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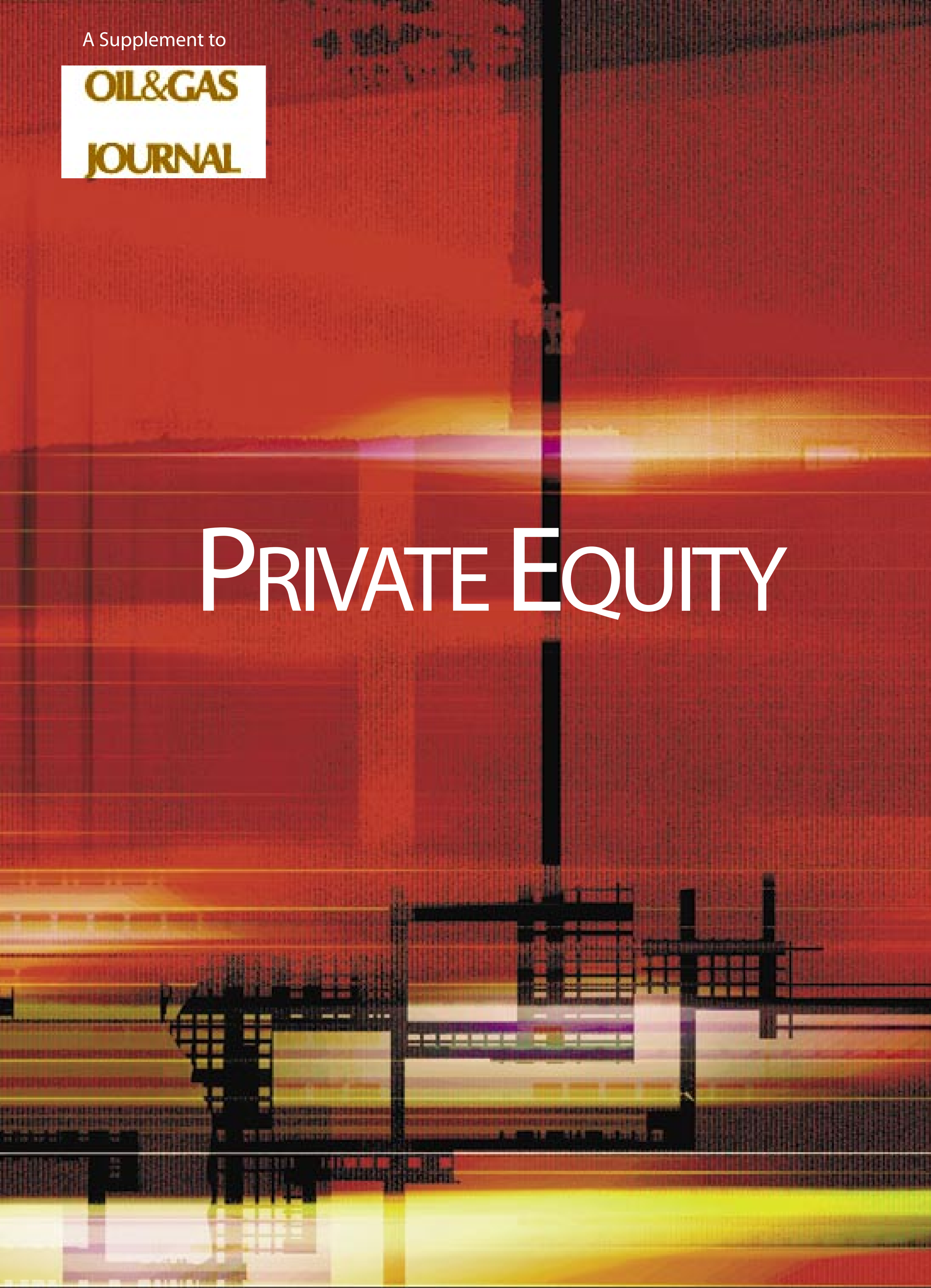

PRIVATE EQUITY

What is private equity?

