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Capital

KEROGEN ENERGY FUND, L.P.

Equity, Mezzanine & Senior Debt Financing Options for Junior E&P Companies

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March 2, 2016

Agenda

- Introduction
- Definitions
- Cost of capital
- Use & Misuse
- Sources of Capital: Changes in 2 Years
- Private Equity for Growth & Development
- Some Conclusions

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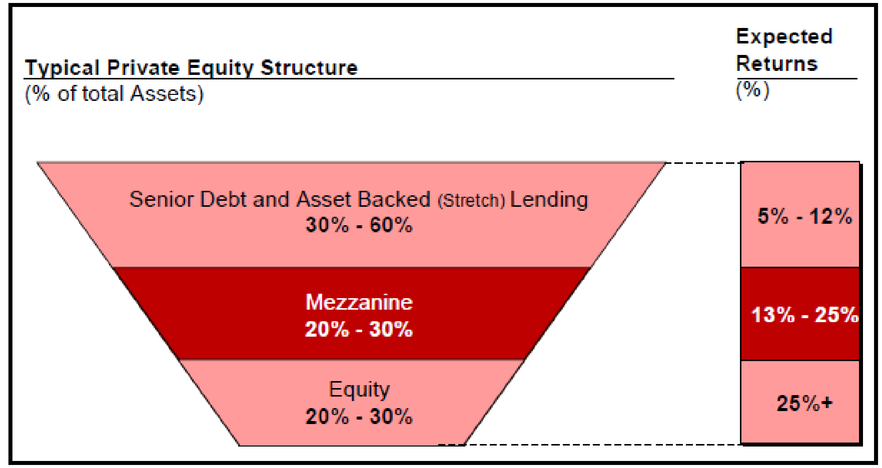
Debt Capital

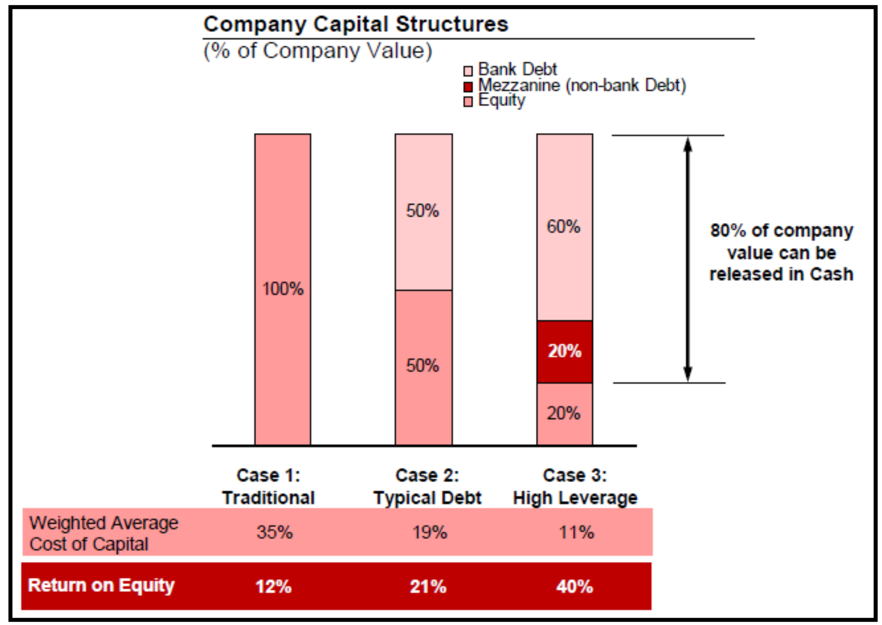
- Loans that have to be paid back over a certain term
- Generally the cheapest form of capital
- Debt is available at the corporate level (majors & mid-caps) and the asset level
- Companies with Baa3[1] (*e.g. NBL*) to Aaa[1,2] (*e.g. XOM*) credit ratings will to obtain debt at rates of LIBOR + 2 to 5 %
- Debt comes with "covenants" relating to the "health" of the company or the project
- The current market is horrible for junior companies with or without commercial Reserves
- It's even worse for emerging markets ("exotic locations")
- Debt usually subordinates [ordinary] shareholders, such that an unpaid debt overhang can wipe out equity shareholders

1. Moody's Rating Agency. Subject to change at any time. 2. XOM is the only oil company to have this rating.

Mezzanine Capital

- *mezza|nine: from Latin “in the middle”*
- An intermediate financing tool rather than a source of permanent capital, literally in between senior debt and equity in terms of the acceptable risk profile, amounts to be advanced, and rate of return
- Around for decades, can take many forms and structures to fund a growth opportunity
- Often project specific, mezzanine providers like to share in the project’s upside
- Higher return than senior debt, often with warrants for equity participation; ranks “lower” than senior debt
- Quoting one investor: “mezzanine is the new equity”
- Use: project too early for bank debt, lower cost than equity, enhance return on equity
- Providers: smaller banks, specialists, Private Equity

