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Commentary

2018's Increased Attention on Fundamentals, Flexibility and Focus

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This article is about three "f" words that defined the exploration and production industry in 2018 and, by extension, the lawyers and law firms serving that industry: fundamentals, focus and flexibility. Increased bank regulation and concentration of capital in the hands of fewer providers, most of which focus on "large" deals, have created a gap in lower middle-market exploration and production industry transactions.

This, in turn, has created a shift in the way lawyers are advising clients engaged in this market. In order to effectively execute these transactions from a commercial perspective, and serve clients from a legal perspective, over the last year lawyers have had to refocus their attention on the fundamentals of the transaction, possess the flexibility to adjust structures and return profiles to fit the transaction, and seek the ability to stay ahead of transactions by focusing on the environment in which the transaction occurs.

Funding Gap

Increased bank regulations on energy lending and post-2014 write-downs of exploration and production loans have limited debt capital availability relative to what has historically been available. Private capital has stepped in to fund the exploration and production industry, either by providing baseline equity capitalization or "plugging holes" in balance sheets through alternative structures. Approximately $60.8 billion was raised for private equity energy funds between 2015 and 2016. However, this capital has been relatively concentrated. The 10 largest energy funds closed in 2016 accounted for 89 percent of overall funding. These funds have, in large part, been competing for a limited set of assets in terms of basins, and the need to deploy this capital has led to increased check sizes. The result has been a "gap" in availability at the level somewhat informally known as "lower middle-market," which, for the purpose of this article, is defined in terms of a funding commitment of between $25 million and $100 million. This underserved market segment has not gone unrecognized. While larger funds with larger required transaction sizes have ignored lower middle-market transactions, a number of smaller funds, typically with smaller support structures and overhead, have been able to take advantage of opportunities that are too small for large funds but too large for angel or family office investment.

But lower middle-market investing can be tricky. Narrower margins and less capital to deploy generally demand greater discipline and more focus on the ability to make a profit from the sale of units of production instead of a sale—fundamentals. The same factors demand constant vigilance, both to existing investments and existing and proposed investment environments—focus. Relative to large transactions, fewer lower middle-market opportunities see formal processes, but it is nevertheless important that capital providers and teams uncover investment opportunities before they become competitive.

At the same time, it has become increasingly important for capital to be able to adapt to the needs of an opportunity—flexibility. This entails not only the ability to tailor an investment structure to the needs of a particular project, but to adjust an expected return profile to what is realistic in the circumstances. Restrictive, mezzanine debt-like protections may actually be value destructive when wedged into fundamentally non-debt structures, such as "drillco" transactions. Conversely, a one-size-fits-all, "team with a dream" equity investment model may not be sufficiently protective. There are relatively few capital providers who can identify, analyze and execute on these types of opportunities.

Shifting Environments

Effectively serving clients in these transactions requires an equal attention to fundamentals, as well as flexibility and focus. It could be easy to view "fundamentals" in this instance as suggesting that a cut-rate service provider would be appropriate; however, value (of which cost is only one part) should be the primary driver. In fact, a greater body of experience and the ability to leverage experience in other practice areas—especially tax, funds and "nuts-and-bolts" oil and gas (and not just oil and gas mergers and acquisitions)—drives fundamentals to a greater extent than lower rates. Of course, there is a limit to this. Value demonstration involves weighing services performed against the cost of those services. Transactions that are fundamentally sound may be especially sensitive to costs, necessitating creative fee structuring; however, it is a mistake to equate this with "value" rather than recognizing it as but one component of value.

Flexibility from the perspective of the delivery of legal services involves assisting clients in truly understanding an investment strategy or structure. This, in turn, drives value and thus fundamentals. Serving lower middle-market transactions in a flexible manner necessitates conforming to the needs of the risk and return profiles targeted by the client and not conforming the transaction to wherever the service provider's (or, for that matter, capital provider's) experience happens to lie.

A "drillco" transaction cobbled together from a precedent purchase and sale agreement and a note purchase agreement is likely to ultimately increase transaction costs throughout the life of a transaction, for example, by not allowing sufficient operational flex to permit a management team or operator to actually operate. Conversely, a client is not necessarily well-served by an attorney who does not suggest that a client's fixation on a square structural peg in a round transactional hole might be counterproductive. Costs resulting from inflexibility do not necessarily scale to transaction size. While they may be a rounding error in a large transaction, they may be significantly value destructive in a lower middle-market deal. A flexible approach, again, necessitates a broad pool of experience from which to draw.

Clients Seek Partners, Not Practitioners

As a whole, clients have begun to demand that counsel act as a partner and not just a provider of legal services. A "partner" in this context drives value through focus on keeping the client appraised of its operational environment, helping the client build meaningful relationships, suggesting alternative investment structures, and other value-enhancing activities.

If this is a good thing for clients involved in large transactions, it is doubly so for lower middle-market transactions that are relatively sensitive to costs. As with fundamentals and flexibility, this is an instance in which "the strength of the pack is the wolf and the strength of the wolf is the pack." The ability to leverage broad transaction experience across a firm drives value by, among other things, assisting clients in identifying new law, deal structures and opportunities without the need to participate in a process.

The number of lower middle-market transactions in the exploration and production space increased markedly over the course of 2018. Effectively serving clients in this market segment in 2019 and beyond will entail an increased focus on value. Value, in the context of these transactions, requires that outside counsel match the client's attention to the three f's—fundamentals, flexibility and focus.

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