

CHANGED WORLD

Tudor, Pickering, Holt & Co.'s Maynard Holt shares his insights on the new-look M&A marketplace.

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“It’s hard not to talk about oil first,” confessed Maynard Holt, co-president and one of the namesakes of Houston-based investment bank and advisory firm Tudor, Pickering, Holt & Co. “Oil is hot.”

Holt provided his perspective on the revived and restructured upstream M&A marketplace at the recent Energy Gathering held by energy law firm Gardere, Wynne & Sewell. He seemed almost incredulous at how quickly the excitement has turned from gas to oil.

“The world has changed,” he declared.

Contrast today’s oil-focused mentality to the seven years prior to 2008, when there was no better investment on the planet than Lower 48 natural gas. Gas supply was limited. Demand was growing. LNG was not coming. Rebalancing a portfolio toward onshore gas was almost guaranteed to improve how a company was perceived and traded.

Oil mania

Now, he said, many companies fear there is too much natural gas in the near term, and his company is catering more and more to companies focused on oil. “Much of the deal environment today is driven by gassy guys wanting to get more oily.”

Oil—anywhere—is very attractive. Where companies until recently liked to stay geographically focused, “now I’m not sure it matters what zip code it’s in anymore.”

Holt cited as an example an executive who recently revealed he wanted to establish a position in California. “After 20 years in the business, no one has ever said to me, ‘I want to go to California.’”

The shift to oil is evident in the shrinking discount rate paid for reserves, he observed. TPH estimates the discount rate paid for proved developed producing (PDP) reserves in May 2009 was roughly 12%, with a 20% discount rate for proved undeveloped (PUD) reserves. By spring 2010, discount rates on PDP had dropped to 9%, and on PUDs, to 12%.

Oil assets are trading at a premium. “Generally speaking, a barrel of flowing oil right now is trading at plus or minus \$90,000 per barrel. This year we could see \$150,000 per flowing barrel for some high-growth opportunities.”

Public investors like the oil message, too, he said. Two companies, Brigham Exploration Co. and Concho Resources Inc., vividly illustrate investor sentiment toward companies with an

oil focus. Compared with TPH’s E&P universe, up 65% since bottoming in May 2009, oil-weighted and Permian-based Concho’s stock has soared 114%, and Brigham—a Bakken player—by an eye-popping 725%.

But if an investor wants to place a bet on oil, period—just oil, no gas—“It’s quite hard.” The choice is limited to four or five public oil-only companies. “If you couple that limited supply with oil mania, you get stocks that were on fire last year.”

Privately held, oil-focused companies are coming out of the woodwork, Holt suggested. “Not a week goes by that we don’t have a meeting with a private oil company about their options.”

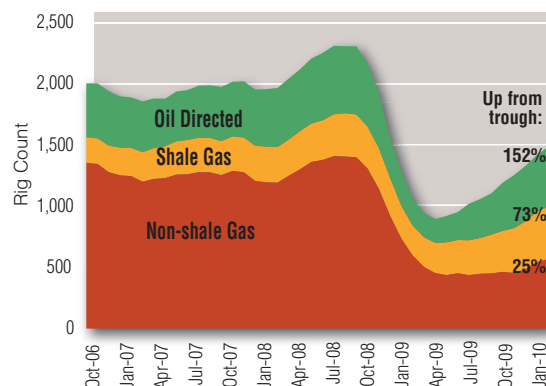
Many high-growth, private oil companies will likely go public, because they can receive particularly high valuations. Bakken companies, he said, are trading north of \$200,000 per flowing barrel at present.

The best recent illustration of investor confidence in oil is Cobalt International Energy Inc., a private-equity-backed company that went public late in 2009. At the time of its IPO, the company was focused wholly on exploration for oil in the deepwater Gulf of Mexico and Angola, with no reserves and no production, just a very large prospect inventory. Its initial valuation was \$4.5 billion.

“It’s all about oil,” Holt said. “In the absence of a world not so focused on oil, that IPO would have been quite difficult.”