Don Stowers, OGFJ Editor

Private equity can be defined as medium- to long-term financing provided in return for an equity stake in a company. Sometimes, but not always, the capital is provided to early-stage or expanding companies. Private equity funding often provides "seed money" to enable expansion, but it also can be a source of capital for management buyouts and buy-ins.

Private equity offers an avenue to long-term, committed share capital for privately held companies that are not listed on stock exchanges either in the United States or abroad. For companies seeking to start up, expand, buy into a business, buy out a company or a division of a company, turnaround or revitalize a company, private equity can help you do this.

Obtaining private equity funding is different from acquiring funding from a bank or other lender. For one thing, lenders typically charge interest on a loan and expect repayment of the capital they lend the user regardless of the company's success or failure.

Conversely, private equity is invested in exchange for a stake in the company, and the investors' returns are dependent on the growth and profitability of the business.

In the US oil and gas industry, private equity firms typically hold investments from 3 to 7 years, although 10 years is not unusual. Some firms even invest for periods much longer than 10 years.

Newsweek magazine financial columnist Allan Sloan called 2006 the "year of private equity" because of all the private equity money sloshing around on Wall Street, resulting in the so-called "buyout boom."

Critics of private equity LBOs (leveraged buy-outs) say the main goal is to squeeze out the best possible return for high-dollar investors at the expense of shareholders. However, shareholders typically receive a 10% to 15% premium over the company's 52-week market high, and the investors taking the company private have to be willing to assume the financial risk of doing so. In addition, "go shop" provisions, which are common these days, allow a company to shop around for better offers after the first bid is announced.

Historically, private equity-backed companies have been shown to grow faster than other types of companies. This can be attributed to the combination of capital and experienced personal input from private equity executives, which sets this type of financing apart from other forms of finance.

In the oil and gas industry, private equity firms provide business and financial acumen to oil and gas executives who typically come from the industry side of the business (geologists, petroleum engineers, etc.) and provide a stable and unemotional base for strategic decision making. Private equity firms strive to increase a company's value to its owners without taking over day-to-day management control.

One private equity firm executive we know commented that, "You may have a smaller slice of the cake, but within a few years your slice should be worth considerably more than the whole cake was worth previously."

Private equity isn't raised just to buy petroleum reserves. The intent is to build a company. Value is created through the development of a business enterprise capable of repeating its success time after time. Ultimately, many of these companies go on to become publicly-traded companies with a considerable payout to management and investors. Others prefer to remain private, especially after the passage of Sarbanes-Oxley, and never go through the IPO process.

There are several advantages of private equity over senior debt. A loan provider, often a bank, receives interest and repayment of the loan, which is often secured either on business assets or personal assets, such as a home. If the company defaults on its repayments, it can be hard on management that has given personal guarantees. Debt secured in this way has a higher priority of repayment that of general unsecured creditors, and is referred to as "senior debt."

Private equity is not secured on any assets. Therefore, the private equity firm accepts the same risk of failure as other stakeholders in the company. The private equity firm is an equity business partner and is rewarded by the company's success, although there is no guarantee of anything.

Ultimately, the private equity partner achieves its principle return through realizing a corporate gain via an exit strategy, which may include:

- Selling the shares back to management;
- Selling the shares to another investor;
- A trade sale; or
- The company going public and becoming listed on a stock exchange.

There are advantages and disadvantages to private equity. To learn more and to gain a critical perspective, turn the page to read "Weighing the pros and cons of private equity funding" by OGFJ correspondent Erica Shillings.

Weighing the pros and cons of private equity funding

Private equity is the preferred method of funding by many E&P companies. While private financing has many advantages, there are some disadvantages as well. To gain a critical perspective of private equity, OGFJ visited with attorneys Edward Rhyne of Haynes and Boone and Hugh Tucker of Baker Botts, as well as PetroInvest's Steven King.