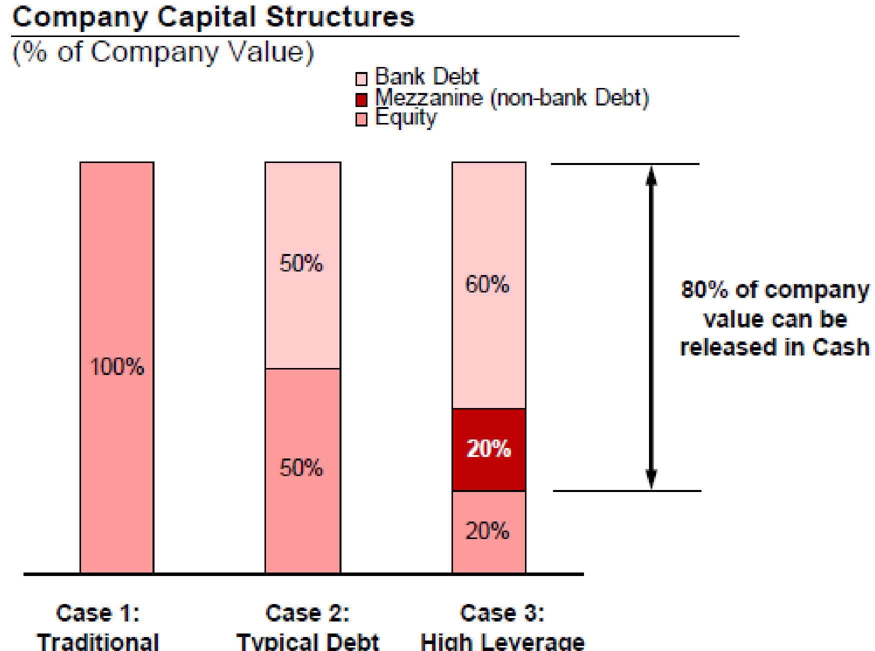




Source: Bond Capital

Senior & Mezzanine Debt Enhance Value

- Debt, including mezzanine, can provide leverage to lower a company's weighted average cost of capital
- Release significant value / Improve return on equity
- But increases financial risk. Required to find optimal debt/equity capital structure



	Case 1: Traditional	Case 2: Typical Debt	Case 3: High Leverage
Weighted Average Cost of Capital	35%	19%	11%
Return on Equity	**12%**	**21%**	**40%**

Source: Bond Capital

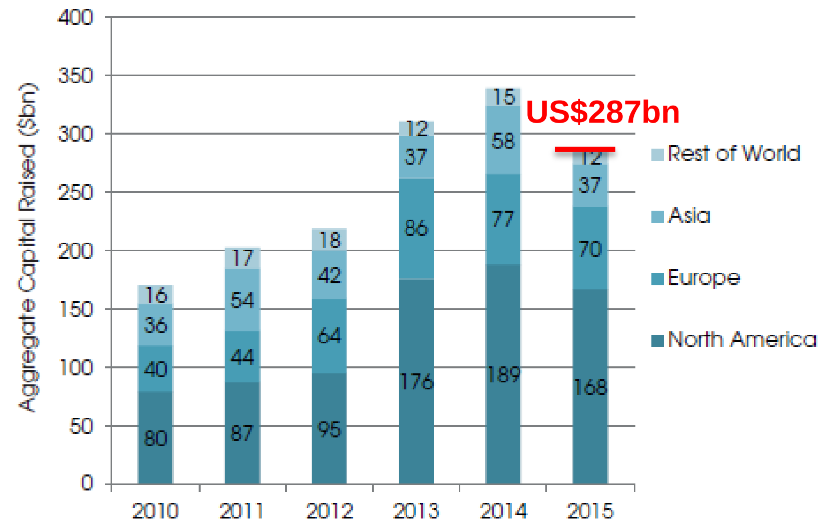
Equity

- the risked capital staked by the owners through purchase of a company's stock
- Unlike debt, not repaid in the course of normal business
- Public Equity investors want dividend income and/or capital growth
- Ideally, a company would want investors aligned with the goals & timing of management, and usually long-only investors ["patient money"]
- Less desirable on the share register?
  - Activist investors
  - Short investors
  - Interlopers
- Enter Private Equity…

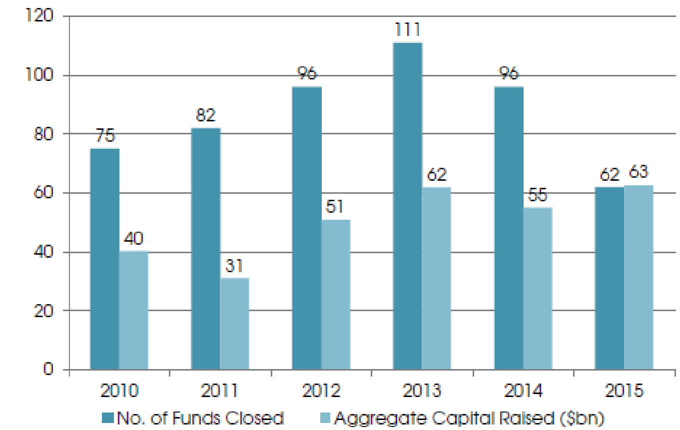
What is Private Equity?

