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Oil & Gas Report

E&P holds serve despite some headwinds

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As the world's subeconomies and commercial markets escaped from the clutches of COVID-19 from 2021–2023, world oil supply and demand reached equilibrium, which enabled crude prices last year to land at a level in which earnings can be achieved for projects inside and outside of the retail investment channel. That said, political and economic developments remain in 2024 that will work to keep oil and gas prices volatile through the U.S. election year and, possibly, beyond it.

From a political perspective, and despite the continuing headwinds from the "left" side of our federal government seeking to impose its "Green Deal" to displace fossil fuels with solar and wind, the U.S. E&P sector arguably held its own in 2023 in terms of upstream-related business activity, which was demonstrated through a year-over-year increase in U.S. onshore drilling activities (i.e., rig counts), as well as a significant increase in daily oil and natural gas production. Drilling momentum in the United States, and particularly the Delaware Basin of the greater Permian, has persisted, despite political pressures from the left and the economic pressure in the United States that surfaced in mid-2022 and the first quarter 2023 due to the interest rate hikes implemented by the Federal Reserve to reduce inflation. Add in the geopolitical pressures occasioned by the conflicts in Ukraine and the Red Sea, and we can begin to appreciate the volatile price ride we're in for this year and into 2025.

As our firm reported in January 2023, the prospects for economic success in E&P continues with "incredibly cautious optimism" going into this year. For oil, a relatively stable price range persisted in 2023 in comparison with what we saw during the pandemic through much of 2022, as world oil supply and demand slowly, yet gradually, achieved a balance point due to the economic recoveries of most countries and their subeconomies throughout the world. As the result of this recovery, oil managed to land at $80 per barrel of crude oil (bbl) for much of 2023. While we achieved equilibrium from a supply/demand perspective, some moments of uncertainty persisted in 2023 as the result of the geopolitical pressures within Ukraine and the Middle East that caused short-lived oil pricing spikes to $90 bbl to $95 bbl during parts of 2023.

As has been the case for the past 20 years, expect natural gas to continue its wild ride through 2024 and 2025, as we deal with changing winter climates and liquefied natural gas (LNG) exporting infrastructure. In terms of gas prices in 2023, they were tempered considerably because of the unseasonably warm weather we had in early 2023 and December 2023. *While a series of arctic blasts in late December 2023 and early January 2024 worked to cool our national winter climate momentarily, natural-gas storage levels in April will again test U.S. gas prices through most of this year, which hinges upon whether a more normal pattern of cold weather comes into play from now through late March, as of this writing.* Against this backdrop, and as mentioned by EQT's chief executive Toby Rice during his press appearances last year, the need for U.S. natural gas abroad on a long-term scale should eventually present better opportunities for favorable natural gas pricing in 2025, 2026 and future years.

Energy sector capital summary

In 2023, we covered 14 sponsor companies that operate within the upstream (E&P) oil/gas sector and raise money from retail investors. This group of sponsors collectively funded 24 private oil/gas programs, which raised $1.226 billion to support drilling and E&P infrastructure, mineral-interest acquisitions and related projects. This represented a 12.17 percent year-over-year increase in capital funding from the $1.093 billion reported by these sponsors in 2022. This also resulted in the highest capital-raise year from the E&P sponsor group that we cover (i.e., since 2005).

For a second year in a row, leading the way in terms of fundraising was U.S. Energy Development Corp. (U.S. Energy), at $483 million; followed by MDS Energy (MDS), at $196 million; and Mewbourne Development Corp. (Mewbourne), at $180 million. Collectively, and as was the case in 2023, these three sponsors accounted for approximately 70 percent of the capital raised by the E&P sponsor group we cover.

In terms of funding growth, about half of the sponsors from the E&P group reported year-over-year gains in fundraising, which helped to continue the capital-raising momentum that was established in 2021–2022 after the headwinds of COVID-19 subsided (with $273 million being the capital raise from the E&P group in 2020 during the pandemic year). The table to the right depicts the fundraising totals of the E&P sponsors we cover.

2023 E&P capital by strategy

Total capital:	$1,226,666,905
Contributing sponsors:	14
Drilling:	$909,400,600 (74%)
E&P opportunity funds: (includes a QOZ fund)	$174,482,305 (14%)
Minerals/royalties: (84% were structured as direct interest)	$142,792,000 (12%)

Ten Internal Revenue Code (IRC) Section 1031 (§1031) eligible programs were wholly or partially funded in 2023 by Resource Royalty, Montego Minerals and U.S. Energy. Overall, the §1031 energy capital raised last year ($121.592 million) increased from what was reported in 2022 ($103.200 million) and 2021 ($31.000 million). Based upon relatively stable oil pricing, as well as longer-term natural-gas market developments, we think this segment will hold serve in 2024.