Erica Shillings
OGFJ Correspondent
Houston

There are many good reasons oil and gas companies should consider private equity funding, but senior management should weigh the various options and look at the pluses and minuses of private equity funding before making their decision, say several experts in this field.

Edward Rhyne, partner, corporate section, in the Houston office of Haynes and Boone LLP, said one of the reasons private equity is becoming more popular is that private equity funds are typically flexible and opportunistic investors move very quickly as compared to large public company investors.

As a company grows, it is a difficult decision as to whether to remain a privately funded company or to go public. Depending on which road a business decides to take, there are plenty of opportunities in private equity funding, but everyone in the industry has their own opinion on whether private equity funding is the way to go.

Why private equity is important

There are a number of reasons why more oil and gas companies are choosing to be privately funded. Rhyne, who has years of experience forming and representing private equity funds, offers numerous reasons why private equity is so important in today's oil and gas industry.

- Owners of companies that desire to sell some or all of their equity typically look to public offerings, strategic buyers, or financial buyers (private equity falls into this category).
- Public offerings generally take much longer to complete than private equity- sponsored transactions, depend on market conditions, and (since the passage of Sarbanes Oxley) require future material expenditures and resources to meet today's regulatory requirements.
- Strategic buyers are often willing to pay higher values than private equity buyers, but they may not offer sellers an opportunity to participate in future growth of the seller's business. In addition, there may be a limited number of strategic buyers for a specific seller, and antitrust issues may make selling to a competitor more difficult to accomplish.
- Private equity funds will usually have longer investment horizons than typical public company investors that all too often have investment horizons no longer than a few months or quarters. That does not mean that private equity firms have lower expectations.
- There are huge amounts of money invested in private equity funds. We now have multi-billion dollar private equity funds. Consequently, there are almost unlimited dollars chasing a limited number of transactions.
- The energy industry has become popular with private equity funds because there have been, at least recently, opportunities to achieve outsized returns in exchange for tolerable risks.
- Private equity firms are able to move quickly, are typically educated investors, may bear higher levels of risks than the public

"Traditionally, LBO funds want to acquire controlling equity stakes in companies and usually want management to hold a significant stake in the company so that their interests are aligned with the private equity investor's interest. Hedge funds may invest in debt or equity, could invest in a project or a business, may have much shorter investment horizons than LBO funds, and may tolerate much greater risks than LBO funds or any other investor. Of course, they also expect great upside potential." – Edward Rhyne, Haynes and Boone LLP

market, and oftentimes have longer investment horizons than the public markets (quarter-to-quarter expectations).

How private equity is structured

While private equity is an extremely complex subject to those unfamiliar with the concept, Hugh Tucker, partner, in the Houston office of Baker Botts LLP, explained, "Private equity firms typically acquire businesses and keep existing management or otherwise invest in an ongoing business by taking an equity stake. On projects, they typically provide equity to a sponsor and become an equity participant in the project company. Usually a single-purpose entity established to own the particular project. The structure of the entity depends on a number of factors, including tax, location of the project, nature and residency of the investors, including the investors in the private equity fund, bankruptcy issues, and regulatory concerns."

Tucker continued, "In either case, they do not typically participate in the lending group. The lending group is typically comprised of commercial and investment banks that may be loosely aligned with the private equity firms (i.e., that is, many banks have relationships with the private equity firms so they are familiar with their requirements and can act quickly along with the private equity firm in making the investment)."

When asked to explain how private equity funding works, Rhyne replied, "I think you first have to distinguish between different types of private equity firms. There are leveraged buy-out (LBO) firms (which are generally what are referred to as private equity funds), hedge funds, and real estate funds. There are then multiple subsets of each, and the distinctions between LBO and hedge funds have become fewer in the last few years.

"Traditionally, LBO funds want to acquire controlling equity stakes in companies and usually want existing or new management to hold a significant stake in the company so that their interests are aligned with the private equity investor's interest. Hedge funds may invest in debt or equity, could invest in a project or a business, may have much shorter investment horizons than LBO funds, and may tolerate much greater risks than LBO funds or any other investor. Of course, they also expect great upside potential."

