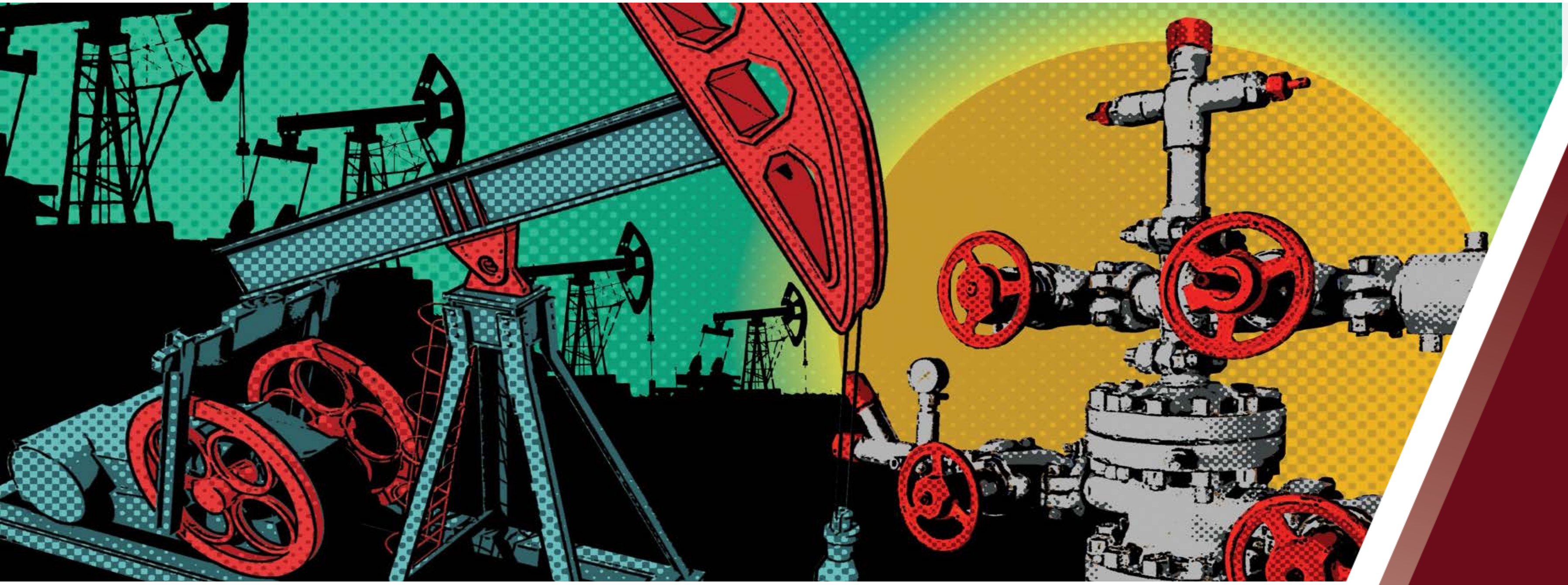

Drilling Your Way out with DrillCos

IPAA Leaders in Industry Luncheon
April 10, 2019

Austin Elam, Partner

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Drilling Your Way out with DrillCos

Alternatives to development capital in a capital constrained environment

Austin Elam

A&D Slow, As Predicted

- First quarter A&D activity down over 90% on a value basis, per drillinginfo

(# of transactions)

US Region	2017	2018	March 2018	March 2019	%Δ YoY
Multi Region	28	22	4	2	-50%
Permian	130	128	32	15	-53%
Gulf Coast	76	73	23	7	-70%
Rockies	77	87	18	11	-39%
Midcontinent	93	67	21	11	-48%
Appalachia	47	24	8	6	-25%
Ark-La-Tex	32	19	3	3	0%
Gulf of Mexico	11	25	12	4	-67%
West Coast	11	13	0	1	NMF
Alaska	1	7	2	2	NMF
Total	**506**	**465**	**123**	**62**	**-50%**

Source: Houlihan Lokey

- New normal, particularly for private equity sponsored producers
  - The business model has changed
- See also: QEP/Vantage, Earthstone/Sabalo