The redirection of capital by independents away from gas and toward oil is reflected in the rig count.

U.S. Onshore Rig Count



Source: Tudor, Pickering, Holt & Co.



“Not a week goes by that we don’t have a meeting with a private oil company about their options,” says Maynard Holt, Tudor, Pickering, Holt & Co.

Gas to oil

More signs of the times: What are the chances, asked Holt, that seven months back a “shale guy” would buy an oil property he was marketing? “I’d have said stay in your core competency—if you’re a gas-shale guy, you should stay gas shale.”

But en masse, traditional gas-focused companies are seeking salvation in oil, too. In just the past five months, shale-gas companies are buying oil, talking about liquids, and changing their portfolios. “It’s certainly the trend.”

Gas players look at oil as the commodity that

is going to carry them through this weakness in gas prices. “If you have to buy (oil) projects and then reallocate capital to them and away from gas, you’ll do it.”

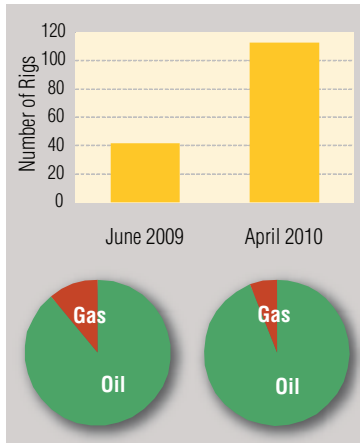
The rig count reflects the move. From the trough in May 2009 through first-quarter 2010, oil-directed drilling spiked 152%, while shale-gas rigs increased by 73% and nonshale-gas rigs by 25%, “which, frankly, is a big surprise,” he noted.

“Independent oil and gas companies are redirecting capital away from gas and toward oil, and you can see it in the rig count.”

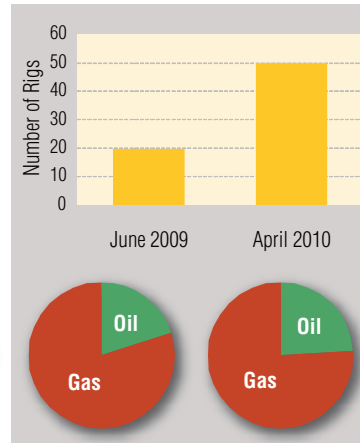
Oil—anywhere—is very attractive. Where companies until recently liked to stay geographically focused, “now I’m not sure it matters what zip code it’s in anymore,” says Maynard Holt of Tudor, Pickering, Holt & Co.

