Vinson&Elkins

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ALTERNATIVE CAPITAL TRANSACTIONS IN THE ENERGY INDUSTRY

Energy Series

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DISCUSSION TOPICS

- Traditional Capital Markets Activity
  - IPOs and Follow-On Offerings
  - Projected Upstream and Midstream Capital Requirements
- Preferred Equity in the Energy Industry
- Preferred Equity Terms
- Joint Ventures
- Going Private Transactions

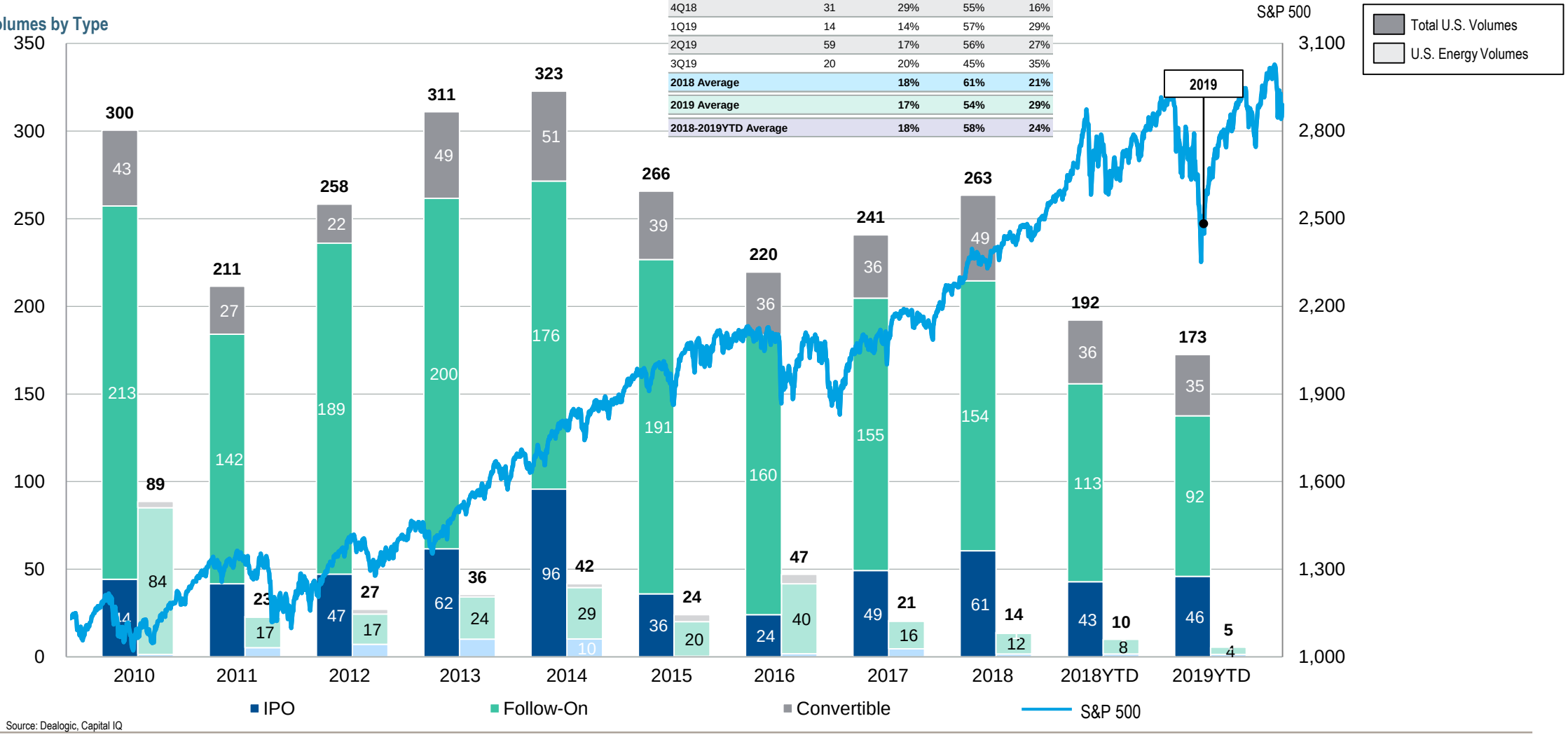
EQUITY CAPITAL MARKETS VOLUMES
SINCE 2010

Since 2010

Total Equity Volumes by Type

Volumes ($Bn)

	# Deals	IPO Pricing Outcomes		
		Below	In Range	Above
1Q18	34	18%	65%	18%
2Q18	54	17%	59%	24%
3Q18	48	13%	65%	23%
4Q18	31	29%	55%	16%
1Q19	14	14%	57%	29%
2Q19	59	17%	56%	27%
3Q19	20	20%	45%	35%
2018 Average		**18%**	**61%**	**21%**
2019 Average		**17%**	**54%**	**29%**
2018-2019YTD Average		**18%**	**58%**	**24%**