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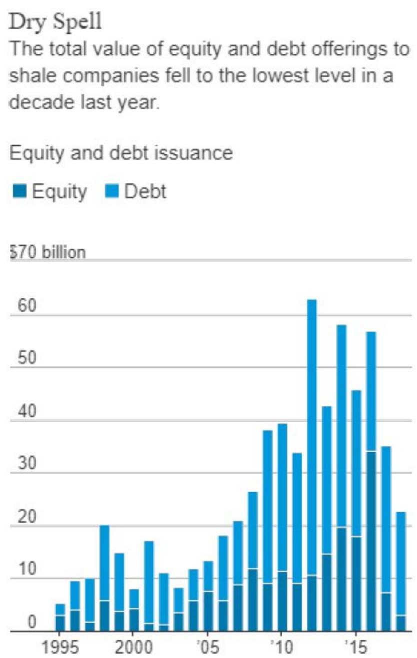
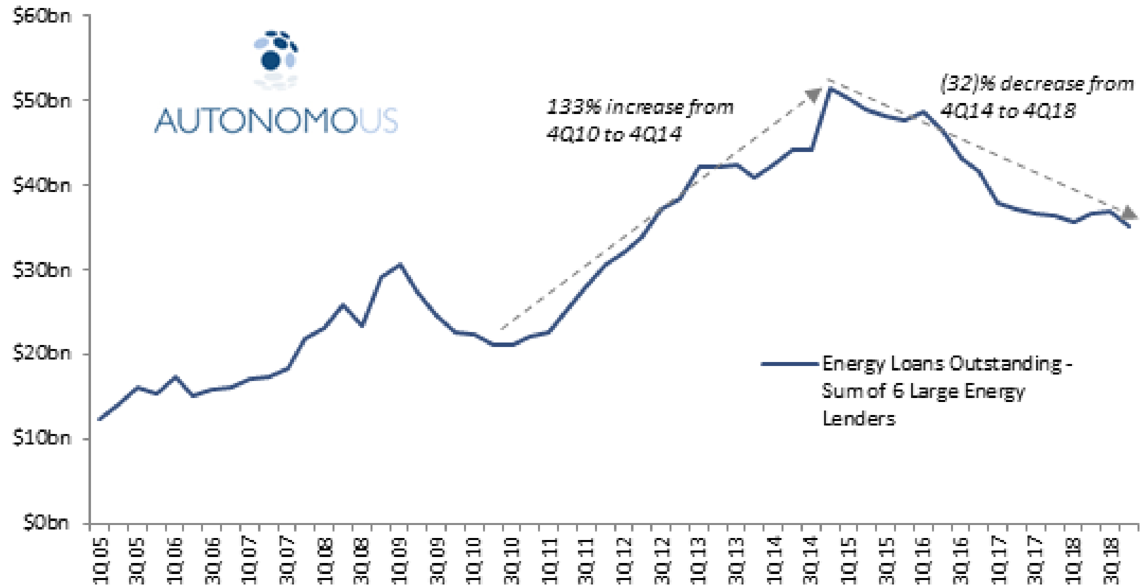
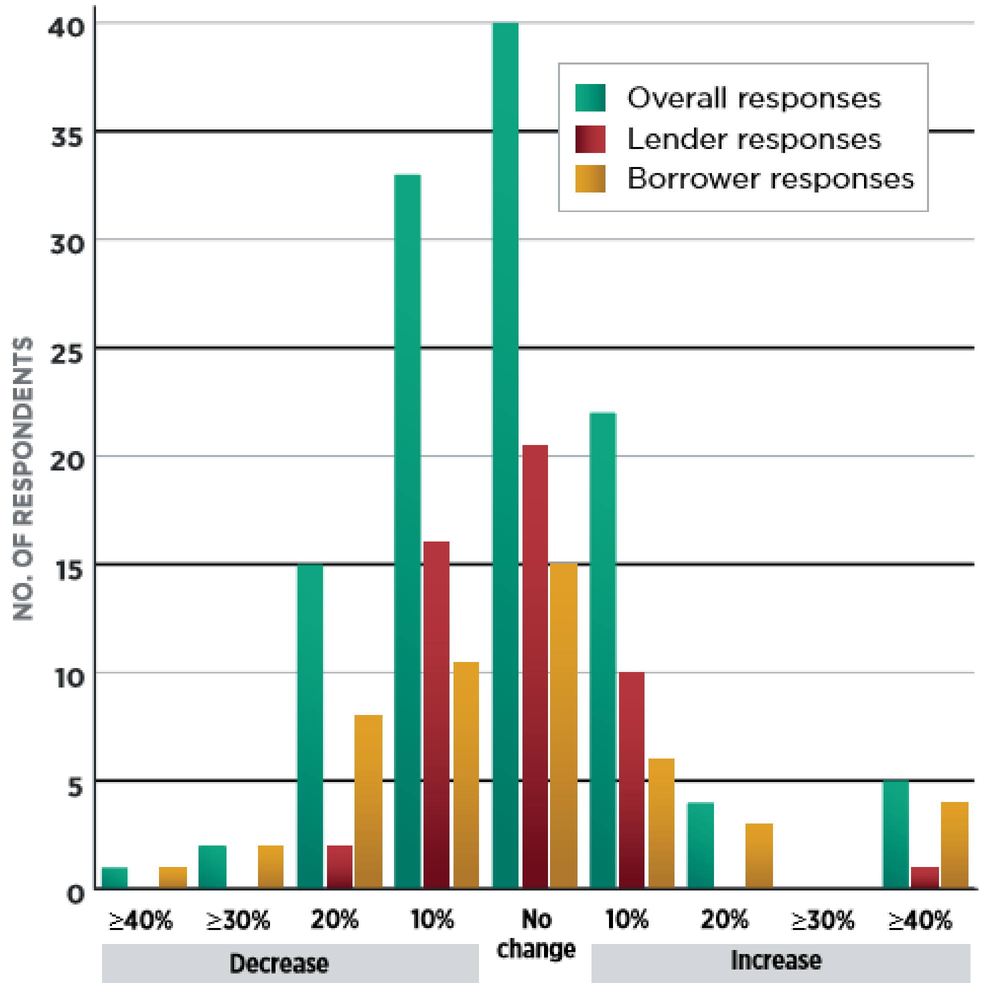
(Lack of) Liquidity a Major Factor

