided by:

GasRock Capital LLC

March 2006

Saddle Rim Energy LLC

$25,000,000

Advancing credit facility to finance acquisitions of producing assets and to fund the associated future exploitation programs.

Provided by:

GasRock Capital LLC

March 2006

EnDevCo Eureka, LLC

A subsidiary of EnDevCo, Inc.

$30,000,000

Advancing credit facility to finance acquisitions and exploitation of the Short Junction Field in Oklahoma.

Provided by:

GasRock Capital LLC

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GasRock Capital welcomes enquiries from companies who want to accelerate their growth with the right capital partner.

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