- Asset class consisting of equity and debt investments into operating companies, private or public
- Started post-WWII in the US aimed largely at leveraged buyouts
- Funds are sourced from high net worth individuals, institutions, pension plans etc. wishing to achieve higher returns
- PE and VC assets under management reached US$3.8Tn in 2014
- The numbers for 2015 … ~US$287bn raised by PE, with ~US$63 for natural resources (see charts)

Private Equity Fundraising by Region[1], 2010 - 2015 ($bn)



Natural Resources Fundraising[1], 2010 – 2015 ($bn)



1. Source: Prequin

Key Value-Add of a Private Equity Model

Long investment horizon	▪ Provide long-term stable capital in an industry that is both highly capital intensive and typically requires at least a five year planning horizon
Bespoke solution	▪ Offers a structured solution for funding which can be tailored to specific project milestones
Management independence	▪ Allows management to retain their independence, e.g. prior to a farm-out decision ▪ Enables focus on the operations and growth of the businesses rather than funding
Alignment	▪ Foster alignment between shareholders, management teams, partners, and other stakeholders through building shared objectives and aligning incentives
All-round support	▪ Deliver strategic, technical, operational and financial support to investee companies

- **Compared to public market investors – PE investors are typically more flexible in terms of investment structure and horizon, and can deliver strategic, technical, and operational support to investee companies**
- **Compared to strategics – PE investors typically allow management to retain independence and control, with key focus on value maximisation**

PE Funding for Junior O&G Companies – *Exploding the myths*

Control / Governance	▪ PE funds do not always require absolute control over the investee company
Returns	▪ The PE Fund's objective of achieving its IRR/MoC targets is not mutually exclusive from oil & gas co. mission statements, especially where shareholder value is key
Alignment with Management	▪ Management compensation / incentives can be aligned with PE equity investors around mutual objective setting
Investment Horizon	▪ PE funds are truly *Long-Only*: PE funds are fixed term, usually 10 years with 2 year extensions ▪ Consequently, PE Funds *rarely* need short-term liquidity and can endure a cycle