- Equity markets remain quiet
- Senior lending down as well, though a case of the chicken vs. the egg with a decrease in M&A/A&D activity

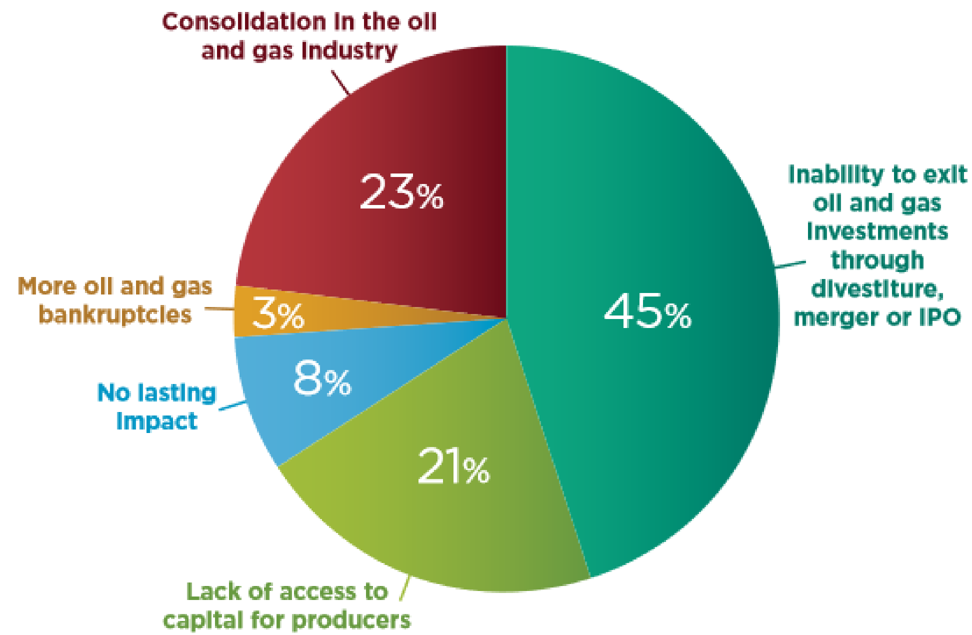




H&B Energy Roundup – Spring 2019 Survey



The survey indicates that oil and gas companies looking to "cash out" in 2019 will struggle to do so.



