

Navigating the Capital Desert

Diversified energy credit presents a compelling opportunity for investors to earn attractive risk-adjusted returns within a more stable investment platform in the face of changing commodity fundamentals



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The Capital Desert

Precipitated by a historic capital flight, a slowdown in traditional financing and a stalled A&D market, the upstream energy sector has undergone a paradigm shift on the heels of the last commodity cycle.

Since 2005 and alongside the rising tide of commodity prices driven by Asian demand, historically low interest rates for debt financing, and a completions technology revolution that unlocked significant new acreage, the oil and gas industry enjoyed more than a decade of buy/build/flip success and repeatedly generated equity returns of +20% IRRs for institutional partners. However, the active buyers of that period, larger independents and majors acquiring inventory, have now accumulated large resource blocks and shifted their focus inward to the active exploitation of their own resources.

Pressure from equity investors is driving these large industry firms to focus on cashflow, dividend reinstatement or growth, and prudent reserve development. This is driving a wave of consolidation as companies seek to increase efficiencies and lower costs through scale. Meanwhile, capital markets have shown little willingness to fund public company development through dilutive equity raises.

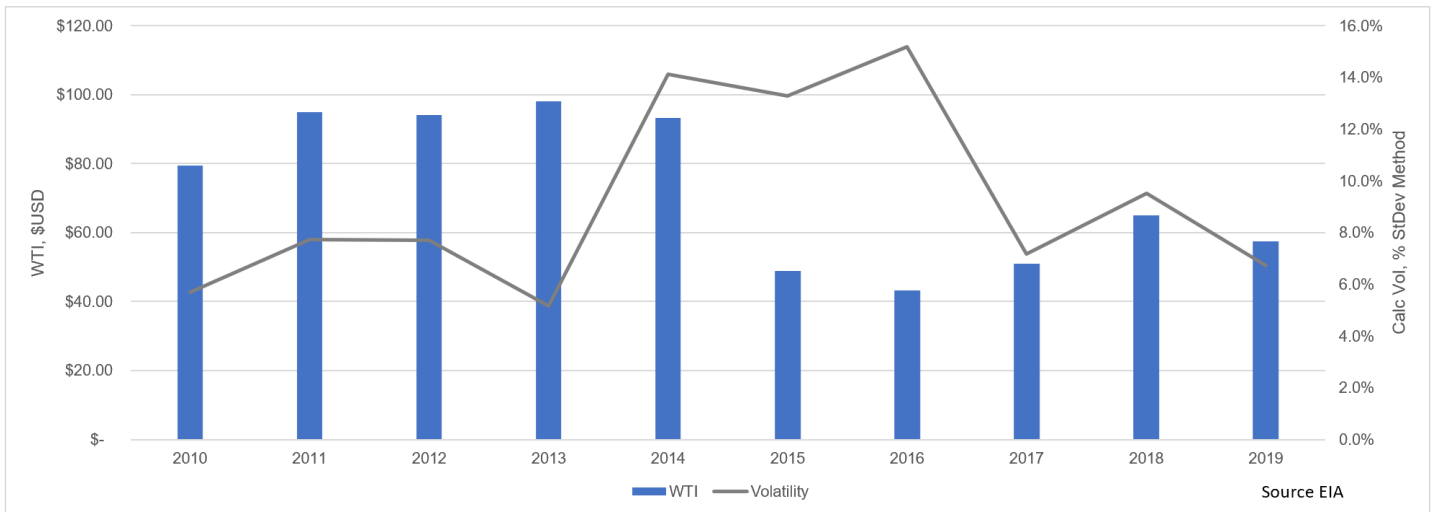
More broadly, E&P public equities have meaningfully underperformed relative to the larger equity market over the last five years; a trend we expect to continue this year as the true detriment of aggressive downspacing, highlighted in numerous 1Q19 earnings calls, is realized in various basins and reserves are written down. Energy equities constitute less than 5% of the S&P 500 today and are viewed as a value allocation rather than growth. These factors, paired with almost double the price volatility since 2014, will continue to drive equity investments from the upstream space to higher returning sectors.