Rhyne further explained that regardless of the type of investment, private equity funds will almost always have much more involvement in the supervision of the operations of their portfolio companies than directors or shareholders of public companies or commercial lending institutions.

In addition, private equity firms pride themselves as "smart money," said Rhyne. They spend many hours learning about and understanding the businesses in which they invest, and to the extent they need additional expertise in connection with an investment, they will find that expertise.

Private equity management is also an important factor. Rhyne noted, "Most private equity investments start with very detailed business plans that are developed with management. Management oftentimes invests in a business alongside the private equity investor. Management's incentives are crafted to reward them richly for achieving their objectives. On the other hand, if management fails, then they suffer along with the private equity investor."

In the past, private equity has been characterized as a "huge slush fund" waiting for investment. When asked if this is a fair description, Rhyne said, "Well, funds certainly have access to large amounts of committed capital to invest, and the sponsors typically have broad discretion in where to invest this capital. On the other hand, private equity sponsors have every incentive to invest their investors' funds prudently. Although private equity sponsors receive management fees from their fund investors (around 2% of committed capital annually during the investment period), their largest financial incentive is a portion of the profits earned on portfolio investments (a carried interest that usually is 20% of net proceeds after investors recover their invested capital (including previously paid management fees) plus an annual rate of return on their invested capital).

"In addition, if a private equity firm profits from one investment, but then makes a bad investment, the funds usually include clawback features that would require the sponsors to repay prior carried interest distributions to the extent necessary to cover future losses. As a result of all this, even though the funds have access to large amounts of capital to invest, fund sponsors have very large incentives to return funds to their investors if they cannot find suitable investment opportunities."

In addition to Rhyne's comments, Tucker noted, "It is true that there is a significant amount of cash available for investment through private equity funds, and they compete very effectively in the M&A market in the energy sector."

What are the pros and cons?

While Rhyne's outline of the popularity behind private equity appears to be quite attractive compared to public equity, there are pros and cons to any situation. According to Rhyne, he views the pros and cons as:

Pros

- Management participation and incentives may be much greater than in public companies (truly aligned incentives)
- No public reporting pressures
- No Sarbox expense (time can be spent running the company rather than satisfying reporting requirements)
- Longer/flexible investment horizons
- Ability to make and implement decisions quickly
- Smart money
- Active/hands-on/helpful oversight

Cons

- Accountability (great for investors, painful for management that is not performing)
- Opportunistic (sales opportunities will be considered)
- Investment horizons. There are horizons. Few firms intend to hold investments indefinitely.
- Over-leverage risks?

Tucker feels that avoiding the significant public reporting requirements, the ability to close transaction more quickly, and that returns are tied to growth of business rather than a set interest and principal repayment schedule are also some of the advantages of private equity.

Hedge funds in private equity

Hedge funds are private investment funds. These funds can charge a performance fee and are normally available to a certain amount of investors. Within the private equity investment markets, hedge funds have increased.

In comparison to private equity funds, hedge funds share some of the same characteristics. Private equity funds and hedge funds are both regulated. Hedge funds are mainly used to invest in liquid assets and allow investors to simply enter or leave the fund. As for private equity funds, they are invested in illiquid assets.

In terms of hedge funds, Tucker commented, "I do not see much hedge fund activity in my practice. They typically have different investment objectives, although the larger private equity funds with brand names are handling both types of funds. I have also recently seen managers who had both types of funds under one management company split those companies because of the very different investment objectives and the way in which they manage their investments."

