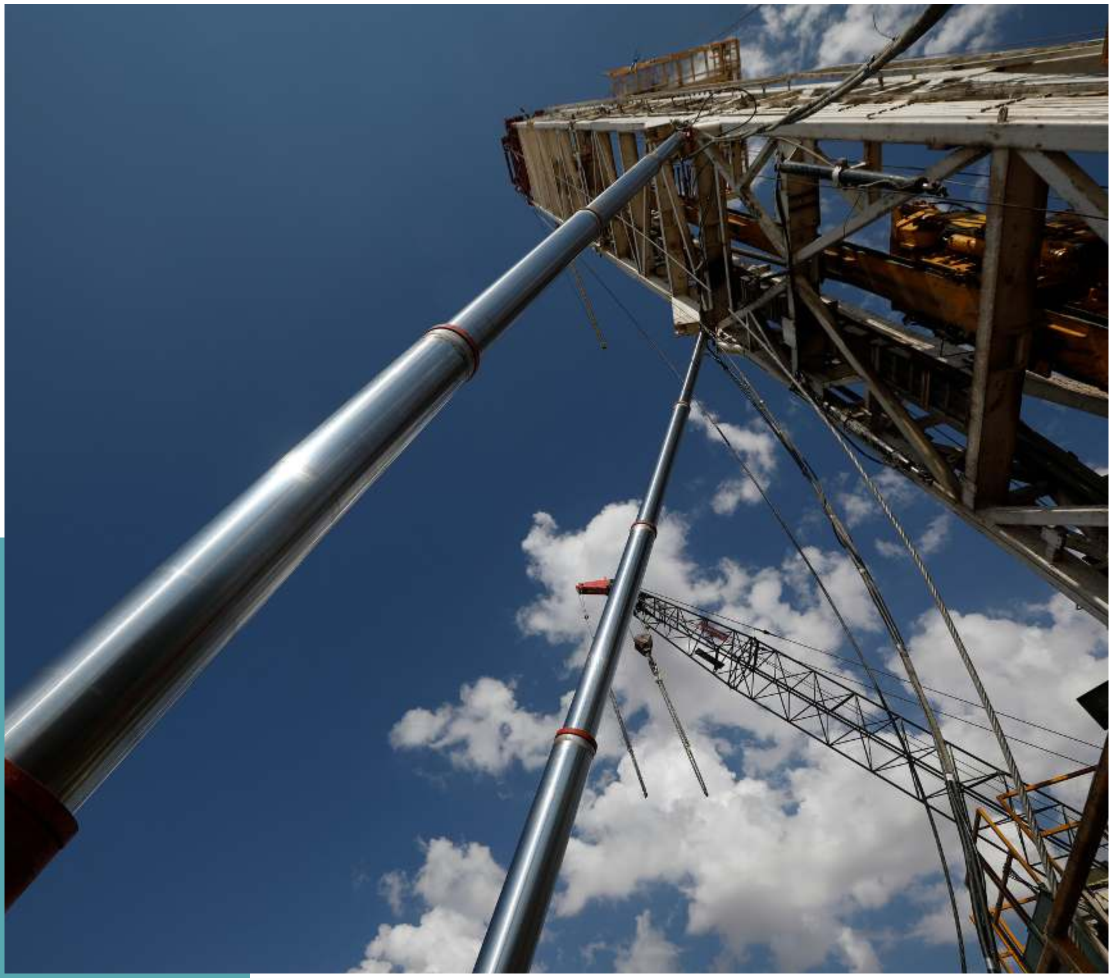
CREDIT AND HEDGING FOR MINERAL BUYERS: TRENDS AND TOP USE CASES



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EXECUTIVE SUMMARY

Access to sophisticated financial products has become necessary for mineral buyers to stay competitive in a sector that is quickly growing and evolving. E&P companies have long used credit lines and hedging derivatives as integral tools to manage their businesses. As mineral buyers' assets and business models evolve and begin to resemble that of its E&P partners, their financial toolkit should also change.

MineralSoft is uniquely positioned to help mineral buyers access such financial products. Our cloud-based mineral-management software can quickly generate the reports and information that are required to participate in financial markets. We simplify what was once a complex and costly process for mineral buyers. By enabling your business to access credit lines and trade hedging derivatives, MineralSoft can help you grow faster and reduce risk exposure.

