PARING RISK IN PRIVATE EQUITY

Structured investments in the oil patch come with commodity price and other risks. Here are two ways to offset downside.

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Despite the prolonged volatility in oil prices, there has been a general uptick in private capital flowing into the oil patch. Holding the view that the worst is behind the industry, many of the biggest names in private equity have jumped at the chance to invest in E&P companies that are distressed or need capital to take advantage of opportunities in the current environment.

While investment prospects abound, it is no secret that a disproportionate number of assets on the market today are not up to par, and any financial sponsor seeking to deploy capital should conduct thorough due diligence to separate the wheat from the chaff. No amount of diligence can completely remove the risks that are inherent in the oil and gas industry, especially in a continuing unstable price environment, but risks can certainly be reduced through structured investments that incorporate two risk-mitigating mechanisms: diversification via a co-investment strategy, and staged financing.

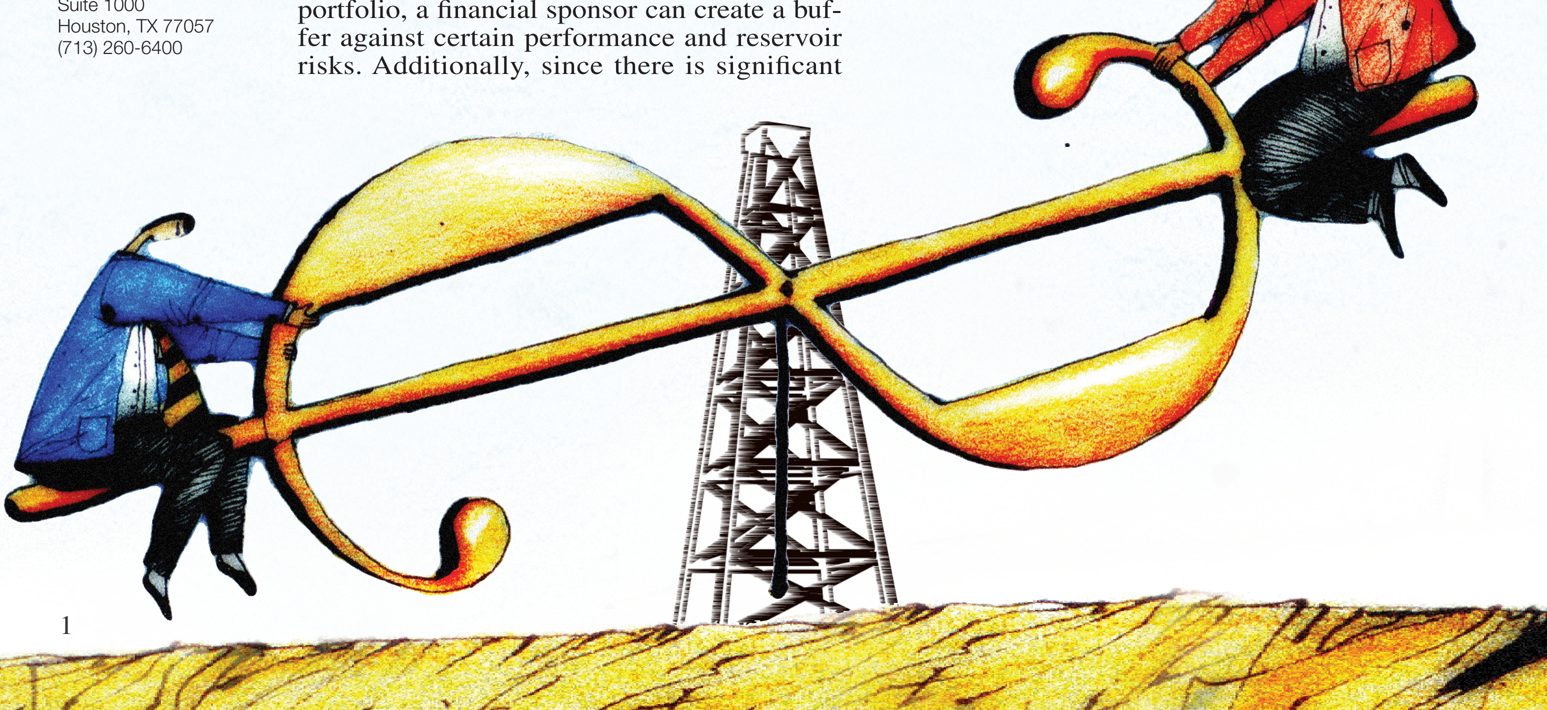
Co-investment diversification

Portfolio diversification is a familiar concept for anyone interested in making oil and gas investments. By aggregating multiple wells with different operators into an investment portfolio, a financial sponsor can create a buffer against certain performance and reservoir risks. Additionally, since there is significant private capital chasing only a few exceptional deals, financial sponsors can team up with other funds to invest in potentially better assets. This approach can also help financial sponsors strengthen institutional relationships and leverage off each other's expertise.

Well and operator diversity can be achieved through a co-investment structure where multiple financial sponsors combine capital and invest in a special purpose entity that holds diversified interests. This may take the form of a single, lead-sponsor-controlled limited partnership that invests in a special purpose entity; a series of lead-sponsor-controlled limited partnerships for each of the individual co-investors; direct investments by co-investors into the special purpose entity; or some combination of these.

Although a co-investment strategy can help achieve such benefits, financial sponsors should bear in mind that each structure is bespoke and may present unique challenges.

If a financial sponsor seeks to diversify too much, for example, its capital may be stretched too thin, and it may be relegated to a rank as a minority investor who is "just along for the ride." However, this type of sponsor can



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regain some modicum of control by incorporating certain customary minority protections—such as consent rights in connection with company actions relating to material matters—into the investment documents.

Among other strategies, co-investors should consider seeking consent rights with respect to the issuance of new securities, the admission of new members into the co-investment vehicle, amendments to the terms of pertinent deal documents and affiliate transactions.