Regional Growth In Oil-Directed Drilling

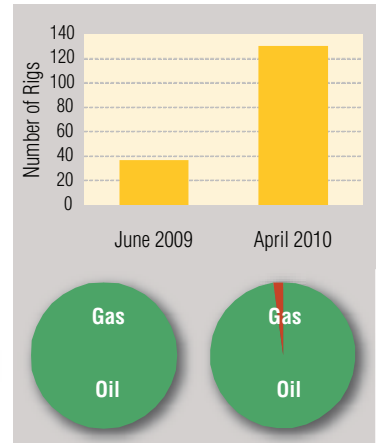
Delaware



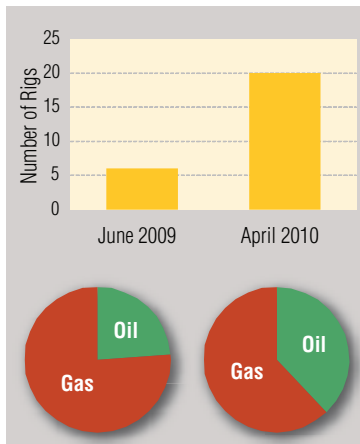
Midcontinent



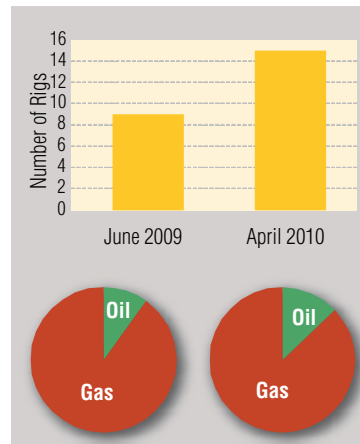
Midland



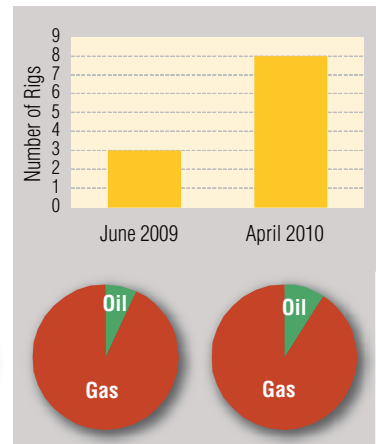
Non-Texas Gulf Coast



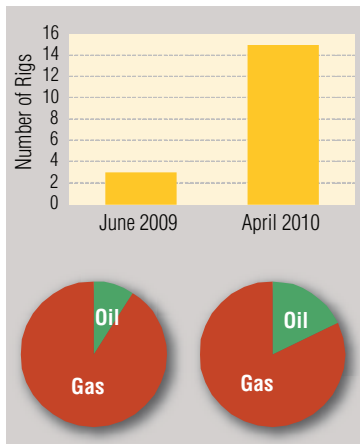
North Texas



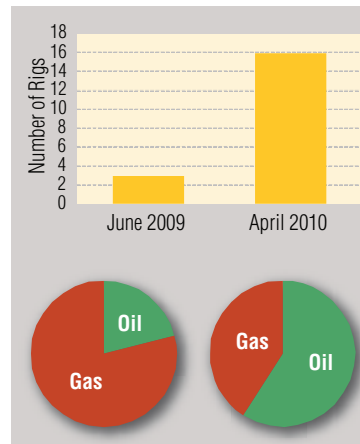
South Texas



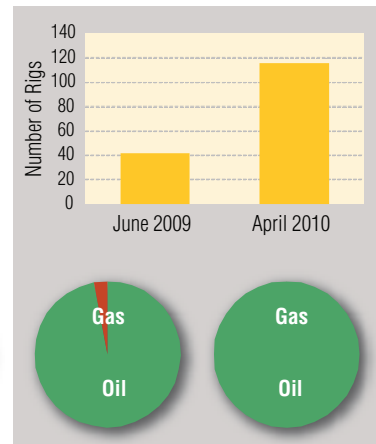
Texas Gulf Coast



Uinta



Williston



Source: Tudor, Pickering, Holt & Co.

Gas stocks have a bit more upside than oil stocks at present, he says, which “is just another way of saying investors are generally not willing to pay as much for gas stocks right now.” Holt said that gassy CEOs are going to great lengths to talk about their oil or how liquids-rich their gas is.

“Gas guys are talking about what the market wants to hear about, and that is oil.”

The poster child in the gas-to-oil space is SandRidge Energy Inc. The once gas-centric Oklahoma City producer has dramatically shifted the weighting of its portfolio, first with a Permian Basin acquisition from Forest Oil Corp., followed by the acquisition of oil-rich Arena Resources Inc. For Arena, SandRidge paid a 17% premium and, more importantly, some \$180,000 per flowing barrel, a new high-water mark for Permian growth assets.

“Swapping oily assets for gassy shares is an interesting bet,” Holt mused. “If you can catch oil at a high and gas at a low, then maybe you’ve got a really great deal two or three years out when gas recovers. This is a conceptual trade people are starting to talk about.”

The shale option

If not oil, then low-finding-and-development-cost shale gas is the next best solution to weather current market conditions, and conventional-gas companies as well as international players are first in line to establish positions.

“There’s obviously a fair amount of pessimism around natural gas and a concern about where prices are going over the near term,” Holt said.

And every time gas prices go lower or pessimism surrounding the commodity’s prospects worsens, the determination to get into the Marcellus, the Haynesville and the Eagle Ford shales just intensifies. “It feels like it’s raining,” he said, “and there are only three barns. You’ve got to get to one of those places if you’re going to drill and keep making money in a low-price environment.”