S&P 500 vs XLE, 2015-2019



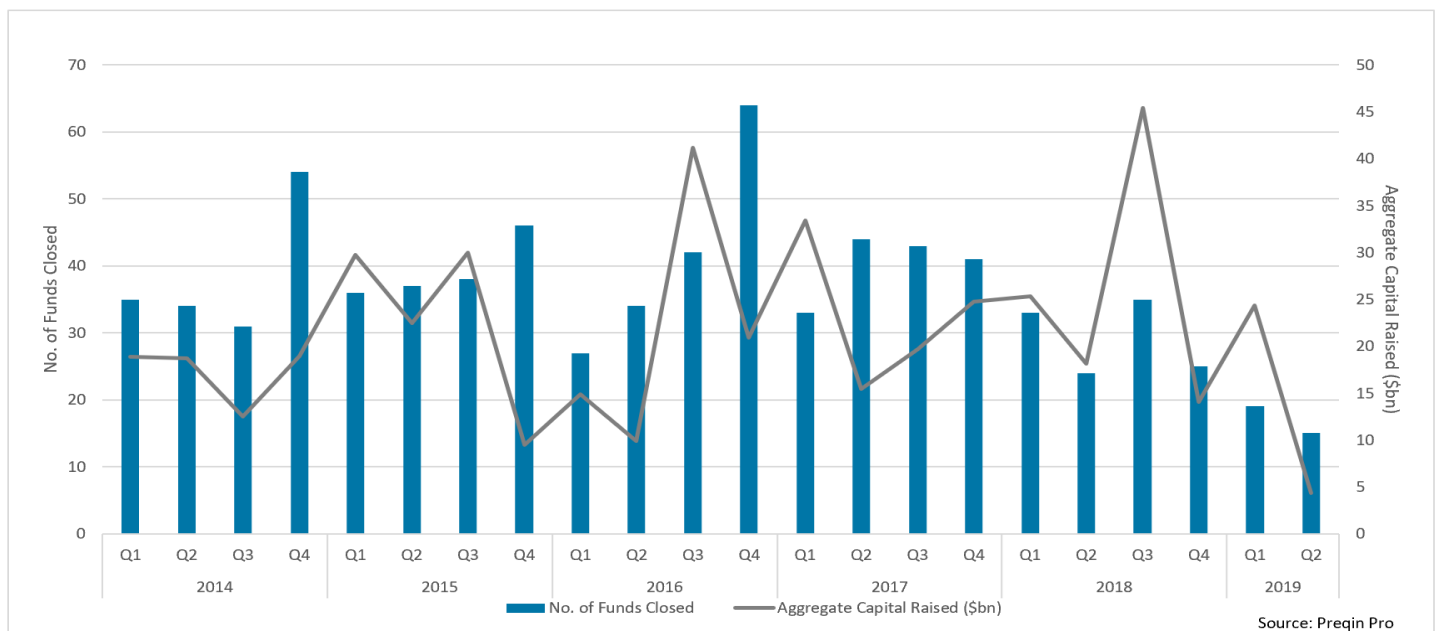
Source Yahoo Finance

Crude Oil Volatility, 2010-2019



On the private equity side, traditional institutional capital has largely elected to sit this round out as they allocate to other sectors with better perceived risk-adjusted returns and fewer ESG concerns. Global natural resources fundraising is largely flat since 2014 but North America unlisted fund closings are down 35% over that same period. Year over year, the number of funds in market has increased 20%. This is not due to renewed interest in upstream, but rather the result of an increase in the time from fund launch to close approaching an unprecedented 18 months, with some funds searching for capital well over two years. Natural resources fundraising, once a consistent \$90B/year market, is on track to finish the year around \$30B.