Source: Dealogic, Capital IQ

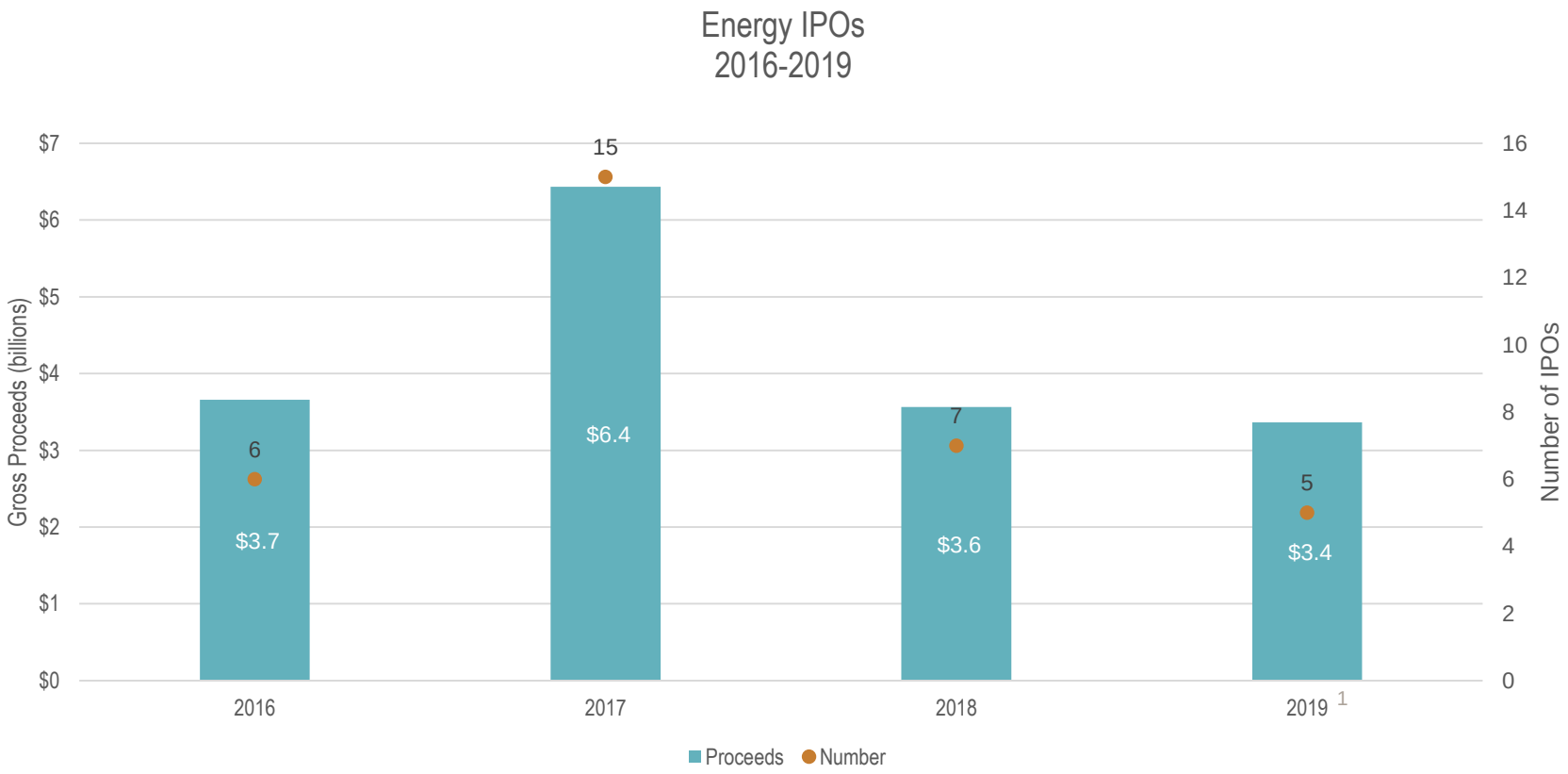
Notes:
1. As of August 16, 2019

ENERGY EQUITY CAPITAL MARKETS – IPOs AND FOLLOW-ONs