Co-investors must be mindful of other provisions to keep the interests of financial sponsors that are participating in a transaction aligned. For example, co-investors often seek to negotiate "a most favored nation" (MFN) clause to ensure they receive as favorable or better terms offered to any other investors on an ongoing basis. In a limited partnership context, where arrangements between a general partner and a limited partner can be modified with side letters without the consent or knowledge of the other limited partners, an MFN clause can be an invaluable tool to align economic incentives, especially given the fast pace of negotiations in this environment and the difficulty of having perfect sight into the terms being received by other investors.

In addition, although co-investors will typically not have much control over the manner and timing of an exit, the inclusion of a tag right will provide some protection with respect to an exit and its economics. However, those negotiating for a tag-along right must remember that a lead financial sponsor also is likely to negotiate for a drag-along right in an effort to ensure a smooth exit.

Finally, a co-investor should be cognizant of information rights that may be required to meaningfully monitor its investment and meet reporting obligations to its own investors.

These information rights can take many forms to suit the needs of the investor, including the right to receive drilling and product information, specific financials and performance reports and notification of certain company events that may be of particular concern to the investor.

Typically, co-investors do not conduct comprehensive due diligence with respect to an investment opportunity, choosing instead to rely on the lead sponsor's diligence. However, it is prudent for any co-investor to engage in as much diligence as possible and review underlying transaction documents to understand deal structure and allocation of risk. In an industry where environmental and title issues are significant concerns, a thorough understanding of these issues may prove critical. Funds engaging in co-investments should stay vigilant in diligence and documentation, even if relying on a well-respected partner, to ensure that they do not fall into a trap of complacency and assume unintended risks.

Staged financing

Like diversification, staged financing can be effectively deployed by private equity funds to mitigate the risk of investing in the oil patch. While not a new concept, staged financing has taken on an increasingly important role in energy investments in both control and non-control situations.

A staged financing transaction structure typically involves a smaller, upfront "hard" commitment of initial capital, backed by a larger, marquee "soft" commitment subject to a number of negotiated conditions. Essentially, a reduced phase-one commitment serves as a test run, and if preliminary performance is as expected, the fund has the flexibility to deploy incremental capital into a now potentially less risky venture. If, however, preliminary results do not live up to expectations, the fund is under no obligation to move to the next phase of the investment.

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In this market, with many players chasing the same E&P opportunities and the potential for otherwise promising companies and assets to be on the brink of bankruptcy, the staged financing structure has a number of benefits for both private equity funds and companies. First, similar to co-investment strategies, the smaller hard commitments can allow the funds to participate in multiple investments, with more companies, before making a larger commitment.