When asked if hedge funds being largely unregulated are a major factor in their growth, Rhyne said, "I do not believe so. Most of the largest hedge funds are registered investment advisers and, therefore, subject to SEC oversight. I believe the growth of hedge funds has been fueled by the tremendous and well-publicized success of a fairly significant number of these firms and the lack of other investment opportunities that offer similar return profiles. But, remember that large returns typically come at the expense of more risks. I do not believe that hedge funds are suitable investments for everyone. They are very complicated structures and usually have very complicated investment strategies. Investments in these funds should be reserved for the most sophisticated investors."

Today's private equity lenders

In the oil and gas industry, some individuals use the word "lenders" when referring to private equity. When asked who the big private equity lenders are today, Tucker said, "To clarify, I think it is a misnomer to say private equity lenders. I view investment by private equity funds different from lending. Several of the big private equity funds in the energy sector include Blackstone, Carlyle, Madison Dearborn, CCMP, Riverstone, Texas Pacific Group, and there are several energy-specific funds that include Energy Spectrum, Quantum, and Sowood."

With regard to private equity lenders, Rhyne said, "Lenders may not be the correct term. There are available lists of the largest funds, which would include KKR, Blackstone Group, TPG (Texas Pacific Group), Thomas H. Lee Partners, Bain Capital, Carlyle Group, and Apollo. There are many more. Perhaps more importantly for companies that are thinking about a transaction with private equity funds are some of the middle market funds that invest in a broad range of industries, including the energy industry."

"CIC Partners in Dallas is one such private equity firm with over 30 years' experience in the private equity industry and industry partners and investors that provide them a broad base of expertise in the oil and gas industry. This type of experience is very important for management teams that are contemplating a transaction with a private equity firm. They will work very closely with the private equity firm after the transaction and relationships and personalities are critically important in choosing a firm to partner with."

Long range trends in private equity capital

In terms of financing aspects, it is always reassuring to hear positive comments when investing large sums of money. Rhyne said, "I am optimistic, especially in light of the current regulatory environment for public companies in the US and what I

"Because of the relatively illiquid nature of the investment from an investor in the private equity fund standpoint, the private equity fund managers look for a relatively high return and the ability to divest within a 3- to 5-year time frame (which is prior to the end of the life of the fund, which is typically 7 to 15 years)." – Hugh Tucker, Baker Botts LLP believe are huge incentives for public companies to manage for quarterly results and not long term growth. On the other hand, it is bothersome to see private equity funds (financial buyers) selling their portfolio companies to other private equity funds in auctions at higher and higher values. I do not believe most companies' cash flows are increasing sufficiently to justify increasingly high valuations. If everyone continues to bid up purchase prices, then I worry that these companies will end up overleveraged, which, by the way, will then provide opportunities for the distressed debt funds, several of which have been very successful."

Attracting investors

Of course with private equity there have to be appealing aspects to attract investors. In terms of what investors are looking for, Rhyne said, "These days I think it is safe to say that there is a private equity firm for every investment opportunity, but start ups are difficult to fund. Most private equity firms want an earnings track record. On the other hand, there have been plenty of private equity funds that have been interested lately with E&P investments."

Rhyne further explained that private equity firms usually require an experienced management team (unless, of course, they already have an experienced management team waiting for the right deal). In fact, for any investment opportunity, the most critical element for a private equity firm is having a management team that can execute their business plan.

When it comes to what investors are looking for, Tucker responded with, "It runs the gamut. New startups are fertile ground, especially in the alternative energy area. Existing companies with significant growth opportunities because of a new technology to enhance recovery out of old fields, an attractive play, or just stable growing companies. Large independent companies with established management and good track record of sustained growth."

Rate of return or ROI

Rate of return or return on investment (ROI) is the percentage of money gained or lost on an investment compared to the sum of money supplied. The ratio of money that is gained or lost is sometimes called interest, profit/loss, gain/loss, or net income/loss. The money that was provided may be referred to as the asset, capital, principal, or the cost basis of the investment. ROI is also known as rate of profit, rate of return, or return.

As to what kind of ROI private equity investors expect to receive in what amount of time, Haynes and Boone's Rhyne said, "Most firms will say they are looking for returns at least in the mid-20s, but as more and more funds are competing for investment opportunities, these expectations seem to be dropping into the high teens."