Source: Dealogic, Capital IQ

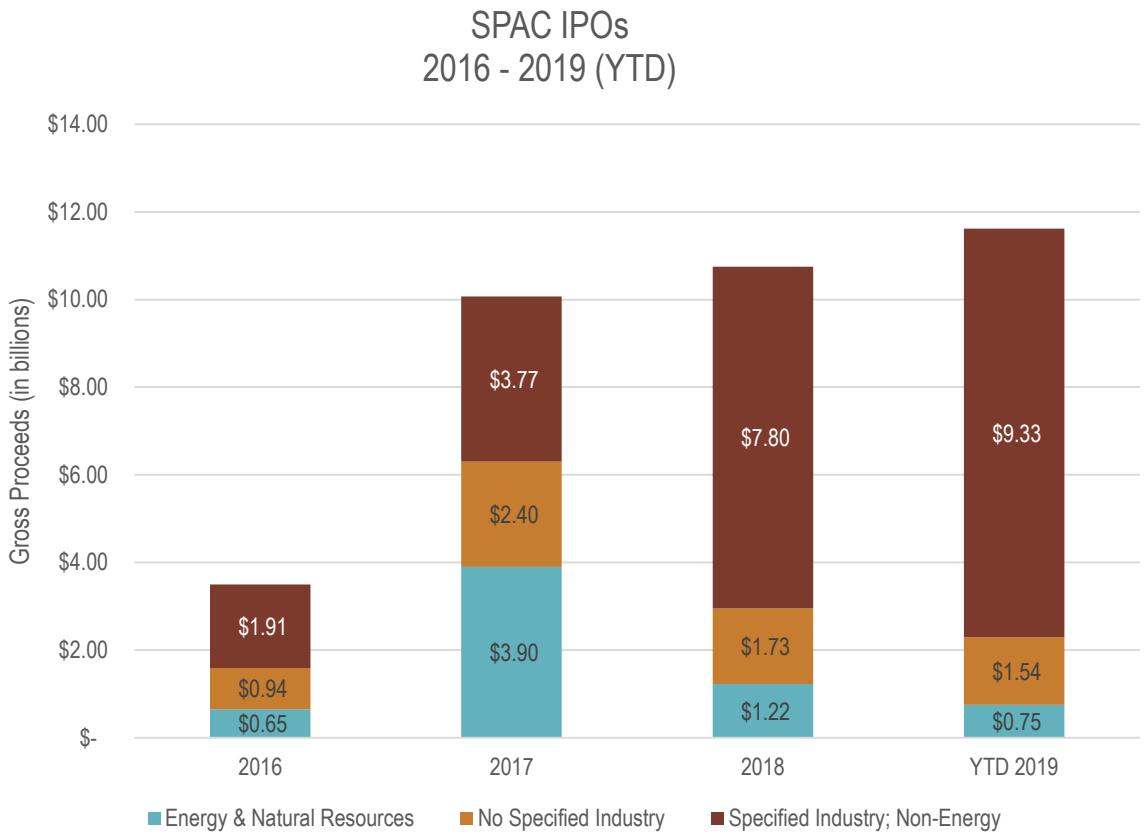
Notes:
1. As of August 16, 2019

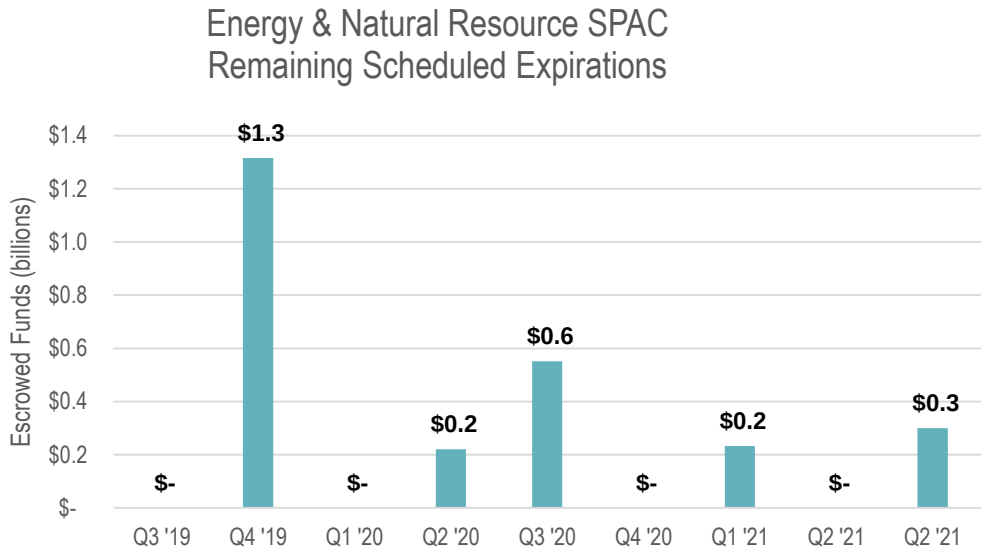
ENERGY CAPITAL MARKETS – IPOS SINCE 2016