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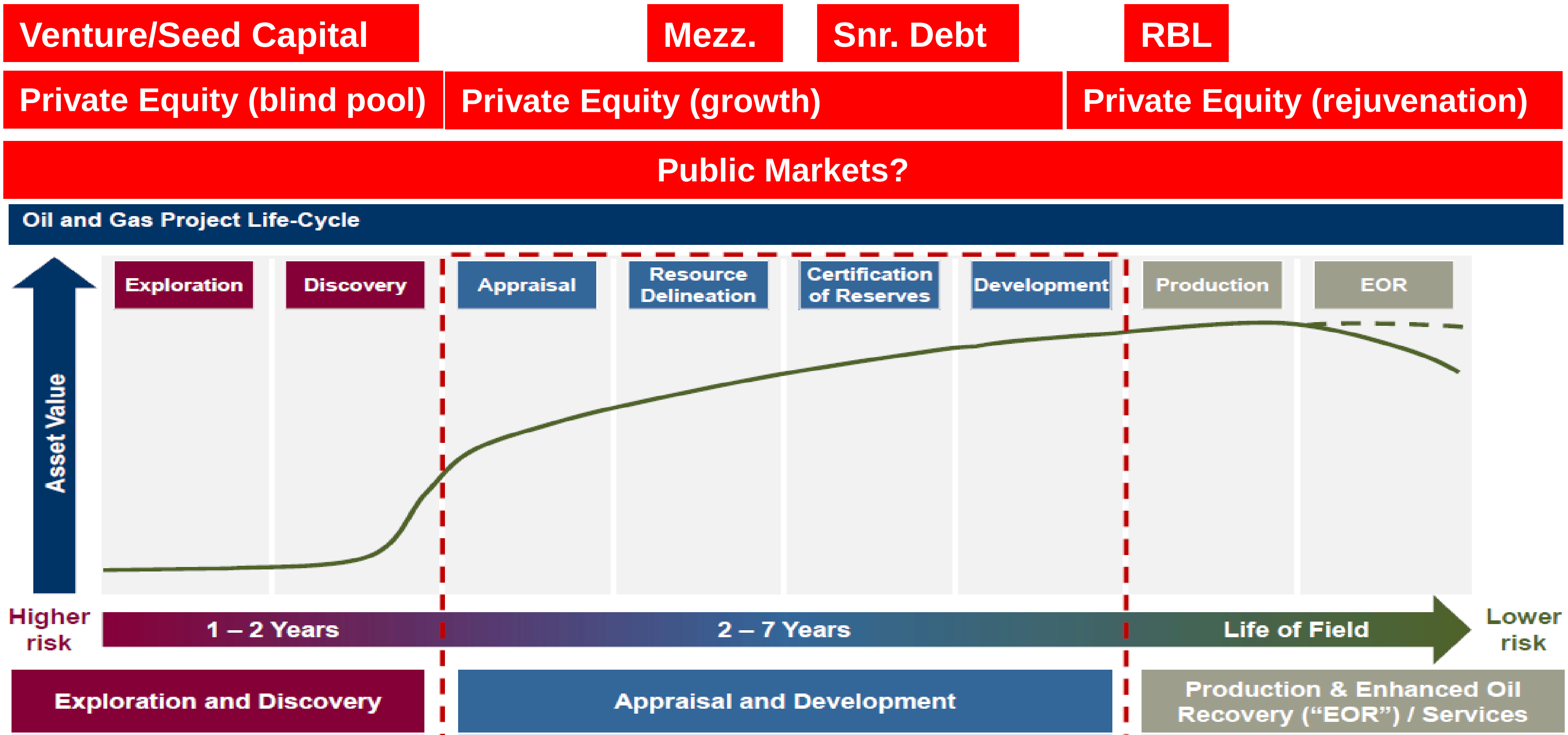
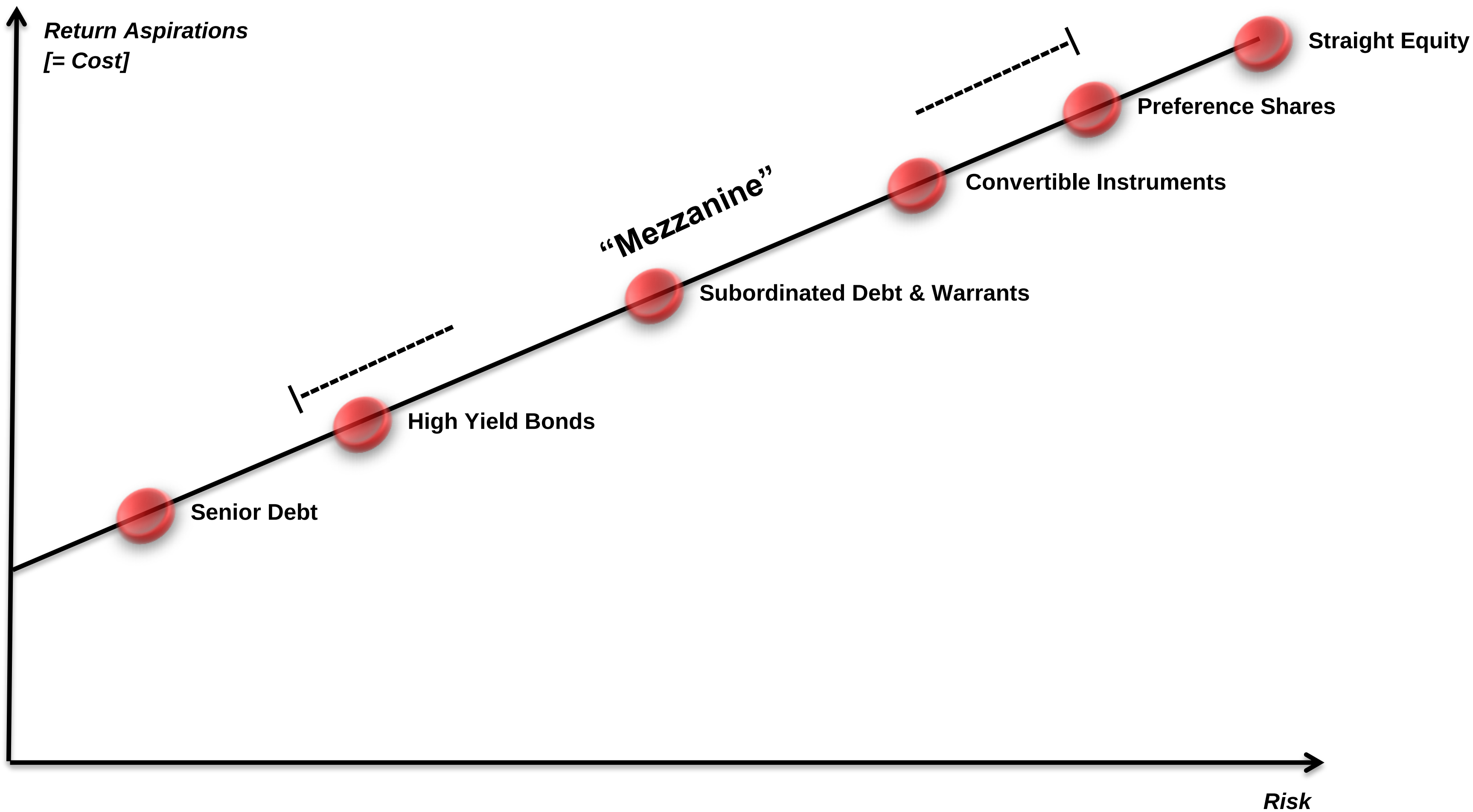
Life Cycle – Where the Funding Comes From