Rhyne further explained that the mid-20s number is an internal rate of return (IRR) target, not ROI. Most private equity funds want a return of 2x to 3x of their investment and an IRR in the mid-20s. You really have to look at both because if a deal is flipped quickly, then the IRR number can be very high without translating into a high multiple, and if an investment is held for an abnormally long time then IRR may become the more meaningful measure.

"Private equity firms typically plan to hold investments 3 to 7 years. On the other hand, some firms are very comfortable holding good investments for much longer. One of the firms, CIC Partners, has, for example, held several good investments for much longer than 10 years," said Rhyne.

In terms of ROI and IRR, Baker Botts' Tucker noted, "Because of the relatively illiquid nature of the investment from an investor in the private equity fund standpoint, the private equity fund managers look for a relatively high return and the ability to divest within a 3- to 5-year time frame (which is prior to the end of the life of the fund, which is typically 7 to 15 years)."

Due diligence

A critical factor of private equity is the practice of due diligence. The process of due diligence involves a thorough investigation of an investment in private equity done in the form of a fund or on a company level. Before signing a long-term deal, it is crucial to have an individual or group analyze every aspect of an investment.

"There are many firms whose whole existence is the providing of the technical and background due diligence for the oil and gas industry," said Steven King, president of Houston-based PetroInvest LLC. King explained that on the non-petroleum insider side, that he has found a complete lack of effective due diligence.

"The biggest flaw that I've seen on the non-petroleum side is the reliance on a single generalist provider of due diligence. This results in only a partial evaluation of the project. And the other areas are either ignored or – even worse – commented on by somebody without the qualifications necessary," said King.

King divides due diligence into four separate areas, which require 4, maybe 5, separate providers.

- Background, credit, or criminal check – "You would be surprised how often everybody assumes that somebody else has done it and how many times the sponsor hasn't even been asked for a statement about his background. I personally think that this is best done by a private investigating firm, preferably a former FBI agent," said King.
- Document review – the one area that is being effectively looked at.
- Technical due diligence – the most important area, but also the area that the non-petroleum side normally does not touch. "I consider this the most important area because it doesn't matter how good the management team is or how good the paper work is, if the project you're getting ready to invest in is poor, nothing is going to change that. And the only way to decide if it's poor or not is to have a quality third party industry technical person to take a look at it," said King.

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– Steven King, PetroInvest LLC

- Economic modeling – this has to be done by somebody taking the numbers provided by the sponsor as checked by the technical due diligence and making that into something that the investor and investment advisor can understand.

In private equity, is it important that companies involve due diligence to ensure a safe and profitable investment. "In my experience, private equity firms spend a tremendous amount of time and money on due diligence. Firm sponsors have huge incentives to invest in deals that are going to be successful and the opportunity costs of investing in bad deals is very high," said Rhyne.

When asked if the due diligence performed by private equity investors was generally adequate, Tucker said, "Yes. Private equity funds have very sophisticated advisors and very knowledgeable financial and, in some cases, industry experts within their management group (or will hire them as advisors). Accordingly, you see a very disciplined and comprehensive approach to the diligence effort. Keep in mind their time horizon makes some of the shorter term financial diligence all the more important unlike traditional industry players who would be looking to invest for a very long term."

Size range for private equity investments

With regard to size range and if investments max out at a certain point, Rhyne said, "I have seen private equity investments as small as $1 million, and in the current environment, I do not believe there is a cap on the size of deals in which private equity firms will invest. There are now private equity funds with more than $3 billion in committed capital. The common factor in every investment is the opportunity to significantly increase profitability."

The current phenomenon is certainly that there is no max limit. Since there is so much money being held by private equity funds they are increasingly looking at larger and larger acquisition targets, said Tucker.