We note that the size of the E&P sponsor group that we cover has been moderately stable during the past few years (e.g., generally 10 to 14 E&P sponsors from 2017–2023), with drilling programs outpacing royalties and opportunistic funds in terms of fundraising (and with the 75/25 allocation of retail funded E&P capital among drilling and other deployment strategies generally also holding true as to the years leading up to 2023). The fundraising of this sponsor group has been incredibly choppy since 2017 ($330 million in 2017, $401 million in 2018, $369 million in 2019, $273 million in 2020, $556 million in 2021, $1.093 billion in 2022, and $1.226 billion 2023). The choppiness has been caused by incredible market volatility,

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

Company	Strategy	2023 Raise	2022 Raise	2021 Raise	2020 Raise
Mewbourne Oil Co.	Drilling – Horizontal wells in the Permian Basin, Texas Panhandle and Anadarko Basin	$180.000 MM	$250.000 MM	$119.800 MM	$55.310 MM
MDS Energy Development	Drilling – Horizontal wells in the Marcellus Shale Play	$196.000 MM	$225.000 MM	$146.919 MM	$60.000 MM
S.T.L. Resources	Drilling – Horizontal wells in the Marcellus Shale Play	$31.000 MM	$42.500 MM	$29.500 MM	$17.300 MM
U.S. Energy	Drilling – Permian Basin, Powder River Basin and Eagle Ford Shale Play; the QOF is an opportunity fund seeking working interests and other upstream assets	$388.000 MM drilling; $80.000 MM QOF; $15.000 MM §1031 program	$267.930 MM drilling; $56.650 MM QOF; $8.100 MM §1031 program	$145.000 MM drilling; and $45.000 MM QOF program	$64.000 MM drilling; and $20.000 MM QOF program
Waveland Energy	Opportunity fund targeting minerals and non-operated working interests in the Bakken Shale Play	$94.482 MM	$42.640 MM	$13.255 MM	$22.000 MM
Resource Royalty	§1031 Programs acquiring minerals and royalties in STACK Play of Oklahoma	$29.592 MM	$32.900 MM	$11.067 MM	$5.373 MM
Montego Minerals	§1031 programs acquiring minerals and royalties in the Permian Basin and East Texas	$77.000 MM	$62.200 MM	$19.730 MM	$12.500 MM
John Henry Oil	Drilling – Oil-producing zones in Tennessee	$3.782 MM	$5.000 MM	$6.704 MM	$4.350 MM
White Hawk Energy	Royalty fund acquiring mineral rights, royalties and overriding royalties	$21.200 MM	$65.700 MM	NA	NA
Barrow Shaver Resources	Drilling – Horizontal wells in the East Texas Bossier and Cotton Valley Plays	$36.500 MM	$4.950 MM	NA	NA
Texakoma Resources	Drilling – Horizontal wells in the Granite Wash Play in Texas	$32.000 MM	$30.000 MM	$20.000 MM	$15.000 MM
Texas Standard Energy	Drilling – Horizontal wells in the Barnett Shale Combo Play in North Texas	$40.000 MM (first full year)	$4.000 MM	NA	NA
Unspecified	Two additional Reg. D sponsors also collectively raised equity for Mid Con-based E&P projects	$2.000 MM	NA	NA	NA

coupled with the fact that the oil/gas sector continues to seek the reestablishment of investor trust that was lost because of performance failures by several companies that no longer raise capital in the retail channel. Based on current oil market fundamentals and longer-term natural gas pricing developments due to anticipated LNG export growth, the E&P sponsor group appears to be fairly positioned to achieve a respectable volume of capital raising in 2024–2025.

Final thoughts: The due-diligence perspective

Despite past optimism about the prospects of oil today and natural gas long term, we must remain steadfast in our underwriting of oil/gas companies, because no one is immune to the next cycle. For this reason, we must pay attention to break-even prices and the break points in which an E&P sponsor's pro forma becomes unprofitable. At a sponsor due diligence level, we must also pay attention to a sponsor's patterns of success in good times and bad, as well as their short-term liquidity, leverage use, and overall dependence upon the retail channel's funding for survival (with all of these being reasons for E&P sponsor blow-ups). As capex and lease operating costs have increased because of improved recent pricing, we must also stay the course in the quest for sponsors and products that have prospects for success under less fortunate market circumstances than those we've seen from 2021–2023.

As we have written in our past year-end reports, stay committed to cautious due diligence. As history has taught us, the next cycle will come – we just don't know when.

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