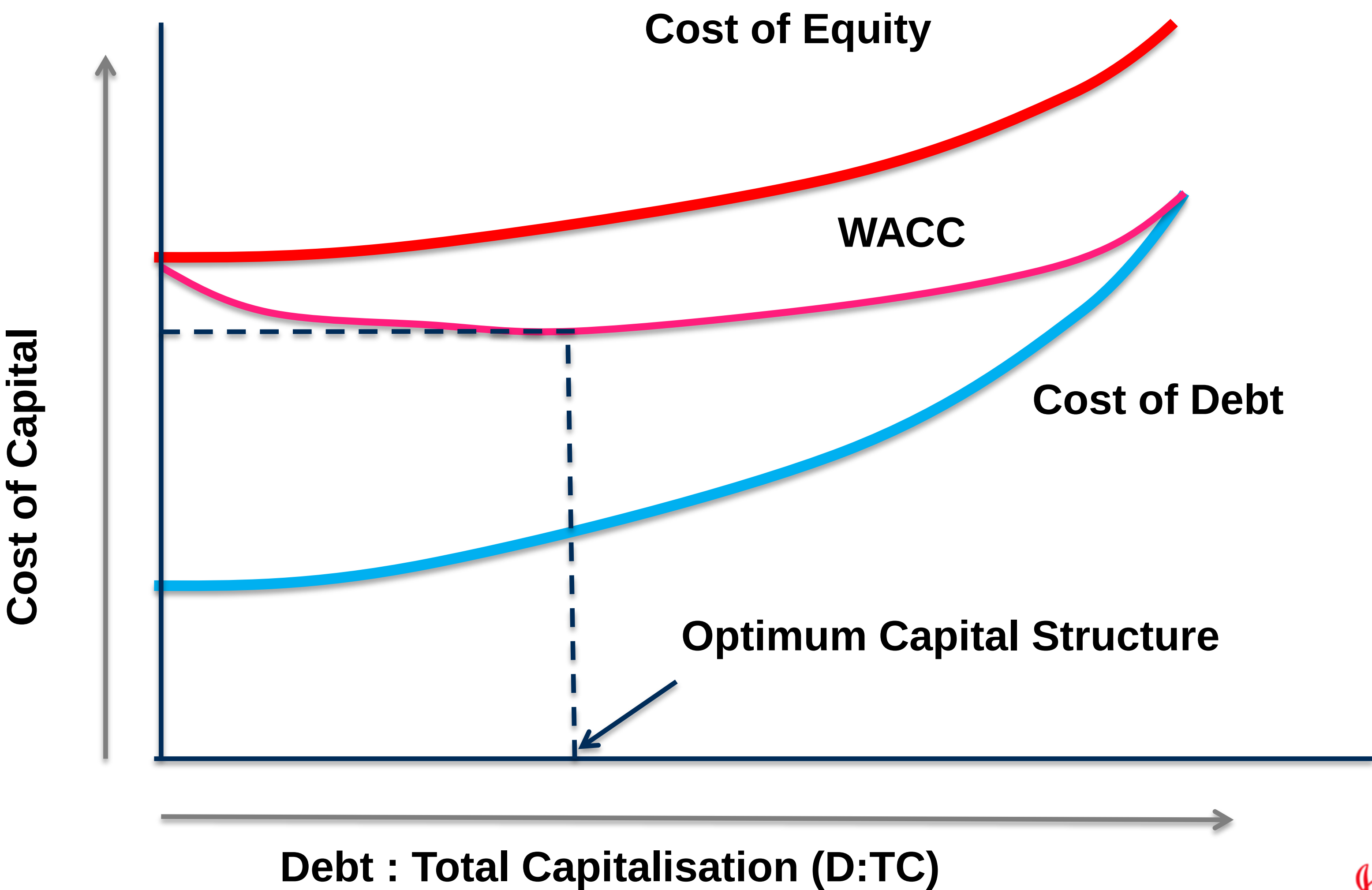


Cost of Capital - the return expected by those who provide capital



Source: Oil & Gas Financial Journal

Debt: Cost? How much?



Examples[1] (D:TC)

- Exxon 18.5%
- Chevron 20.2%
- Shell 26.2%
- ConocoPhillips 42.8%
- Anadarko 50.5%
- Tullow Oil plc 58.3%
- PremierOil 63.0%
- petroceltic 77.8%
- Johnson & Johnson 21.6%
- Microsoft 36.7%

[1] Source: FT.com, Company PR, www

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Over-leverage - Some Current Symptoms