Beyond diversification, though, one of the most significant benefits in this environment, especially for E&P companies facing liquidity issues, is that the initial hard commitment provides the capital infusion they need to stabilize. The larger soft commitment amount serves as an important market signal to banks and other industry participants that the company is back on solid financial ground and ready to re-engage in acquisitions, joint ventures and other development activities.

Another benefit: The smaller hard commitment may allow investors to move more quickly if time is of the essence, and they have determined that their diligence and structuring support a certain level of investment but are not yet certain if they need a larger amount. Further, for the financial sponsor, even if preliminary results do not live up to expectations, the structure offers potential leverage to renegotiate the deal structure, if prudent.

No matter the situation, conditions relating to the use of capital and triggers for the next round of investment are important when negotiating these staged financing investments. For a classic control investment, the answer is usually fairly easy, in that capital calls are most often made by the company's board of directors, which is controlled by the financial sponsor. Typically, this control is further bolstered by provisions in the company's organizational documents that provide the board with a suite of controls over the budget process, use of funds and other "material" matters.

Management and other investors may attempt to negotiate around the margins of the use of capital, budget and call provisions in order to ensure they can use the capital as

Relevant Risk Terms

Most favored nation clause
Provides that an investor will receive as favorable or better terms offered to any other investor on an ongoing basis

Tag-along right
Provides an investor with the right to join a sale by another equity-holder under similar terms

Drag-along right
Provides an investor with the right to require other equity-holders to join a sale of equity of the company under similar terms

Information right
Right to receive certain specified information from the company such as drilling and production information, specific financials and performance reports and notification of certain company events that may be of particular concern to the investor

Springing board seats or approval rights
Allows an investor to appoint a director or board observer to the board of the company, or to gain special approval rights, which spring upon the occurrence of certain events or the failure to meet performance metrics

Source: Akin Gump Strauss Hauer & Feld

expected, are involved with the process or to incentivize additional infusions. But ultimately, if the control investor is not satisfied with the E&P's management or the investment performance, it will not put in more funds.

In a non-control investment or those situations where the fund does not have plenary control over the board and capital call process, conditions and provisions related to those capital calls and funding involve more detailed negotiations and nuance so that the private equity funds do not find themselves inadvertently committed to something they did not sign up for. These conditions and control provisions can take a number of forms including:

- time-limited commitment periods;
- requirements that capital calls be supported or initiated by persons other than the board;
- general limitations on the use of proceeds;
- springing board seats or approval rights upon certain events;
- failure to meet performance metrics;
- or subjecting certain strategic activities or capital calls above a threshold to consent or an opt-out procedure.

Further, given that the fund generally will have limited input in driving the capital call process, it will want to ensure that there is more than sufficient time for it to respond to a capital call. It is also important to have protections against draconian default provisions, such as cure periods or restrictions on forfeitures or forced sales for default.

In any event, it is critical that any restrictions on use and performance or financial hurdles be well-defined to reflect the fund's investment thesis and what is actually intended. In negotiations, it always seems that parties see eye to eye on what it means to "drill" a well or use funds for "general corporate purposes." As time goes on, however, and as may happen, the financial situation declines, funds will want to give themselves clear definitions, exits and blockers so that their capital intended for growing the company isn't used for less desirable projects or, even worse, pre-bankruptcy "rescue" equity financing.

At the end of the day, staged financing is a great strategy. It can allow companies and funds to move more quickly to support promising companies with capital needs while creating necessary various midterm checkpoints throughout the investment's life. Although these staged financial structures can ensure for financial sponsors an additional level of control over the investment process, they are not a panacea to diligence shortfalls in the course of investing in the current energy environment.

Further, while staged financing can allow a fund to make more investments, private equity sponsors with an eye to the future will always need to be careful to avoid overcommitting their capital and internal resources, or using soft commitments to make a wider swath of investments than they might normally make if they are not willing to take "venture capital" type of risks for a larger home run. As with any investment structure, investment discipline remains very important.

In sum, while certain risks associated with investing in oil and gas cannot be completely removed, they can be mitigated, including through thoughtful diversification via co-investment and staged financing strategies. A carefully structured private equity investment might not change the price of hydrocarbons or the performance of a reservoir, but it may help secure an overall productive portfolio in a competitive market, with a powerful impact on returns. □

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