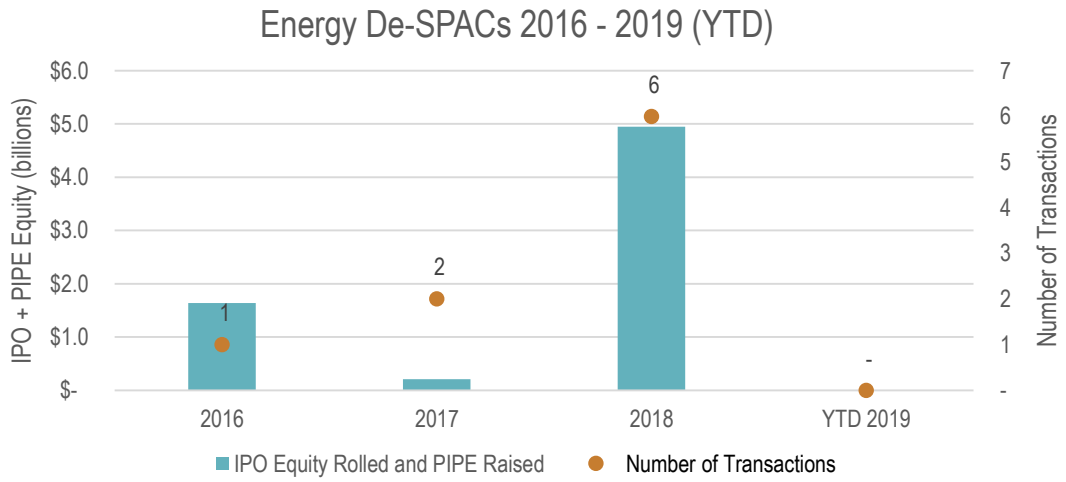


1 New Fortress Energy, L.L.C., Brigham Minerals, Inc., Rattler Midstream, LP, Borr Drilling Limited, Vista Oil & Gas (SPAC)

SPAC ENERGY IPOS AND M&A







TALE OF TWO CITIES: WHILE CAPITAL MARKETS LARGELY CLOSED TO ENERGY EQUITIES, LONG TERM FORECASTS SHOW SUBSTANTIAL CAPITAL REQUIREMENTS

- U.S. Production Forecast Through 2050, Energy Information Agency's "Energy Outlook 2019"
  - Oil Production: expected to increase through 2030, with production in excess of 14 MBPD through 2040; US Net exporter from 2020 – 2049
  - Gas Production: expected to increase through 2050, from 20 TCF to 32 TCF

- U.S. Energy Capital Expenditure Forecast
  - Oil & Gas Drilling and Development
    - 2014 - $198 Billion
    - 2017 -- $114 Billion
    - Assuming $100 Billion through 2035 -- $1.5 Trillion
  - Midstream Expenditures Through 2035
    - American Petroleum Institute -- $1.06 - $1.34 Trillion
    - Interstate Natural Gas Association of America -- $471 - $621 Billion for Dry Gas Midstream
    - US Midstream Market Cap June 2019: $600 Billion

PREFERRED EQUITY IN THE ENERGY INDUSTRY

TRENDS IN PREFERRED EQUITY IN THE ENERGY INDUSTRY

- During the past 4-5 years, preferred equity in a variety of forms has served as an alternative source of capital for both public and private issuers
  - Challenged public capital markets have led public issuers to seek alternatives to issuing common equity at dilutive prices
  - Lack of desire by private equity sponsors to "double down" on existing investments has resulted in a string of preferred equity raises by private companies
    - Serves as a source of acquisition or bridge development capital, while preserving maximum common equity upside for sponsor and management

- Historically, preferred equity securities issued by private and public companies have been structured in very different ways
  - Private companies are not subject to fiduciary duties to a broad shareholder base
  - Private companies are much less likely to have rated debt securities
  - Private companies do not have publicly traded common equity to provide upside/liquidity through conversion of the preferred to common

TRENDS IN PREFERRED EQUITY IN THE ENERGY INDUSTRY

- Preferred equity issued by private companies is generally a fixed-return security
  - The security pays a quarterly dividend and the investor must receive some "Minimum Return" in cash as a preference to the common equity
  - While the "Minimum Return" may be coupled with warrants to provide additional upside, the Minimum Return often serves as the investor's sole source of return on the investment
  - Issuer may typically call the preferred for cash at the minimum return at any time and the investor may put the preferred to the issuer after some period of time
    - Issuer will want to preserve equity treatment under its debt by setting the put feature outside existing debt maturity
    - But the more onerous rating agency requirements (which will generally give no equity credit to a preferred with a holder put right) will not be in play