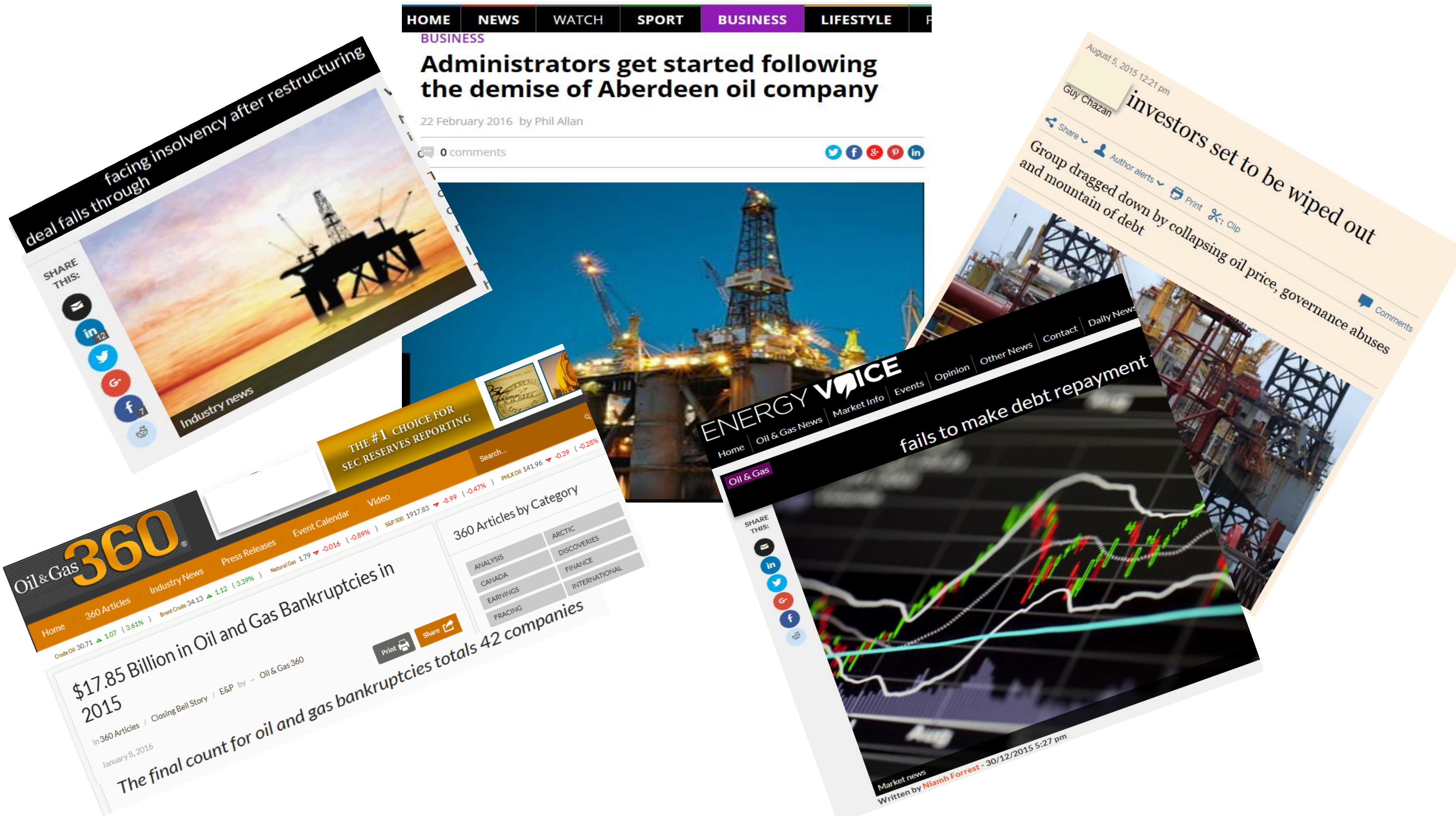
- Very high, even too high, gearing in terms of debt:equity
- Much debt obtained at US$100/stb+
  - *What's Plan B?*
- The paradox of success
- Covenants being breached:
  - Loan repayments
  - Credit metrics
  - Cashflow & debt cover ratios
  - Reserves redeterminations & borrowing base

The Correct Borrowing Base?

- Loans not to exceed asset value
    - Various price scenarios
- Tight covenants adhered to
- Take action when prices change
- Portfolio optimisation
- Right-sizing G&A
- Cost reductions
- Successful commodity price hedging

April loan redetermination cycle in US to further reduce borrowing bases

Debt "War Stories" – The Headlines



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Sources of Capital – *what I said & thought in 2014*[1]

		Current Availability	Issues
Public Markets	IPO	▪ Challenging ▪ Some appetite	▪ Hefty discounts to NAV ▪ Onerous bourse rules / Fees
	Follow-on Raise	▪ Option still available ▪ Share price performance?	▪ Dilution ▪ Use of funds
Private Placement		▪ Limited capacity	▪ Timeframe ▪ Comps.
Traditional Farmout		▪ Frequent ▪ Promotes remain possible	▪ Derisking varies
Private Equity		▪ Start-up to late stage ▪ 2013: US$450billion raised by PE[2]	▪ Some myths ▪ LP universe
Debt	Senior / RBL	▪ Readily available ▪ RBL: asset? country? company?	▪ Cheapest source of funds ▪ XOM (2014): $5.5bn, ≤3.176% 10-yr bonds
	Mezzanine	▪ Less popular	▪ More expensive than senior debt