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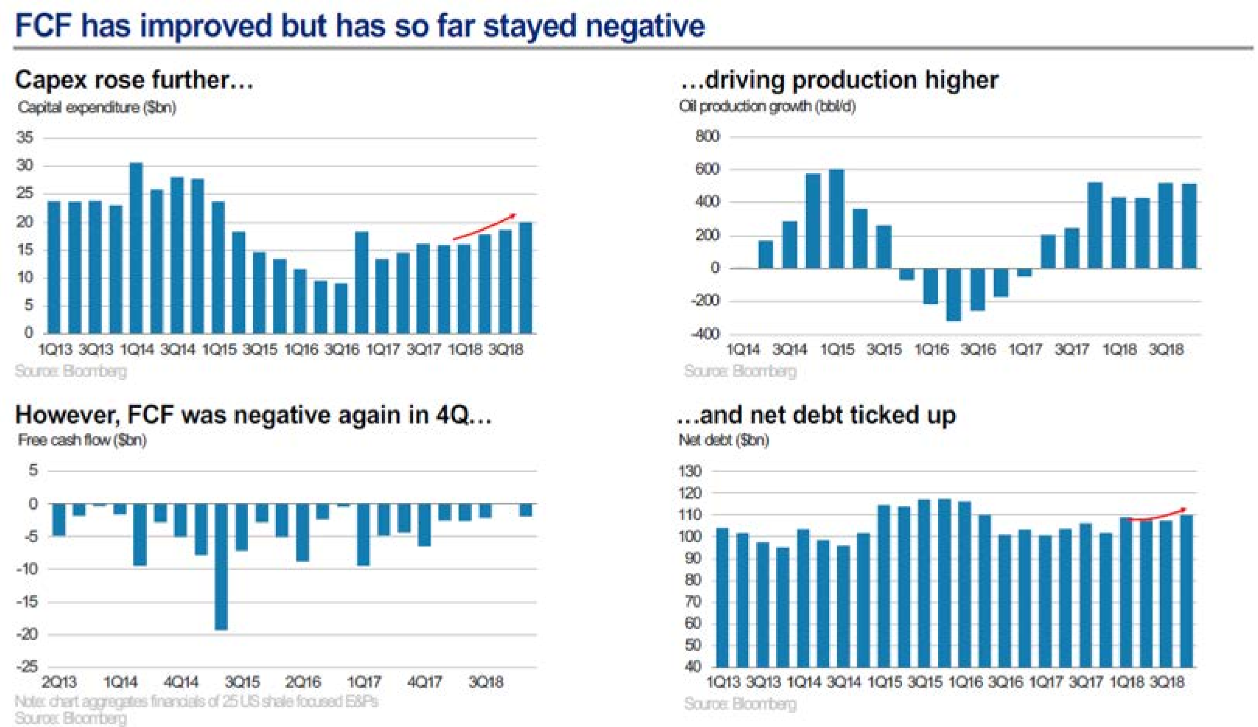
Development Capital from Where?

- "Drilling within cashflow"



Source: Morgan Stanley Research – 4/4/19

- Many RBL Credit Agreements permit farmouts of "undeveloped acreage."
  - "farmouts in the ordinary course of business of undeveloped acreage *to which no Proved Reserves are attributed in the most recently delivered Reserve Report* and assignments in connection with such farmouts"

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To the Rescue - "DrillCos"

- DrillCo 101 – a drilling joint venture between a Producer and a Capital Provider
  - Not a company or jointly-owned entity – a "financial" farmout agreement
  - Capital Provider agrees to fund Producer's drilling of wells in exchange for negotiated "Before Payout" and "After Payout" returns and interests
- Most commonly, the interests assigned are "wellbore only" and not acreage assignments
- Limited recourse back to the producer, with the Capital Provider accepting production and operational risk

	Producer	Capital Provider
Drilling/Development Costs	20%	80%
Payout Hurdle	13% IRR	
Before Payout Working Interest in Wells	40%	60%
After Payout Working Interest in Wells	90%	10%