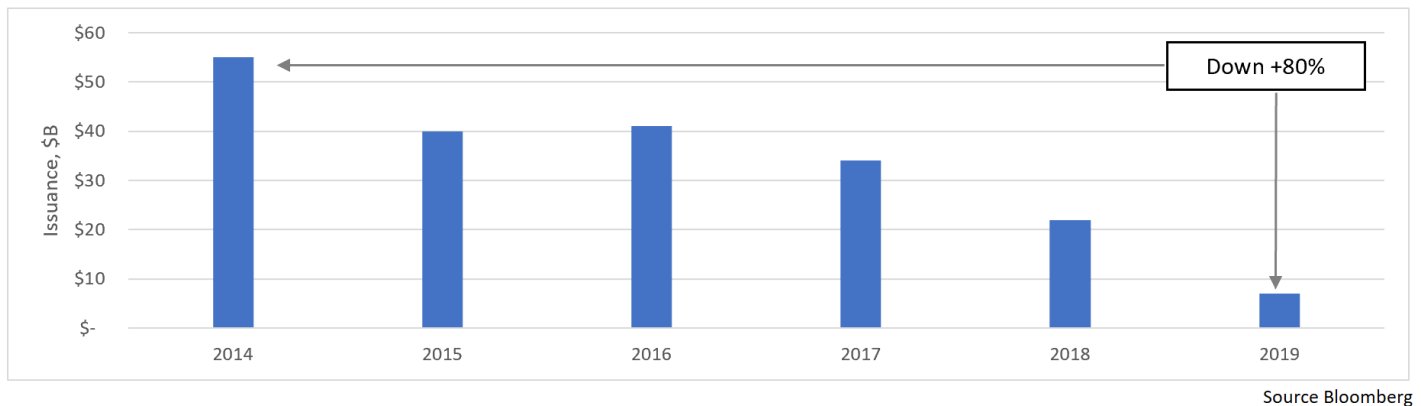
Global Quarterly Unlisted Natural Resources Fundraising, Q1 2014 - Q2 2019



Additionally, scattered in the wings are more than one hundred portfolio companies of various private equity “allocator” strategies--many of whom are far beyond the investment period and struggling to generate the promised high returns. With sponsor capital drying up and downward pressure on senior debt due to declining PDP production, many of these portfolio companies are unable to develop their existing leasehold or optimize production. Due to increased pressure from LPs for realizations, allocator managers are forcing these portfolio companies to exit in unfavorable conditions, consolidating them under one preferred asset manager, or pushing them towards higher cost capital to survive.

Adjacent to the retreat of public and private equity, high yield issuances and traditional bank financing has withdrawn. High yield issuance on average contributed almost \$40B of liquidity annually to the E&P space over the last five years. That issuance began to slow in 2018 with only \$22B of issuance and nearly cease in 2019 with \$7B of issuance year to date. Alongside this decline and amidst the equity flight, valuations have declined to historic lows. The advance rates associated with traditional bank financing have declined as banks adjust asset valuations downward and broadly restrict leverage to address OCC compliance.

Upstream High Yield Bond Issuance, 2014-2019



Lastly, upstream M&A has consistently provided \$70B of annual liquidity to the energy market over the last five years, further fueling the growth engine. However, as of Q1 2019, US upstream M&A has fallen to a ten-year low of \$30B leaving equity investors exposed to a volatile commodity environment with no clear exit. The upstream energy landscape is increasingly prevalent with compelling acquisition and development opportunities, however this equity capital flight has stalled a historically robust market, particularly in the middle market. Furthermore, we expect these market dynamics to begin to impact the US midstream environment, which has been historically viewed by market participants as “safe” and “above the fray” of upstream volatility.