To pick an example, “it might be obvious that a Piceance Basin-focused company would rather hold Marcellus shale acreage in its portfolio during times of gas duress, but the problem is if you decide to sell out of the Piceance right now, you’re selling into a buyers’ market. And if you try to buy into the Marcellus, you’ll be buying into a sellers’ market. That’s a tough trade.”

Thus, this type of portfolio shifting is difficult at present. “What you end up having to do is improve the portfolio by adding and not by subtracting. It’s just not a good time to sell out of conventional gas.”

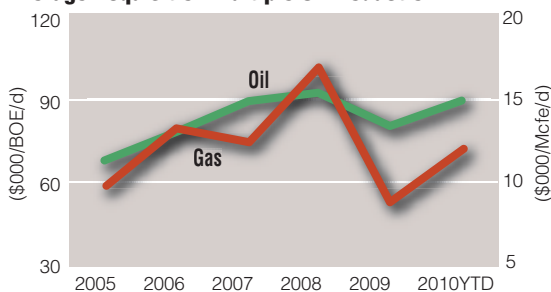
Holt expects to see gas companies consolidate this year. “Bigger is better in this environment,” he said, “and a stock-for-stock deal feels like it improves your downside while keeping most of your upside.”

Acreage holders in the shale plays have found joint ventures to be an effective tool in

getting cash to accelerate development, particularly when credit and equities markets were tight and while cash flows from gas are down. And into that space have come a lot of players—particularly foreign players with a strong interest in U.S. shale plays.

The joint-venture trend is far from over, Holt portends, and some “truly exotic” names are showing up in data rooms. “We’ll see more shale-play joint ventures and more internationals. Who hasn’t done one yet? It’s like the Boy

Average Acquisition Multiple Of Production*



*U.S. transactions >\$500 million; excludes joint ventures. Source: Tudor, Pickering, Holt & Co.

Oil valuations have been increasing as crude prices stay strong.

Scouts—you’ve got to get your shale-gas badge.”

He recounted an episode from the past summer when his team was in an international E&P’s offices in Europe—discussing Pennsylvania’s Lycoming County in great detail. “That is the brave new world that we all live in.”

Many U.S. E&Ps perceive that international companies are moving in and probably overpaying. Maybe... but maybe not, he countered.

“There’s a sense when you work with these international types that they may have a better sense of how the world is changing than we do—an energy revolution seems at hand.”

Large companies’ expanded vision allows them to peer 10 to 30 years down the road, he said.

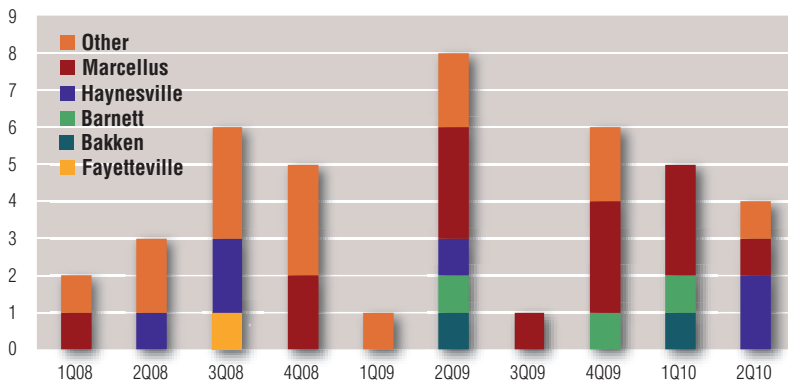
“Twenty-five years from now this thing called natural gas will be much different than it is today. These companies are thinking about what the world looks like decades out and what kind of technology transfers they can reap. In the broader scheme, \$300- to \$500 million to figure out what’s happening in the U.S. with shale plays looks very cheap compared with what the world might look like not too far from now,” he said.