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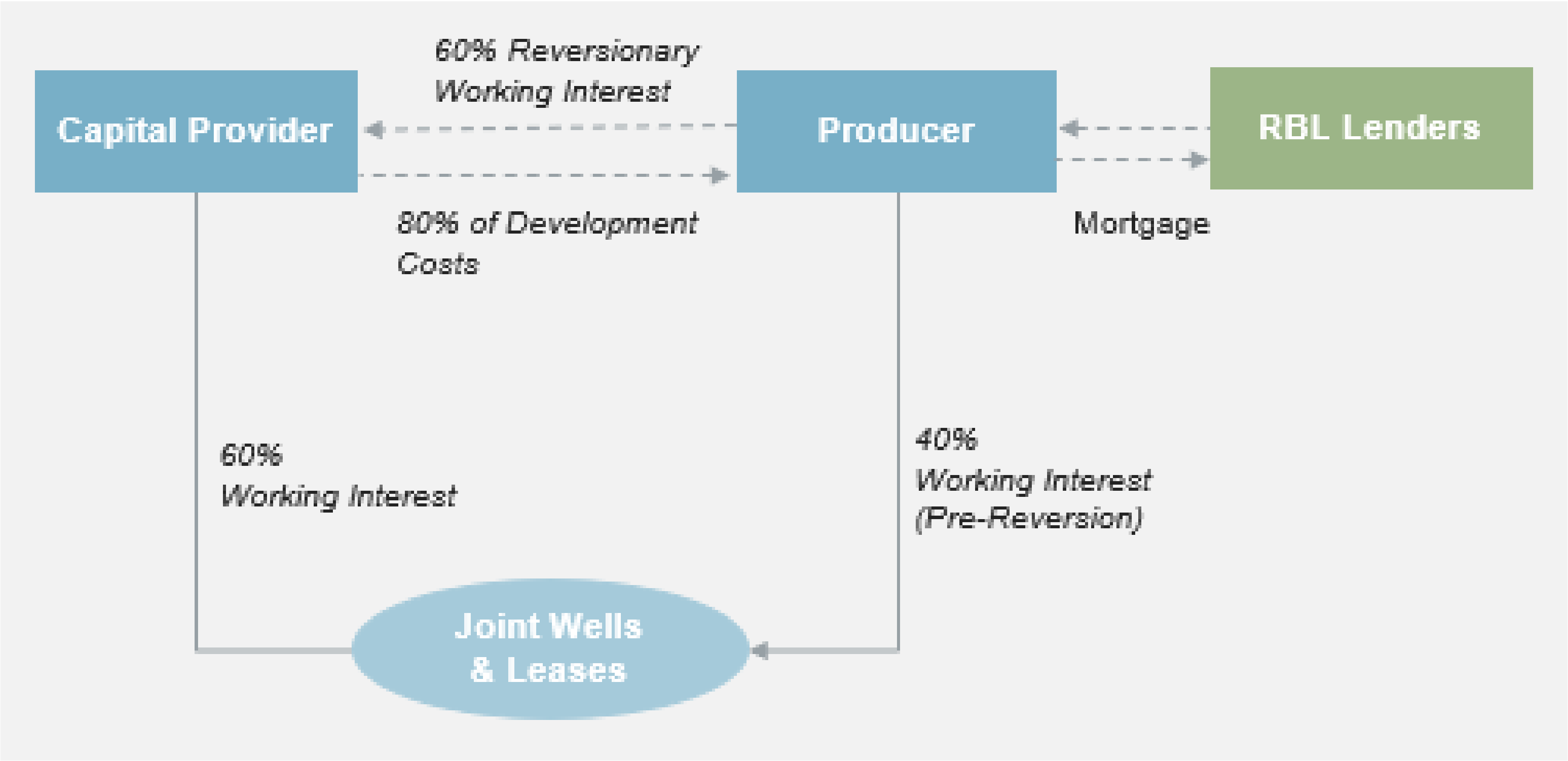
DrillCo Structure – Pre-Reversion



