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2022 Oil & Gas — E&P Momentum continues despite some recent headwinds

by Brad Updike, LLM, JD, CSA

Despite the headwinds from the left side of our Federal Government seeking to impose the Green Agenda to displace fossil fuels with more carbon-friendly sources (i.e., solar and wind), the U.S. exploration and production (E&P) sector managed to hold its own in 2022 in terms of up-stream business growth, which was demonstrated through a year-over-year increase in onshore drilling activities (i.e., rig count), as well as a gradual increase in U.S. daily oil/gas production. As a result, oil/gas E&P capital raising within the retail financial sector saw a significant uptick in volume in 2022.

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– Brad Updike, Director

As was the case prior to COVID, the fortunes for the E&P sector continue on a roller coaster ride into 2023 and 2024, as oil prices, which reached $130 per barrel (bbl) in May 2022, have settled into a more stable pricing pattern ($76 bbl WTI as of Feb. 3, 2023). As to the prospects for natural gas, prices in the short term have fallen from those observed through much of 2022, due to unseasonably warm weather in January 2023. On a cautious note, natural gas storage levels will likely test domestic U.S. gas prices through much of 2023, hinging on whether the warmer weather stays through the year. Notwithstanding, the general need for U.S. natural gas abroad on a long-term scale should help to present opportunities for better pricing into 2024 and future years, due to a gradually increasing capacity to export gas to Europe, as well as the effects of the lingering Russian-Ukraine conflict that could affect gas supplies through parts of 2023 and possibly into 2024.

Energy sector capital summary

In 2022, our firm reviewed 13 sponsor companies that operate within the upstream oil/gas sector of the energy value chain. This group of companies collectively funded 22 private placement programs and raised $1.093 billion to support oil/gas drilling and infrastructure, mineral rights acquisitions, and related E&P initiatives/projects within the retail investment channel in 2022. This represented a 96 percent year-over-year increase in private capital funding from what was reported by these companies in 2021 (i.e., 10 sponsors and $555.974 million), and also resulted in the highest capital-raise year from the E&P sponsors group that we have reviewed since 2014.

Leading the way in terms of fundraising was U.S. Energy Development Corp. (U.S. Energy), at $332.68 million, which was followed by MDS Energy (MDS), at $225.0 million, and Mewbourne Development Corporation (Mewbourne), at $250.0 million. In terms of funding growth, eight of these sponsors also reported year-over-year gains in fundraising, which helped to continue the capital-raising momentum established in 2021 after the headwinds of the pandemic began to loosen its grip on the U.S. economy (i.e., with $273 million being the capital raise from the E&P group in 2020).

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The firm provides clients individualized legal opinions with an additional focus on project and fund structure, financing, valuation and exit analysis. Mick Law's experience allows it to assist clients in gaining an understanding of not only what the regulators require but, more importantly, how a direct private placement product compares to its peer group and the likelihood of a program's success.

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Capital raised – The fundraising totals of the E&P sponsors we covered

Company	Strategy	2022 Raise	2021 Raise	2020 Raise
Mewbourne	Drilling – horizontal wells in the Permian Basin, Texas Panhandle and Anadarko Basin	$250.00 MM	$119.80 MM	$55.31 MM
MDS	Drilling – horizontal wells in the Marcellus Shale Play	$225.00 MM	$146.919 MM	$60.00 MM
APX	Drilling – Mississippian oil targets in the Illinois Basin	No raise 2022	$19.00 MM	$12.00 MM
S.T.L.	Drilling – horizontal wells in the Marcellus Shale Play	$42.50 MM	$29.50 MM	$17.30 MM
U.S. Energy	Drilling – Permian Basin, Powder River and Eagle Ford Shale Play; the QOF is an opportunity fund seeking working interests and other upstream assets	$267.93 MM drilling; $56.65 MM QOF; $8.10 MM §1031 program	$145.00 MM drilling; and $45.00 MM QOF program	$64.00 MM drilling; and $20.00 MM QOF program
Waveland	Opportunity fund targeting minerals and non-operated working interests in the Bakken Shale Play	$42.64 MM	$13.255 MM	$22.00 MM
Resource Royalty	§1031 Programs acquiring minerals and royalties in STACK Play of Oklahoma	$32.9 MM	$11.067 MM	$5.373 MM
Montego Minerals	§1031 programs acquiring minerals and royalties in the Permian Basin and East Texas	$62.20 MM	$19.730 MM	$12.50 MM
JHO	Drilling – shallower oil zones in Tennessee	$5.00 MM	$6.704 MM	$4.35 MM
White Hawk Energy	Royalty fund acquiring mineral rights, royalties and overriding royalties	$65.70 MM	NA	NA
Barrow Shaver Resources	Drilling – horizontal wells in the East Texas Bossier and Cotton Valley Plays	$4.50 MM	NA	NA
Texakoma Resources, LLC	Drilling – horizontal wells in the Granite Wash Play in Texas	$30.00 MM*	$20.00 MM	$15.00 MM

**Texakoma Resources raised capital through its captive broker-dealer for drilling within its one-well program platform in 2020–22; sponsor will resume its launch of a diversified drilling asset platform in 2023.*

2022 E&P capital by strategy

Total Capital:	$1,093,340,000
Contributing Sponsors:	12
Drilling:	$824,930,000 (75%)
Opportunity Funds:	$99,340,000 (9%) (includes a QOZ fund)
Minerals/Royalties:	$168,900,000 (16%) (61% structured as direct interest)

Nine Internal Revenue Code (IRC) §1031-eligible programs were wholly or partially funded in 2022 by Resource Royalty, Montego Minerals and U.S. Energy. Overall, the §1031 energy program capital raised last year ($103.20 million) increased from what was reported in 2021 ($31 million) and 2020 ($18 million). Driving this upward movement in §1031 capital was the doubling of §1031-eligible offerings last year (i.e., nine offerings funded in 2022 vs. five in 2020). This increase in §1031-eligible offerings was fueled by (i) better oil/gas fundamentals coming out of COVID, (ii) certain acquisition-related opportunities that have surfaced from the movement within the public E&P sector to monetize non-operated drilling location assets in response to ESG, and (iii) pressure placed on companies by shareholders to use cash flows to pay distributions as opposed to enhancing drilling budgets. Based on current oil market fundamentals and perhaps longer-term natural gas pricing due to anticipated LNG exporting growth, this E&P sponsor group appears to be positioned to achieve a respectable volume of capital raising in 2023 and 2024.

The need to stay disciplined with E&P due diligence

Despite some welcomed optimism about the prospects of oil (currently) and natural gas (longer-term), we must remain steadfast in our underwriting of oil/gas companies, as no one is immune to the next pricing cycle. As such, we must pay attention to break-even prices and the break points in which an E&P sponsor's pro forma becomes unprofitable. Capital expenses and lease operating costs have increased by 50 percent or more in many areas as a result of recent oil pricing trends, so it will be more difficult for sponsors to structure successful products. As we have written in our past year-end reports, one must stay committed to cautious due diligence. History has taught us, the next cycle will come — we just don't know when.