1. Based on Oil & Gas Investor Summit, June 2014 (oil averaged US$98.18/stb nominal); 2.Bain PE Report, 2014 (funds with final close)

Sources of Capital – *2016 Thoughts*

		Current Status
Public Markets	IPO	▪ Non-existent! (*2015: 1 on AIM, 2 on TSX*)
	Follow-on Raise	▪ Some hand-to-mouth raises, some larger
Private Placement		▪ Limited capacity
Traditional Farmout		▪ Rare, with shrinking promotes & back costs
Private Equity		▪ Remains start-up to late stage ▪ 2015: ~US$300billion raised by PE[1]
Debt	Senior / RBL	▪ XOM (2015): US$8.8bn, ≤3.176%, 10-yr bonds ▪ Asset-level RBL dried up for smallco
	Mezzanine	▪ Less popular

1. Prequin 2015 Fundraising Update (full year data not yet in)

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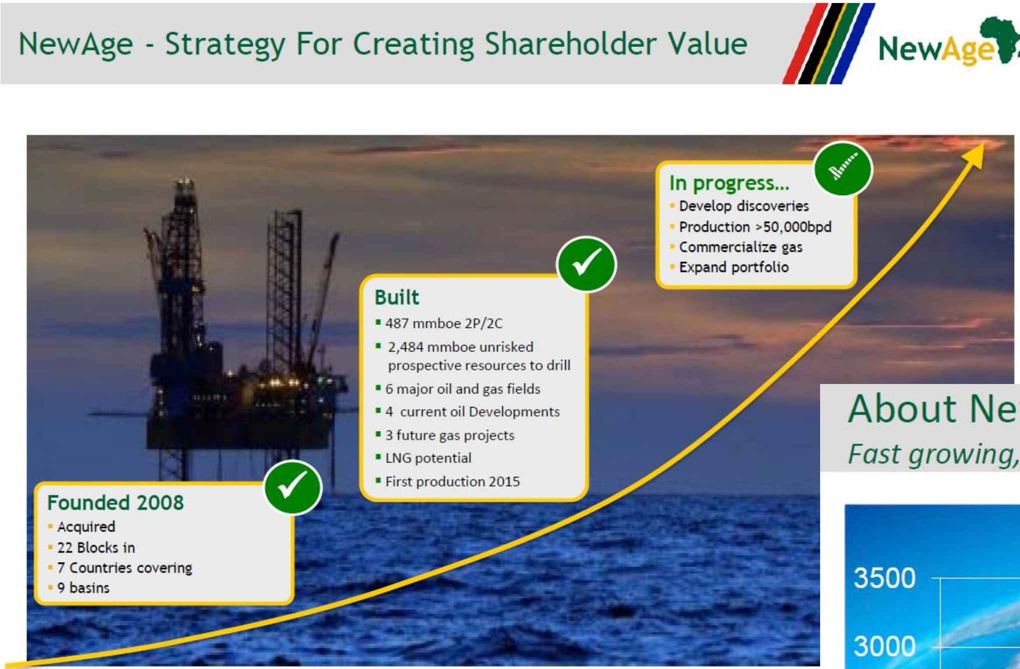
Kerogen Capital

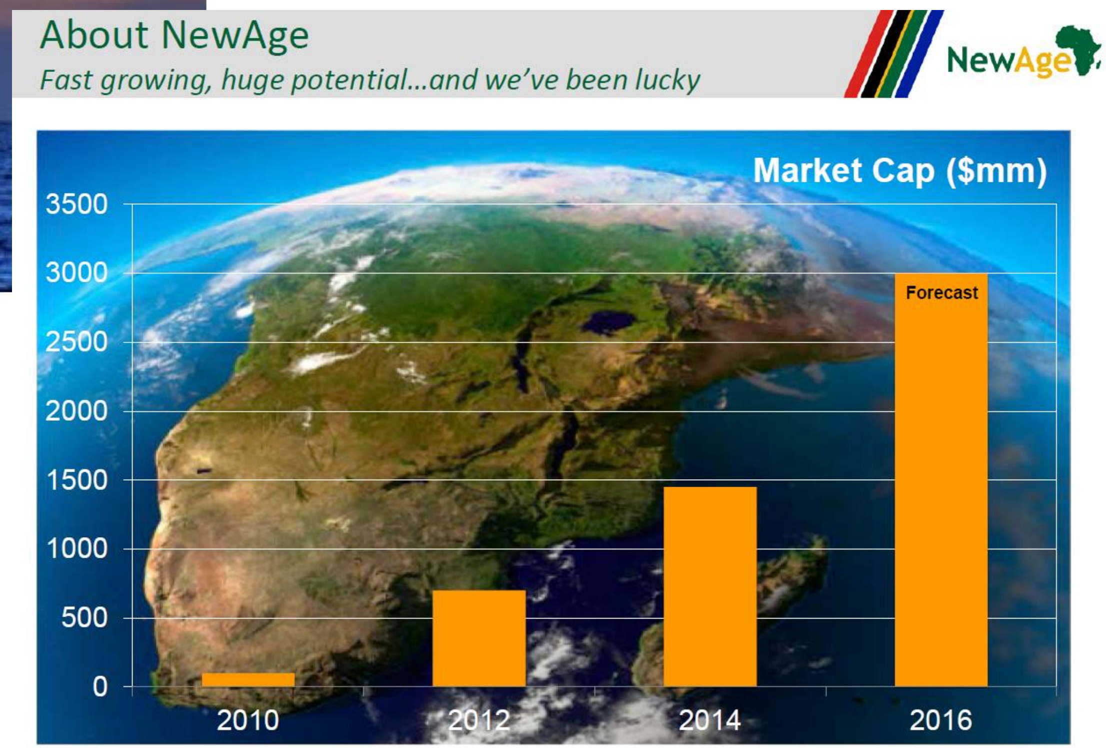
- Kerogen is an independent private equity fund manager specialising in the international oil and gas sector
- On third managed fund. Global institutional investor base : ~US$1.6bn AUM
- Formed in 2007 with offices in HK and London. Professionals from financial, technical and operating backgrounds
- Focused on funding junior E&P companies with growth and development capital
- Geography: outside North America
- Financial solution combined with an active value added investor approach
- Signatories to the UNPRI, issued ESG Policy February 2014