E&P Transactions by Qtr, 2014-2019

<u>Quarterly Upstream M&A, \$B</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Q1	\$ 18.4	\$ 3.7	\$ 6.8	\$ 25.5	\$ 25.2	\$ 4.9
Q2	\$ 26.4	\$ 8.1	\$ 17.5	\$ 22.7	\$ 9.3	\$ 9.6
Q3	\$ 31.5	\$ 10.6	\$ 21.8	\$ 13.3	\$ 34.3	\$ 16.9
Q4	\$ 32.1	\$ 13.2	\$ 27.3	\$ 11.2	\$ 23.1	
Total	\$ 108.4	\$ 35.6	\$ 73.4	\$ 72.7	\$ 91.9	\$ 31.4

<u>Avg Daily Spot \$</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
WTI, Avg \$/Bbl	\$ 93.26	\$ 48.69	\$ 43.14	\$ 50.88	\$ 64.94	\$ 57.31
HH, Avg \$/MMBTU	\$ 4.37	\$ 2.62	\$ 2.52	\$ 2.99	\$ 3.15	\$ 2.61

Source PLS, EIA

To recap: we find ourselves in an environment of vanishing equity from traditional sources across the majority of the energy space, restrictive and defensive bank financing, and a growing volume of untransactable deal flow, -- all amidst a commodity market that is evidencing high, sustained volatility.

The Need for a Better Capital Solution

Tactical energy credit has the potential to offer a more compelling risk-adjusted return to investors and to provide a more stable investment vehicle in the face of changing commodity fundamentals for multiple reasons:

- Equity-like returns and diligence with seniority on the capital stack
- Higher velocity of capital return than equity investments [with downside price protection]
- Opportunity to capture value across the entire energy chain
- Flexible capital allows for creative entry and exit vs. longer tenor equity investments

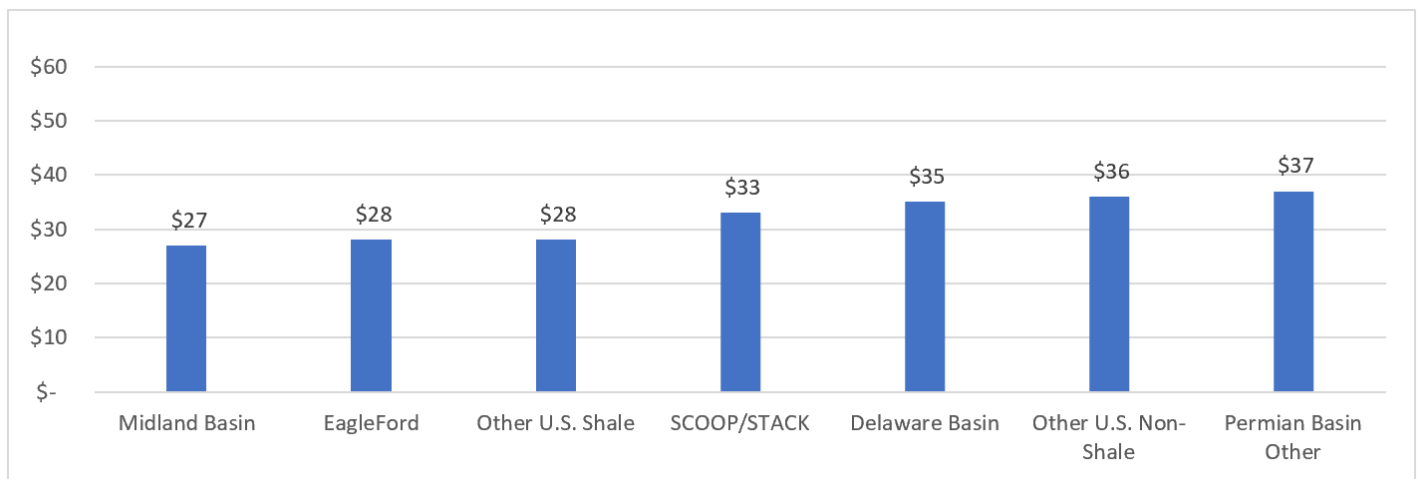
As fleeing equity has slowed the A&D market, transaction discount rates for producing properties have increased from PV10 to PV13-17 on average with advertised deal IRRs climbing from the low-teens to the mid-teens. However, the majority of assets currently transacting are mature, lower quality producing properties and we believe this increases the risk for delivering lower equity returns than promised. In a high commodity price environment, mature producing assets have sufficient margin to warrant inclusion in upstream strategy. Paired with a typically low decline, these assets can offer yield and consistent cashflow. However as pricing falls, these assets often suffer from margin compression and reduced cashflow which can lead to higher declines and less distributable cash. This asymmetric performance warrants a higher discount rate in today's volatile price environment but must be paired with the right terminal value assumptions to deliver a true picture of IRR. We continue to see upstream GPs acquiring assets at PV13-17 but underwriting a terminal value