- Preferred equity issued by private companies also typically includes a robust suite of governance rights providing the investor with negative controls on a variety of matters from capital structure decisions to M&A

TRENDS IN PREFERRED EQUITY IN THE ENERGY INDUSTRY

- Preferred equity issued by public companies in the energy industry has most commonly taken the form of a perpetual, convertible preferred
  - Security pays a quarterly dividend, but investor's upside is in the form of a conversion to common equity
  - Investor may not put the security to the issuer (other than in a change of control)
  - Security typically may not be called for cash – instead, the issuer has a right to force conversion to common if certain conditions are satisfied
  - Governance rights for the investor are generally limited to adverse changes to the issuer's governing documents, issuances of senior securities and special distributions on common equity
  - Series of issuances by PAA, MPLX, WES and others in 2015/2016 resulted in very standardized set of terms
    - Lack of put right and other features seen in private company deals enabled these and similar securities to receive 50% equity credit from the rating agencies

TRENDS IN PREFERRED EQUITY IN THE ENERGY INDUSTRY

- In the last couple years, lack of investor confidence in common equity upside has resulted in terms of preferred securities issued by public companies moving more closely to the private company model
  - Put features in lieu of conversion rights
  - Fewer deals with issuer forced conversion (structured instead as cash redemption)
  - Enhanced governance around capital structure and business operations
- One of the biggest challenges facing issuers and investors in the current market is structuring a preferred security that satisfies investor desire for certainty of return while preserving at least partial equity treatment for the issuer

PREFERRED EQUITY
RATING AGENCY TREATMENT

- Only July 1, 2019, S&P released updated guidance on its treatment of hybrid securities
- Much of the guidance reiterates prior positions, but several of the S&P's statements seem to call into question the way in which preferred equity has historically been structured and marketed in the energy industry
  - Holder put right will result in no equity credit
  - When loss absorption is achieved by deferring coupon payments, the issuer must be able to defer for at least 5 years to receive any equity credit
  - In order to receive intermediate equity treatment, security must not be callable within 5 years
  - Preferred balance / (book equity + book debt + preferred balance) must not be greater than 15%
  - No equity content for a hybrid security that is issued to one or two investors
  - To receive intermediate equity content, a hybrid must have a time until its effective maturity exceeding 20 years for BBB- or higher, 15 years in the BB category and 10 years if in B category or lower
  - Security must be free from terms that discourage or materially delay deferral (e.g., higher interest rate on PIK dividends)

PREFERRED EQUITY
RATING AGENCY TREATMENT

- While the guidance is written as a set of bright-line rules, our sense is that at least certain of these rules will be applied as factors in an "entirety of the facts and circumstances" analysis
  - Call features – expect to see noncall 5 and/or ability of issuer to settle call in common equity
  - Expect that the issuer must be able to settle a portion of any put feature in common to receive equity credit
  - Penalty interest and/or increased rates for PIK interest will be viewed negatively (though likely not determinative if other features suggest equity treatment)
  - S&P will be very focused on securities issued to a limited number of investors and preferred issues that represent greater that represent a large portion of the issuers capitalization
    - May complicate marketing process
    - Allocation of governance among multiple material investors may become a significant topic of negotiation

PREFERRED EQUITY TERMS

PREFERRED EQUITY
ECONOMICS

- Quarterly dividend, typically in the range of 8-10%
  - Rate may increase over time, including by reference to LIBOR in out years
  - Often may be paid in-kind for some period; may result in increased coupon rate
- 1-2% transaction and/or commitment fee
- Reimbursement of investor's deal expenses
- Transaction fee and expense reimbursement do not count toward IRR / MOIC calculations for redemption / liquidation preference

PREFERRED EQUITY
ECONOMICS

- Investor liquidity / upside beyond the quarterly dividend may take a variety of forms
  - Conversion to common equity at a fixed conversion price (premium to closing date VWAP)
  - Put / call and liquidation preference at a fixed “Minimum Return”
  - Warrants – typically coupled with a “Minimum Return”-based preferred as additional equity upside
  - May include some combination of the above (e.g., convert with a put at a minimum return beyond some outside date)
  - If security is convertible, the put feature will often be at par plus any accreted PIK amounts (as opposed to some higher “Minimum Return” concept)