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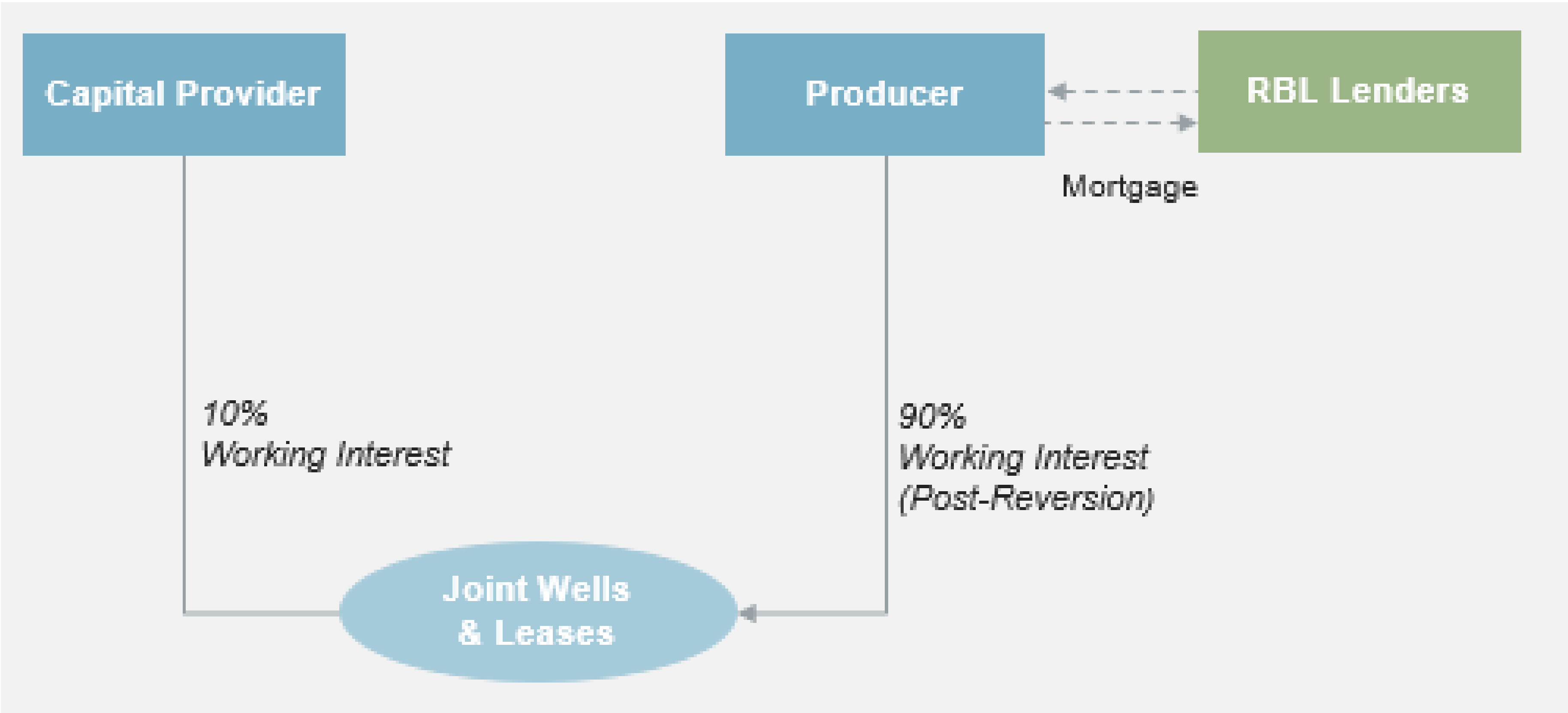
DrillCo Structure – Post-Reversion



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Solving Problems without Creating More

- Scalable based upon size of agreed budget and program
- **Producer** receives:
  - Access to capital to finance drilling of an agreed well program
  - (Likely) no additional debt on the balance sheet
  - The upside and full ownership of all in-fill and adjacent drilling locations outside of the program
  - Works within existing RBL structure and potential Borrowing Base uplift from DrillCo program wells once PDP (up to the Producer's retained working interest in each well)
- **Capital Provider** receives:
  - Firm obligation by Producer to drill agreed well program
  - Right to a return on invested dollars (BPO) *plus* a perpetual APO "tail" working interest in each program well
  - Direct non-operated working interest in each funded well, carved out of the Producer's estate in the event of a bankruptcy, with some strings attached

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Deal Points in Practice – DrillCos 201

- **Push and Pull – Structural vs. Contractual Protections**

- **Spacing Concerns** – What protects the Capital Provider's "wellbore only" interest?

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Deal Points in Practice – DrillCos 201

- **Non-Op and Non-Budget Wells** – Participation right for Capital Provider?
- **Cost Overruns and "AFE Caps"** – Who bears risk of cost increases/overages?
- **Hedging** – Included within reversion calculation? Who takes open positions upon reversion?
- **Infrastructure and Marketing** – And water issues

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Broken Promises and Changing Circumstances

- **Defaults and Reversion**
- **“Customary” JOA liens** – That secure (some) obligations under the development agreement
- **Acceleration Payments and Off-Ramps** – Plans change
- **Distressed Transfers**
- **Not Debt** – Right?

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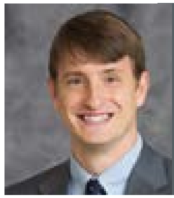
CONTACT INFORMATION



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