Initial public offering (IPO)

Within private equity funding, companies are sometimes left to make a decision to strive for an initial public offering (IPO), which is also referred to as "going public," or to sell the company for a profit. Companies that make the choice to do an IPO usually are somewhat new and small in the industry and are making the step to increase their business with equity capital.

There is no predisposition as to the type of exit. When the IPO market is hot, private equity firms will take companies public. When the buyout market is hot, they will sell their portfolio companies to strategic or other financial buyers. If no market is hot, then the funds will continue to operate and grow their companies, said Rhyne.

As to whether most private companies have a goal of an IPO or to sell the company for a profit, Tucker said, "They all have an exit strategy but it varies depending on the purpose of the fund and the nature of their investors. Recently, you are also seeing private equity funds joining forces with a strategic industry player to realize synergies in creating a larger company to compete in the particular sector of the energy business they are involved in."

As far as whether or not management and the investors are on the same page regarding this decision, Tucker said, "This can be a source of tension but generally management is aware of the exit strategy at the time the private equity firm invests in the company and, as indicated, there is typically a 3- to 5-year time frame (increasingly we are seeing private equity firms with a somewhat longer time horizon) before that exit event will occur."

Private or public?

With the pros generally outweighing the cons in terms of private equity funding versus public equity, it is no wonder that more E&P companies are choosing to stay private. However, when the right opportunity presents itself, even hardcore private companies may decide to go public.

Newsweek magazine recently referred to 2006 as "The Year of Private Equity." This is undoubtedly a reflection of the positive growth and numerous opportunities that remain within private equity investments. No where is this more true than in the oil and gas industry.

Rhyne said, "The last report I saw (which may not be the latest report issued) was in Dow Jones Private Equity Analyst, which reported that approximately $96 billion was raised by about 150 private equity firms in the first half of 2006."

PIPEs offer alternative method of financing

Erica Shillings, OGFJ Correspondent, Houston

Private equity is a preferred form of raising capital by many in the oil and gas industry. However, another unique financing mechanism is being used increasingly when more traditional forms of equity financing are difficult to arrange. PIPEs (private investment in public equity) appear to be gaining in appeal as significant amounts of capital are invested and as the advantages of this method become apparent.

As an industry and its transactions change, so do the preferred financing vehicles. Although public offerings have traditionally served as a means of raising capital, private equity is now playing a larger role.

PIPEs, available to a number of industries, present advantages that an increasing number of companies, large and small, are finding attractive. In transactions ranging from $1 million to $400 million, PIPEs offer a unique alternative.

Understanding PIPEs

Finding the right financing at the right time drives all transactions. Keith Behrens, principal and managing director of Dallas-based Energy Capital Solutions LP, explained why PIPEs warrant consideration.

"The main advantage of a PIPEs transaction is timing and what happens is companies will issue their equity securities privately. Shares are not freely tradable until the shares become registered. The equity offering closes prior to the SEC registration process so the company has access quickly to use the proceeds from the offering to drill wells, etc.

"After closing of the offering, the company will then go through the registration process related to the equity securities that they issued in the offering. Once the SEC declares the registration statement effective, then the shares that the investors bought in the offering become freely tradable.

"The difference is you can go out and do a public offering, but in that case you have to go through the SEC process prior to the equity offer closing, and so that could be anywhere from a three- to nine-month difference in timing between when the company actually closes the offering in both of those cases."

Behrens emphasized the importance of timing, especially in acquisitions. "Often you will see a PIPEs deal done in conjunction with an acquisition because the company needs to close the acquisition by a certain date. Because there is more uncertainty, an acquisition could get away from a buyer if it has to wait for the SEC process to reach a conclusion versus a PIPEs financing where the deal can close more quickly. A PIPEs offering is perfect for that instance where there a short timing deadline."

Considering PIPEs features

Timing, however, is not the only benefit attracting companies and investors.