of PV10, oftentimes taking a bullish stance on commodity pricing after year 3. Mature assets acquired today are unlikely to trade at a premium a decade from now. This disconnect in acquisition vs disposition discount rates suggests a large artificial inflation to the underwritten equity returns.

Energy credit can offer an identical mid-teens return profile but with seniority on the capital stack and the opportunity to own the assets at a significant market discount. A fixed income portfolio with appropriate allocations to credit, asset, and structured equity products can be constructed to deliver mid-teens net returns while approaching 1.5X MOIC. Additionally, this portfolio can be underwritten with the same diligence and confidence of an equity investment while maintaining a senior position on distributions.

In the event of an equity conversion, the assets are being acquired at 2-2.5X cashflow which is a compelling entry point and represents +20% IRR equity returns. Of note, a strong engineering evaluation is the foundation to any successful investment in energy assets. Understanding the reserves, operating environment, and takeaway optionality are critical diligence items during underwriting. An experienced operator can identify the nuance between different producers and find opportunity in the cost and capital structure. The ability to act upon these opportunities post-acquisition is a unique source of alpha. By building a fixed income portfolio leveraged to higher margin production with operational tailwinds, a manager can mitigate important investment risk in a volatile price environment.

Operating Breakeven by Basin



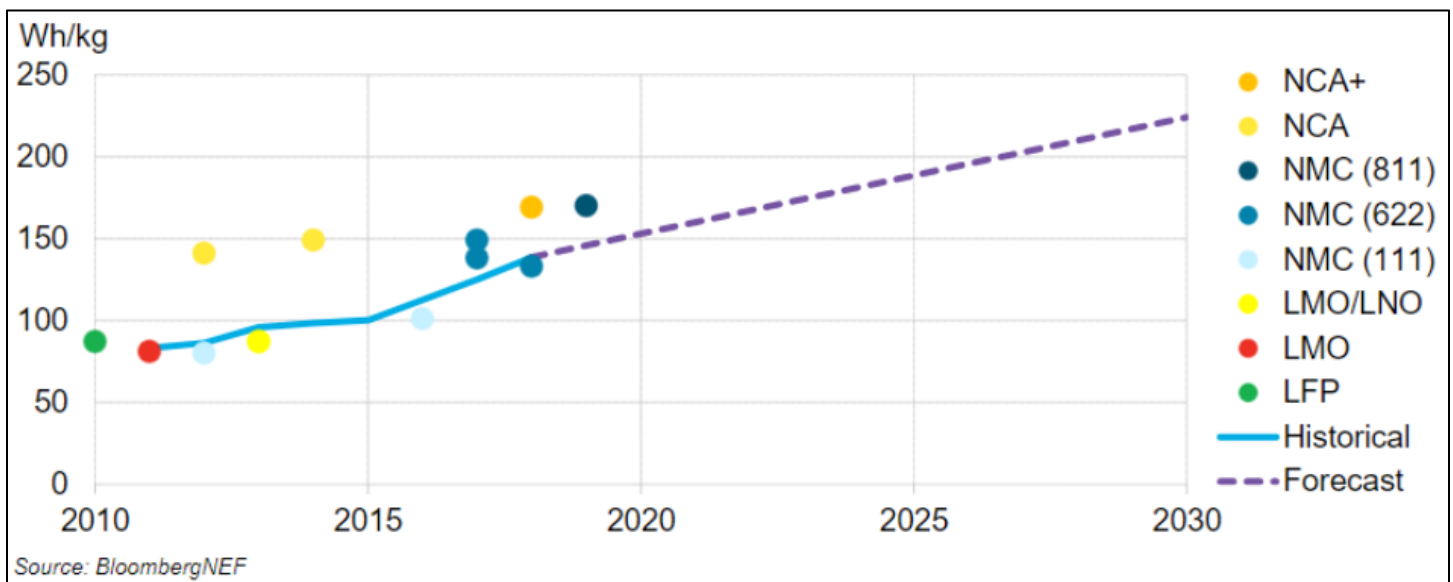
Source Dallas Fed Energy Survey

While a typical energy equity investment may pay a coupon, these investments are generally slow to return capital until an exit occurs. With a lethargic upstream M&A market, equity investors can no longer rely on the quick exits which delivered high returns in the past and prompted so much capital investment initially. Today, those investors are faced with two disappointing options: sell into a distressed market or hold the assets well beyond the investment period in hopes of another commodity upcycle.

An energy credit strategy with an active mandate can capitalize on this dislocation by providing capital acceleration to sellers, multi-tranche solutions to buyers, and thoughtful development capital options when the current equity investors cannot take any additional balance sheet risk. All of these opportunities offer a faster return of capital than equity, often inside of four years, with multiple take-out scenarios but benefit from a historically low entry point in the event of an equity conversion. More importantly, these capital solutions are often amortizing, hedged, and covenanted heavily to protect the investment. Given the asymmetric unmet demand for energy capital (historically high) and supply (historically low), energy capital providers can afford to be incredibly selective with their investment decisions.