PREFERRED EQUITY
GOVERNANCE

- With the exception of a limited number of deals in the MLP space, governance in both public and private deals typically includes in the following:
  - Amendments to terms of the preferred or other amendments that adversely affect the preferred
  - Issuances of senior and parity securities (not uncommon to have a basket for pari issuances provided certain financial ratios are satisfied)
  - Creation of non-wholly owned subsidiaries
  - Cash distributions (see next slide for more detail)
  - Debt incurrence typically subject to a leverage ratio test; may also include a prohibition on high yield and/or borrowings in excess of some percentage PV-10 value
  - Agreeing to “restricted payment” or other provisions restricting the payment of dividends / redemption that are more restrictive than those existing on the date of issuance of the preferred
  - Affiliate transactions
  - Changes in entity form or tax classification
  - Changes in business purpose
  - Change of control and other exit events that do not result in a full redemption of the preferred at the minimum specified return amount
  - Bankruptcy, liquidation/dissolution
  - Material asset acquisitions/dispositions
  - Deviation from an agreed upon hedging policy (in upstream deals)

PREFERRED EQUITY
DISTRIBUTIONS ON COMMON EQUITY

- Common to have a flat prohibition on cash distributions while the preferred is outstanding
  - Limited exceptions for distributions on the preferred and tax distributions
  - Preferred typically receives priority in tax distributions in the event available cash is not sufficient to cover assumed tax obligation for all equity holders
- Certain transactions have provided the issuer with limited flexibility to pay interim cash distributions to the common equity
  - PIK period has expired and issuer is current on preferred cash coupon payments
  - Leverage ratio test is satisfied
  - X% of any such distribution is used to redeem preferred units at the specified minimum return amount
- For MLPs and other dividend paying issuers, distributions on common equity are typically permitted as long as distributions on the preferred are current and potentially subject to specific leverage tests being satisfied

PRIVATE COMPANY PREFERRED OFFERINGS
MISCELLANEOUS PROVISIONS

- Investor expenses typically reimbursed by issuer; may be subject to a cap
- Transfer restrictions
  - Commonly include restrictions on transfers to “competitors”
  - Certain rights, particularly director/observer rights, may be personal to original investor(s)
- Preemptive rights, particularly if preferred is convertible or warrants are issued
- Information rights

JOINT VENTURES

WHY JOINT VENTURES?

- Strategic investment (e.g. customer, interconnected assets, marketer)
- Risk spreading (capital, competing systems)
- Preservation of capital
- Capital to deploy
- Monetization of non-core assets
- Enhanced ability to finance
- Secure anchor shipper commitment (midstream) or production takeoff capacity (upstream)
- Increased governance and negative control for sponsor investments
- Avoid staff-up and G&A cost centers

MIDSTREAM JOINT VENTURES – STRUCTURING ALTERNATIVES

- ***Equity Joint Venture (joint ownership of common entity)***
  - Ease of administration
  - Shared financing
  - Common exit strategies
  - Delegation of roles and responsibilities
  - Segregation of liabilities
  - Clear jurisdictional status
  - FERC regulated pipelines
- ***Asset Joint Venture (joint ownership of common pipeline system)***
  - Differing financing strategies
  - Differing exit strategies
  - Multiple producers
  - Variability of system expansion alignment
  - Segregation of system capacity (pipe-within-a-pipe)

TYPICAL JOINT VENTURE ISSUES

- Growth JVs/competing activities in the AMI
- Management and deadlock resolution (particularly in 50/50 JVs)
- Transfers and changes of control
- Required capital contributions v. leveraging with debt
- Capital expansions
- Operating / construction management
- Timing of distributions / capital reserves
- Timing and process for exits
- Transfers to upstream competitors (by the midstream) or midstream competitors (by the upstream) or related parties