Deal size matters in how easy it is to get the deal done, and perception is everything. Holt joked that a deal value above \$500 million seems to require 87 people to review the transaction, while a deal at \$499 million and below “can be done by one guy.”

If a seller is willing to part with 1% to 49% of an acreage position, an “incredibly healthy” market exists. “Lots of people around the world would love to talk with you about that position,” he said.

But the list of buyers shrinks dramatically at

JV Count



Source: Tudor, Pickering, Holt & Co.

Acreage holders in the shale plays have found joint ventures to be an effective tool in getting cash to accelerate development.

50% and higher. “Now you’re talking about someone that can operate, that has experience, and that probably has their own shale inventory. The market changes dramatically.”

Corporate revival

Corporate deal-making has returned to the playing field, and Holt believes market conditions are ripe for more. “We’re in a period where some combinations make sense and where deals should happen.”

One “big bang” in this category was ExxonMobil Corp.’s pending acquisition of U.S. shale leader XTO Energy Inc., announced this past December. If ExxonMobil’s motivation was to get more exposure to North America, XTO is one of the best companies on the screen, said Holt. “So if you’re going to buy, buy quality.”

And if ExxonMobil had tried to recreate a “synthetic” XTO by buying similar stakes in the Barnett, Marcellus, Haynesville, Bakken, etc., “They would have paid much more than they are paying for XTO, even with the premium.”

Third, the same shale-gas brain trust that powers XTO would not have been included with asset acquisitions. “It all adds up if you’re ExxonMobil.”

Holt believes too many corporate acquisitions are done for the wrong reasons rather than because the combination makes a better company. The ExxonMobil/XTO merger passes that test, as does Apache Corp.’s play for Mariner Energy Co.

“What Mariner faced was sometimes painful,” he said. A relatively small company valued at about \$3 billion, it would partner in a significant offshore discovery, only to experience a brief stock bounce before the market would question how it would pay for its share. “So success wasn’t translating into the kind of stock-price performance that they deserved.”

Likewise, Mariner’s three asset bases—the Gulf shelf, deepwater and Permian—were not valued individually by the Street. Instead, they were valued closer to the multiple associated with its more notable position, the shelf.

“The market is merciless about inefficiency in valuing multiple-asset companies,” said Holt. “That was the difficult reality for Mariner.”

Up stepped Apache, which had been waiting in the wings with dry powder since the downturn began. Mariner and Apache were both players in the Permian and on the shelf. And Mariner’s deepwater stake gave Apache the step-out it had been contemplating.

“This deal is good for each side. It’s rare that a deal passes that test, but this sure seemed to. In the current market, you’re going to see more of these kinds of deals where people are coring up. They’re going to cut costs, and take advantage of scale.” □

WHERE’S THE \$7.50 GAS?

Herd mentality trampled the forecast, declares Tudor, Pickering, Holt & Co.’s Maynard Holt.

TPH boldly made the forecast late last summer that 2010 would bring \$7.50 per thousand cubic feet (Mcf) for gas during a time when prices languished close to \$3. The finely tuned and test-driven, company-by-company, basin-by-basin model was predicated on the assumption that producers would “hit the brakes really hard” when drilling became uneconomical and would slash rigs, thus sharply curtailing supply.

Problem was, nobody blinked first.

“At some level, our research team’s forecast expected people to do the right thing,” says Holt. Instead, he believes the pain of drilling into the wind was less severe than the pain of facing investors with declining growth.

“It’s a problem that comes from group behavior. We think the model called a lot of things correctly, but what the model missed was a lot of the marginal gas kept flowing.”

He rejects the argument that the gas glut is caused by companies holding shale-play acreage. “I’m not sure I buy it. I think they would keep drilling anyway.”

The rush of gas companies to retool toward oil is evidence that gas drilling will continue unabated and keep the markets saturated, he says. “These companies are indicating the gas thing is a problem, and that most companies are going to keep drilling. As a result, they think they’ve got to get oily—and do it now.”

TPH recently revised its forecast to \$6.20 per Mcf, which also might be tough to reach, he says. “But when it stops, everybody will stop, and I do think it will correct.”