Other advantages include:

- SEC registration prior to a PIPE offering is not required
- Requires little preparation
- The cost relating to PIPEs is less expensive than public offerings
- Transactions are more flexible when it comes to size

PIPEs transactions can also define their own guidelines for investors, such as type of industry, location, minimum share price, etc. Businesses are able to pinpoint the type of investor sought by outlining these details in a PIPEs transaction, resulting in less time spent on each transaction.

Behrens identified some of the investors involved in PIPEs: Silver Point Capital LP, Greenwich, Conn.; Laminar, which is an affiliate of DE Shaw; Wellington; HBK; Bonanza Partners; Laurus Capital; Heights Capital; Polygon; and Centaurus.

PIPEs in the oil and gas industry

The continued growth and strength of PIPEs are driven by the pairing of the types of companies and investors involved. PIPEs are ideal for hedge funds and private equity firms because their purpose is to help companies raise money by selling shares to a group that is specifically seeking that type of investment.

Behrens, who co-founded Energy Capital Solutions a little over 5 years ago, said that the company has done 25 PIPEs transactions to date. "We have been doing more and more each year. I think we did, and this is just rough numbers, I think we did 8 of them last year. We are up to 25, and continue to see more activity."

PIPEs have gained acceptance over the last few years. "Over the past several years, hedge funds raised more capital, and when commodity prices went up there was more interest from hedge funds in investing in energy. One of the chief ways they have been able to invest in the energy sectors is through PIPEs deals. So it has definitely become a popular financing vehicle for small- and mid-sized public energy companies."

Within PIPEs, Behrens said that Energy Capital Solutions deals with hedge funds with energy expertise on staff and that are serious and committed to this industry. "They will always go up and down on their portfolio allocations to the energy sector and maybe move some capital out of energy into other sectors, if they become a little more negative on energy and a little hotter on other certain sectors.

"Generally most of our hedge funds will probably always have at least some allocation of capital to energy over the next several years. It has been a good financing source that has just become available in a big way for energy companies as a financing source over the past few years," said Behrens.

One trend contributing to the shift of investment toward energy companies observed by Behrens is related to this industry's tangible assets. "Some of these hedge funds had been investing in technology companies that may have had less in the way of tangible assets. Energy became attractive after some of the technology bets did not pay off. There was little downside protection because of little in the way of tangible assets.

"With energy companies, there is generally some tangible asset value involved, which provides downside protection if fundamentals move against you. And of course, hedge funds' views on fundamentals within the energy sector is a driver for interest in investing. One way of playing a bullish view on commodity prices is to invest in companies operating in this sector."

Primary uses for PIPEs

PIPEs are applicable to varying energy business structures, which Behrens illustrated with deals completed by Energy Capital Solutions:

- E&P—PIPEs proceeds are generally used to drill wells or fund an acquisition.
- Oil field service—proceeds are used to buy oil and sell service equipment, build drilling rigs, or other types of oil field service equipment, etc.
- Alternative energy—in the largest PIPEs financing completed by the company to date, a $90 million equity offering, proceeds are going to build an ethanol plant in Hartford, Tex.

A promising 2007

Behrens anticipates an increase in PIPEs deals in 2007. He points to the growth of hedge funds, the main investors in PIPEs, and Energy Capital Solutions' strong contacts within this community focused on energy or, at a minimum, have part of their portfolio focused on energy.

"Their appetite for investments in PIPEs deals is a big driver to overall PIPEs volume and is driven by fundamentals such as the hedge funds' view on commodity prices and company valuations," he said.

"Certainly the commodity prices are still very good, but they have come back. This generally slows deal activity and has caused stock prices for oil and gas companies to trail down. At lower stock prices, some of the companies are not as excited about issuing equity. However, hedge funds still have an appetite to invest in energy companies, and energy companies always need capital."

Behrens concluded, "Generally, valuations are still pretty good, so I think we will continue to see strong activity in 2007."

J. Russell Weinberg (left) and Keith Behrens, principals and managing directors of Dallas-based Energy Capital Solutions, say their firm has done 25 PIPEs transactions to date, including 8 last year.