Lastly, an energy strategy built today and designed to last multiple decades must account for the growing impact of technology and renewables on power generation and waning demand fundamentals for oil and gas. Today, US power generation capacity is approx 4,000 BKWh with 52% of that generation derived from natural gas or renewables. The US Energy Information Administration forecasts US generation capacity will be approximately 5,400 BKWh within thirty years with 70% of that power generated from natural gas and renewables. It is critical to note that of that 70% generated in 2050, 31% will come from renewables which represents almost a two-fold increase from today's 18% and is driven almost entirely by a ten-fold increase in solar generation.

Battery Energy Density, Historical & Forecast: 2010-2030



Alongside the growth in renewable generation, battery cell energy density is rapidly improving and forecast to double with the next decade. Constructing a portfolio of credit investments across upstream, midstream, and power/renewables offers a more opportunistic, top-of-capital structure approach to capture value across the energy chain.

About Open Water Capital Partners

Critical to the success of any energy investment is strong engineering. Through a fifteen year track-record of upstream investing, our team has underwritten energy opportunities in every major basin across the lower 48. We have successfully led the onboarding and integration of transactions from \$500K to \$700MM, deploying over \$1.6B of equity in our previous venture while executing on development programs in the conventional, unconventional, and EOR space. Our deep technical experience differentiates us as:

- 1) We can perform more robust diligence with a unique appreciation for technical risk than finance-oriented firms. Our firm can underwrite across a variety of basins, mitigating concentration and portfolio risk.
- 2) We can lever our experiences to create more successful investments with our operating partners. Our industry relationships allow us to provide unique insight into improving operational performance.
- 3) We have the skills and people to ensure our investments are protected. Our team has physically operated production in challenging environments and can seamlessly step into controlling positions.

Collectively, our team has deployed \$2.5B in equity, structured equity, and debt over the last fifteen years in upstream and credit platforms. We have negotiated with, and across from, some of the largest private-equity and financial institutions in the energy sector. Furthermore, we have managed the legal and structural documenting for those investments to accommodate all parties, including institutional and international capital.

We believe that collaborative solutions create the best outcomes for both parties. Our experience and constructive approach allows us to offer a variety of appropriate products including secured financings, non-op & royalty positions, and structured investments to our partners in an expeditious manner with appropriate capital protection.

By combining our diverse engineering, underwriting, and structuring experience to create middle market credit solutions, our team offers a differentiated investment platform with ESG-conscious exposure to the entire energy value chain.