INTRODUCTION

When it comes to financing the oil & gas business, capital markets have historically been more open to exploration-and-production operators than to non-operating companies and mineral owners. Equity investment, lending, and hedging have largely focused on supporting operators, who bear most of the costs and risks of drilling, extracting, and transporting hydrocarbons. With the massive influx of capital into the mineral and royalty asset class over the last twenty years, non-operating interest owners are starting to look and feel much like traditional oil & gas companies. The lines have blurred with many mineral funds owning working interests and many operators managing large non-op portfolios. Everyone is in the game with the same basic requirements for capital and the need to hedge against commodity-price risk.

Capital markets are now more accessible to mineral buyers than ever. This is largely due to banks and underwriters having an increased appetite for exposure to the mineral-buying space. Equally important, mineral owners have evolved from landowners and mom-and-pop operations to private equity-backed startups and large mineral-buying organizations. To fuel expansion, acquire prime acreage, and gain early mover advantage, these companies also have an increased appetite for credit and risk management products.

As a mineral buyer, navigating the new world of financial services available to you can be challenging. In addition to more traditional lending options, such as reserve-based loans and senior debt notes, mineral buyers now have access to a wide variety of alternative financing and hedging solutions. The complexity is multiplied by varied types of secured and unsecured products and the highly specialized knowledge required to effectively implement these nuanced financing solutions.

Hedging has become especially important, requiring all players to pay close attention to price movement. This wasn't the case two decades ago, but today's mineral buyers are impacted by daily trading and market-moving forces, like Iranian sanctions and Venezuelan production decline. Mineral buyers need to manage risk more than ever, including flat price risk as well as basis risk. This requires paying close attention to localized mineral interests and commodity price differentials by basin and understanding where infrastructure bottlenecks may materialize and cause basis-price blowouts.

No matter the size or stage of growth, an effective credit and hedging strategy can transform the way a mineral buyer does business, enabling startups to become profitable faster and established mineral funds to expand into new markets. Hedging can play a vital role during an acquisition and enable buyers to mitigate their exposure to commodity-price risk. In this paper we discuss more details on the financing options now available to mineral buyers, the top use cases, and tools that will help you navigate credit and hedging complexity.

EVOLUTION TOWARD LENDING AND RISK MANAGEMENT

Twenty years ago, the mineral buying space was essentially a cottage industry. With a few exceptions of larger non-operating oil & gas companies, mineral owners could either be classified as mom-and-pop operations that acquired mineral interests or individuals and landowners with royalty interests. Active acquisition of mineral interests was limited and incremental. Financing options for these mineral buyers were few and they were heavily exposed to commodity price risks.

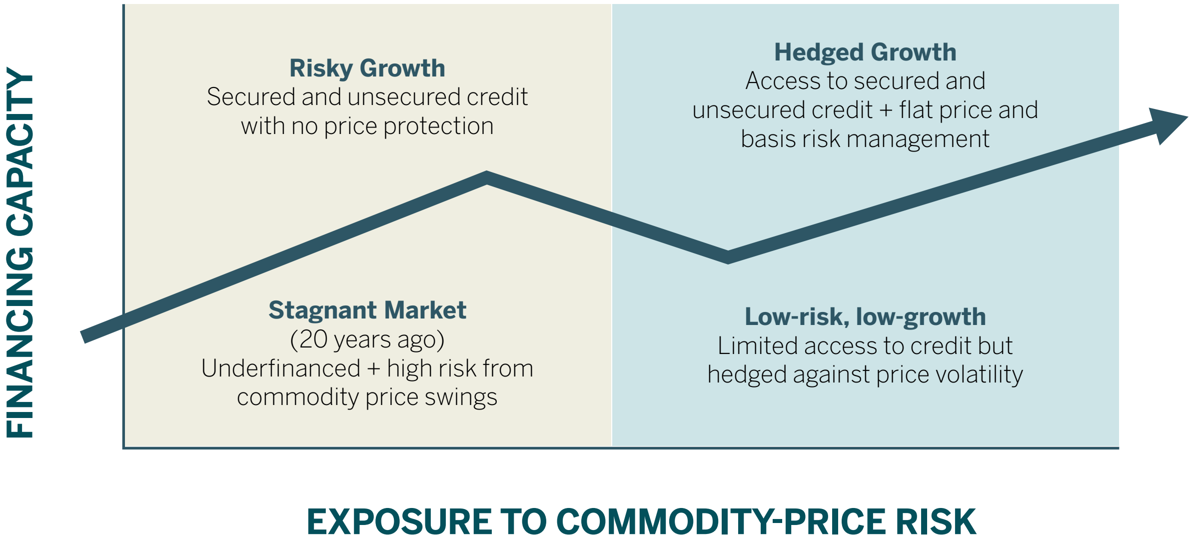
On the lending side, a mineral buyer could only obtain smaller, legacy loans. Such financing was almost always secured with collateral and an established track record of cash flow. Those few startups that existed would have to bootstrap themselves with equity only, and obtaining an unsecured line of credit for a small mineral buyer in the past was virtually impossible.