JV / LLC AGREEMENT ISSUES – FORMATION AND OPERATIONAL ISSUES

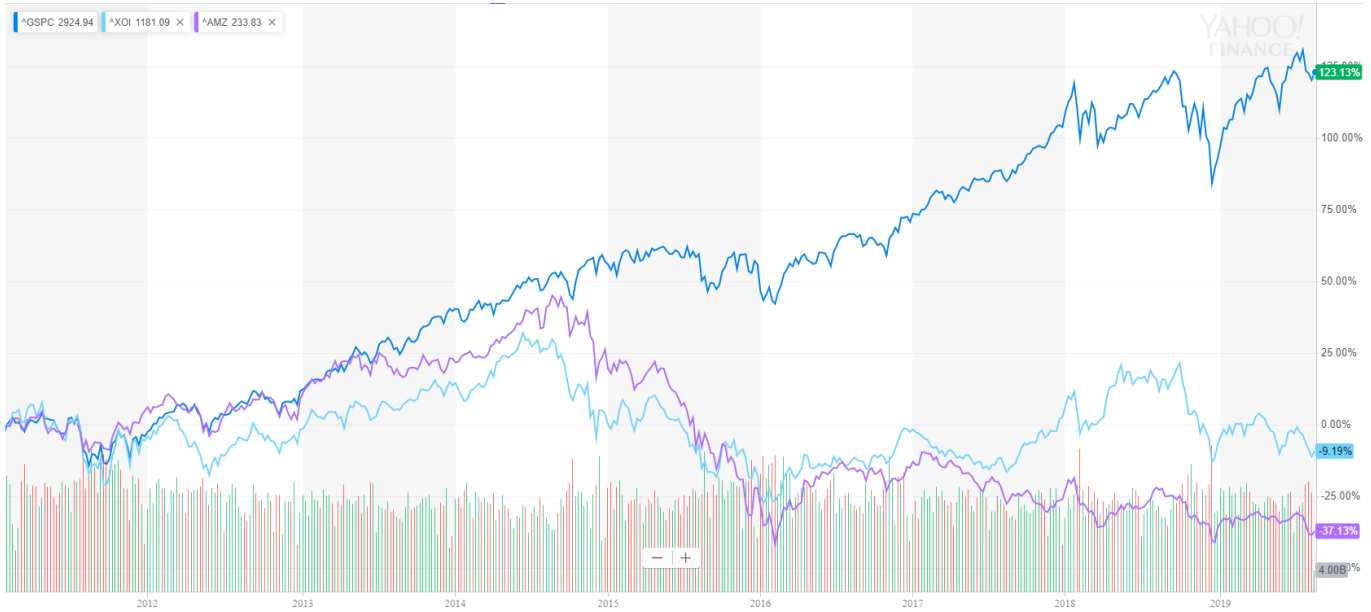
- ***Diligence / Formation Issues:***
  - Are existing midstream assets being contributed to the JV? If yes, consider diligence, reps, warranties and indemnities.
  - What acreage is being dedicated by the Producer? What are consequences of Producer losing acreage, not meeting development schedule, having undisclosed existing dedications, defaulting under commercial agreements?

- ***Operational Issues:***
  - Will the JV have officers / employees or will midstream services be provided through an Operating Services Agreement (OSA)?
  - If there is an OSA:
    - Are services provided at cost? How is G&A allocated over 5, 10, 15+ years?
    - What level of control does the midstream provider have? How do third party midstream contracts get reviewed and approved?
    - What rights does the JV have to terminate the OSA (e.g., material breaches, change in control, transfer of midstream interest, key person events, term of contract, etc.)?
    - Liability beyond gross negligence, willful misconduct?

GOING PRIVATE TRANSACTIONS

TRADITIONAL ADVANTAGES OF PUBLIC MARKETS
DO THEY STILL APPLY?

- Public markets provide easier access to attractively priced equity capital?
- Publicly traded equity is an attractive acquisition currency?
- Public investors have longer investment horizons?
- Public markets provide access to liquidity for sponsors, employees and other sellers of equity?



OVERHEARD ON CONTINENTAL RESOURCES Q2 EARNINGS CALL

"I don't mean to sound petulant in any way, but what is the value of Continental being a public company?"
- *Doug Leggate, BofA Merrill Lynch analyst*

"In today's market, we don't see a lot of value in it. Just let me tell you."
- Harold Hamm, Chairman & CEO, Continental Resources

AN ASIDE ON HAROLD HAMM AND TAKE PRIVATES

Executive proposes Hiland buyout

BY RANDY ELLIS
Published: Fri, January 16, 2009 12:00 AM

Harold Hamm Chief Executive of Continental Resources

ENID — Energy company chief executive Harold Hamm has offered to buy out his fellow investors in two Hiland natural gas gathering and processing companies for about $65 million to take the Enid companies private, Hiland officials announced Thursday.
Hamm is proposing to pay Hiland Partners LP unitholders $9.50 in cash per common unit, which would be about a 21 percent premium over Wednesday's closing price of $7.90 a

18,[illegible] views | Jan 21, 2015, 05:12pm

Billionaire oilman harold Hamm. (Bloomberg via Getty Images)

Oil Billionaires Hit The Bargaining Table As Kinder Morgan Pays $3B For Harold Hamm's Hiland Partners

Steve Schaefer Former Staff
Markets
If you can put the word markets after it, I cover it.

Plummeting commodity prices have started to take a bite out of the U.S. oil patch, but even with no imminent end to the pain in sight, the value hunters are emerging.

Companies like Schlumberger SLB +0%, Halliburton HAL +0% and Baker Hughes BHI +0% have announced thousands of layoffs and many more companies are mulling production cuts. A landscape of battered players is ripe for dealmakers though, and helped bring together billionaires Richard Kinder and Harold Hamm, who cut a $3 billion deal for the latter's transportation business Hiland Partners.

SO WHAT IS A GOING PRIVATE TRANSACTION?