Kerogen Investee Companies: Financial Instruments Employed

LUCAS, CUADRILLA RESOURCES	Public Market Equity & Senior Debt
NewAge	Equity, Bridging, Convertible Instruments, Junior Mezz., bolt-on acquisitions
Buried Hill	Equity
twinza	Equity
HKN ENERGY LTD.	Preference Shares (quasi-debt)
Zennor Petroleum	Straight Equity + co-investment; bolt-on acquisition

Kerogen Case Study: NewAge - *What the Company Said*





Source: FirstEnergy Capital Seminar "*Value within the Private E&P Sector*", 4 June 2014.

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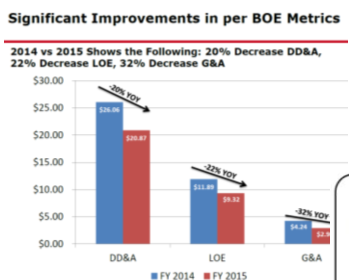
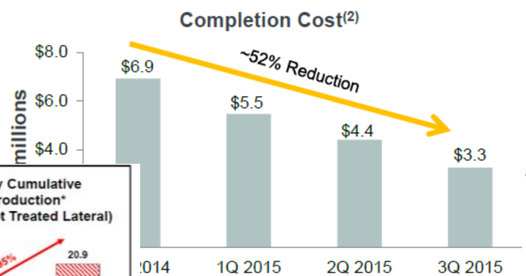
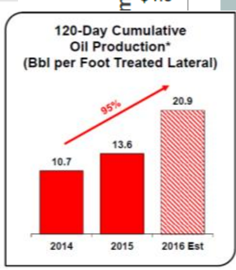
Reasons to be cheerful?

Rigs are cheaper!







Humans are ingenious!

Future Oil Prices [?]

	2016	2017	2018	2019	LT (headline)	LT (2016 real)	Date of forecast
EIA	40.2	50.0					Jan-16
IHS	47.8	58.4					Jan-16
Brokers							
BAML	50.1	61.0	70.5	80.0	80.0	75.4	Jan-16
Canaccord	42.0	60.0	N/A	N/A	67.5	64.9	Jan-15
CS	58.0	65.0	70.0	70.0	75.0	69.3	Jan-16
GS	49.5	65.0	65.0	60.0	55.0	50.8	Dec-15
JPM	50.0	60.0	65.0	70.0	75.0	69.3	Jan-16
MS	48.5	72.0	85.0	85.0	90.0	83.1	Jan-16
RBC	42.5	60.0	74.0	N/A	79.0	74.4	Jan-16
Scotia	54.0	59.0	65.0	75.0	80.0	73.9	Dec-15
SocGen	53.8	62.5	67.5	70.0	75.0	69.3	Dec-15
UBS	42.5	55.0	70.0	75.0	75.0	70.7	Jan-16
Median	**49.8**	**60.5**	**70.0**	**72.5**	**75.0**	**70.0**	
Average	**49.1**	**62.0**	**70.2**	**73.1**	**75.2**	**70.1**	

Some Conclusions

- Conventional debt sources & public market funding have for the moment all but dried up for junior oil and gas companies

- To attract debt at the asset or corporate level, there is no substitute for: quality, low breakeven assets, *flexible* developments, lean G&A and right-sized debt:equity ratios for differing market conditions

- The war stories and insolvencies we're currently hearing about - it seems every week - are generally because these guidelines have been flouted

- Private Equity can *help* investee companies with very flexible, creative financial instruments, and *alignment* with management goals

- Companies need to be nimble to adapt their sources of funding to the particular phase of their projects & to market conditions: CEOs & CFOs take note…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