Hedging was rarely used as a tool in the mineral buying space. It was often required as part of a larger credit facility to fund upstream and midstream capital projects and were almost always secured through an intercreditor agreement. For mineral buyers, though, there was limited demand for large-scale hedging and little interest from counterparties to take on risk from small or new companies with no balance sheet. Limited hedging activity was also cultural. The players and any private-equity sponsors at the time just weren't trained with the right financial knowledge to take full advantage of such tools.

The shale revolution and revitalization of the Permian Basin disrupted everything, and since 2016 the United States has exported every barrel it does not use. The establishment of North American oil & gas dominance unleashed a torrent of capital and renewed interest into upstream operations and the mineral asset class. The advent of large-scale private-equity sponsors and mineral-buyer startups has been a game changer for the industry. As the oil & gas business evolved, lenders and service providers have evolved the products they offer to the various industry participants.

Mineral-related credit might now account for as much as 15% of a lender's energy book, a massive commitment to the industry and sign of thriving market interest. More mineral buyers are now willing to borrow, and creditors are increasingly willing to take on unsecured risk from large, PE-backed firms to smaller companies with high growth potential.

Today's private equity sponsors and limited partnerships are more educated on the financial tools and capabilities. Mitigating price risk has become more important as the scale, complexity, and equity component of M&A transactions have all grown. With such unprecedented access to a credit and hedging ecosystem, the playing field has finally begun to level for mineral buyers.



LENDING OPTIONS FOR MINERAL BUYERS

Mineral owners rely on banks for many support services, such as treasury and accounts receivable. These days, however, your banker is increasingly empowered to offer you a line of credit that would have been unthinkable just a few years ago. With the competition in the Permian, Eagle Ford, and SCOOP/STACK – just to name a few – being able to draw on an eight-figure credit line is a big lever for many mineral companies looking to secure prime tracts.

There many options for mineral owners for secured and unsecured credit. These products include the types of traditional loans that E&Ps have utilized for decades, including investment-grade senior debt with fixed rates and long-term maturities. A reserve-based loan (RBL) is another cornerstone of oil & gas credit to which mineral buyers now have access.

With an RBL, your lender will conduct a thorough engineering audit of your oil & gas portfolio to establish oil, gas, and NGL reserves. Based on decline-curve analysis and economic forecasts, the lender will be able to provide a level of credit support commensurate with your projected revenue, all secured by your mineral interests.

Flexibility is incredibly important. Most lenders are more than willing to work with mineral buyers to find the right fit for secured and unsecured credit. Alternative financing options take into consideration collateral quality, asset location, and equity capitalization. Such loans are typically short-term, 24 to 42 months, and are often linked to a 3-month trailing average of historical cash flow.

Today's mineral owners have access to new opportunities for unsecured credit. Similar to secured credit, your lender relies on cash flow, however as much as a 3-year track record can be assessed. Lenders are willing to underwrite unsecured credit, but it will require you to open up your books to scrutiny, including providing check stubs, the names of your operators, and a breakdown of revenue by region. Again, the key is flexibility and banks are ready to lend if they understand their risk.

ANATOMY OF OIL & GAS HEDGING

Simply put, hedging is all about mitigating risk related to commodity-price volatility. As an example, consider an operator who calculates that$50/bbl WTI is the price required to generate a minimum acceptable return on an investment to drill a well. That operator may wish to trade a simple swap derivative, with terms that are aligned with the well's investment-breakeven price, expected production volumes, and timing. Commodity consumers (e.g., refining and power companies) and speculators often represent the commodity producer's trading counterparty (directly or indirectly) for a hedging derivative. Banks often serve as broker-dealers in the transaction.

Hedging derivatives, in practice, are often more complex and are engineered to mitigate more specific forms of commodity-price risk. For example, rather than hedge against the absolute price of a prominent price index, a producer may wish to hedge against the difference in prices (or basis) between two price indexes. One common basis hedge for Permian producers is that which is linked to the difference between the WTI Midland and WTI Cushing indexes. To understand and mitigate basis risk, traders, creditors, and other market participants pay close attention to the myriad of factors that influence localized oil & gas pricing.

Producers and other market participants often have access to unique information and analysis that can be used to inform their forecasts for regional price indexes. Such analysis can be used to inform a producer's hedging strategy and introduce speculative, opportunistic elements into their program. For example, Permian producers seemed to foresee the infrastructure bottlenecks that caused the WTI Midland oil price to trade at steep discounts to the WTI Cushing index during 2018 before other market participants. Producers aggressively hedged their basis risk while the futures market still reflected 2018 Midland-Cushing basis near parity. When WTI Midland began trading at steep discounts to WTI Cushing, producers' basis hedges were heavily in-the-money and mitigated the negative effects of the basis blowout. Sophisticated producers conduct such analysis on all of their assets' markets – especially growing markets – and use the analysis to inform their hedging strategies.

There are several takeaways for mineral owners. First, a general understanding of how hedging works is valuable when analyzing your oil & gas portfolio's performance. Your operators are actively trading complex hedging to limit their exposure to commodity-price risk and, in turn, provide more certainty for near-term planning and budgeting.

Second, mineral buyers now have access to tools for hedging the energy market and locking in prices. Hedging derivatives can help mineral buyers trade and profit on their proprietary views of their regional markets, protect a company from price fluctuation during an asset acquisition, and remove uncertainty while planning and budgeting. Similar to credit, mineral buyers can choose between secured hedging products – linked to senior debt – and unsecured hedging solutions. Combined with credit, a price hedge can be a powerful tool to lock in long-term pricing for loans linked to a mineral owner's portfolio valuation, such as an RBL.

CREDIT AND HEDGING USE CASES

Mineral buyers today benefit from large-scale private-equity sponsorships. Due to the evolution of credit and hedging in the mineral asset class, oil & gas investors now have access to an expanding ecosystem of products to fuel expansion, accelerate startups, and mitigate price risks during acquisitions.

Established Funds

Mineral funds that have been active for years have an established track record of cash flow and reserves. Such companies looking to aggressively expand or access new markets without raising additional capital have several options to fuel their growth. This includes borrowing a certain percentage of their proven developed producing (PDP) reserve value or securing credit based on a trailing average of cash flow history.

Startups

A newly launched mineral fund or non-operating oil & gas company may only have a tax ID. Some startups may already have acquired acreage but lack cash flow. In these situations, secured lines of credit aren't an option, however, many lenders offer unsecured equity support. Under such an arrangement, loans are made available based on an agreement between the mineral buyer, its equity sponsor, and the bank. Typically, this means leaving some level of equity commitment unfunded to support the debt amount. This can provide a short-term kick start with access to capital that enables startups to attain a desired level of cash flow sooner rather than later.

Acquisitions

The mineral asset class has seen a steady stream of acquisitions as mineral owners look to monetize. Depending on the terms of a purchase and sale agreement (PSA), acquisitions can take anywhere from 30 to 90 days to close. The value of such deals is linked to oil, gas, and NGL pricing, and markets can move significantly higher or lower in just a few weeks. Rather than bear such risks, A&D participants are now hedging in order to lock in a desired sale price. Such hedges are often executed at signing of the PSA, are unsecured, and require no collateral from the mineral buyer.

Additionally, many lenders now offer a short-term line of credit to fund acquisitions that is typically based on a simple multiple of cash flow.

Early Movers

Gaining early mover advantage often means getting ahead of infrastructure bottlenecks. Credit and hedging can give mineral buyers the dry powder, as well as the risk protection they need to move on emerging acreage opportunities. Early movers can take advantage of hedging tools secured by credit and reserves, commonly anywhere from 50% to 90% of PDP over a 5 to 7 year tenure. Such hedging frequently combines the benefits of fixed price and differentials (such as the Midland-Cushing price spread) to take as much commodity-price risk off the table as possible.

TOOLS TO SIMPLIFY CREDIT AND HEDGING

As we have seen, obtaining credit and hedging products can involve significant work from both the mineral owner and creditor, including RBL engineering analysis, cash flow breakdown, and much supporting documentation. Assembling all of this is often a challenge, yet essential to qualify for loans. It's a process that must be repeated periodically as redeterminations are conducted by the lender.

MineralSoft's cloud-based mineral management software makes it easy for mineral owners to track large oil & gas portfolios with purpose-built tools for tracking mineral income and expenses. As a result, users can create and export all of the essential reports lenders look for when qualifying a mineral buyer for credit. Many MineralSoft users give their lenders direct access to their records, enabling a bank engineer to log in and run the reports needed to qualify or requalify a loan. This total transparency goes a long way with most lenders.

Enverus equips mineral buyers with powerful tools to secure credit and hedging. These capabilities include pre-built models for all major basins and sub-basins that offer a holistic view of production, geology, infrastructure, and economics. Rather than relying solely on a bank's engineering analysis, mineral buyers can quickly value potential deals and get up and running faster with financing products.