- **A "Going Private Transaction"** is a transaction with a controlling stockholder or other affiliated person that allows the company to terminate its public company status and Exchange Act reporting obligations by reducing the number of stockholders. The most common types of going private transactions are**:**
  - An acquisition of a publicly traded company by a majority stockholder or its affiliates
  - Acquisitions by a significant non-controlling stockholder
  - LBOs by a third party (usually a PE firm) working with management

TAKE PRIVATE TRANSACTIONS
POTENTIAL DRIVERS

Potential Targets	Potential Buyers	Potential Hurdles
• Issuers with depressed equity valuations • Issuers with large stockholders frustrated with a lack of liquidity • Distressed issuers with controlling equityholders that need a capital infusion without a change in control under their debt agreements	• Existing strategic sponsors • Management/founders • Existing private equity sponsors • Unrelated private equity sponsors, including long-term private capital	• Entrenched controllers or management • Debt or preferred equity change of control provisions • Over-levered targets • Continuing uncertainty deters buyers • Equity check too large or small for traditional private investors

KEY LEGAL CONSIDERATIONS
CONFLICTS AND FIDUCIARY DUTIES – CORPORATE TAKE PRIVATES

- In most unconflicted M&A transactions courts review the transaction under the "**Business Judgement Rule**" whereby courts will not second-guess rationale business decisions absent a showing of a conflict or gross negligence.
- If the acquiror (or an affiliate of the acquiror) in a going private transaction is a controlling stockholder, special considerations arise because the transaction is a "***conflict transaction***" which can be subject to the "**Entire Fairness**" level of scrutiny if challenged (as they almost always are) and the appropriate procedural protections are not employed.
- In contrast to the more forgiving Business Judgment Rule, under Entire Fairness the board of directors bears the burden of proving that the challenged decision was "entirely fair" to the corporation and its stockholders, which includes:
  - Fair Dealing (process) – timing, structure, negotiations, disclosure
  - Fair Price (result) – economic and financial considerations taking into account all relevant factors
- Delaware law has recognized certain procedures that shift the burden of proof (as to Entire Fairness) back to the plaintiff:
  - Independent Committee
  - Majority of the Unaffiliated Minority Stockholders

- In a significant 2013 case, now Chief Justice Strine ruled that using ***both*** an independent committee and a non-waivable majority of the minority condition from the outset in a conflicted transaction results in not just a shift in burden, but a shift in standard of review to the Business Judgment Rule. (*In re MFW stockholders Litigation*)
- As a result, a controlling stockholder may avoid Entire Fairness review and rely on the Business Judgment Rule (*increasing the likelihood of dismissal at the pleading stage*) if such stockholder conditions its offer on:
  - Approval by a special committee that**:**
    - is independent;
    - is empowered to freely select its own advisors and say "no" definitely; and
    - meets its duty of care in negotiating a fair price.
  - Approval by Majority of the Unaffiliated Minority Stockholders that**:**
    - are informed
    - are not coerced

KEY LEGAL CONSIDERATIONS
CONFLICTS AND FIDUCIARY DUTIES – MLP TAKE PRIVATES

- MLP partnership agreements eliminate and replace traditional corporate fiduciary duties
- A merger involving an MLP typically requires approval of the MLP's general partner and approval of holders of a majority of the MLP common units, **including** units held by affiliates of the general partner.
- In addition, there is typically a safe harbor in MLP partnership agreements that cleanses a conflicted transaction if **either**:
  - "Special Approval" – approval by a majority of the members of the Conflicts Committee acting in good faith – is obtained; **or**
  - Approval of holders of a majority of the shares held by unitholders not affiliated with the general partner is obtained.
- Courts have held that the Conflicts Committee should have real negotiating authority on behalf of the public and should:
  - Have independent legal and financial advisors; and
  - Simulate arms' length bargaining.

KEY LEGAL CONSIDERATIONS
SECURITIES LAWS AND DISCLOSURE ISSUES – SCHEDULE 13E-3

- A proxy statement and Schedule 13E-3 will be filed in connection with any take private transaction.
- The Schedule 13E-3 has many of the same disclosure requirements as the proxy statement, and in many cases will cross reference the proxy statement.
- In general, all "material facts" that are relevant to the decision by the shareholders in assessing the transaction must be disclosed in the proxy statement and Schedule 13E-3.
- In addition to customary proxy statement disclosures, Schedule 13E-3 also requires:
  - Discussion as to whether each insider involved in the transaction believes it is "fair" to the unaffiliated equityholders
  - Copies of **each financial advisor presentation** received by the target and the affiliated buyout group that are related to the going private transaction

KEY LEGAL CONSIDERATIONS
SECURITIES LAWS AND DISCLOSURE ISSUES – SCHEDULE 13D

- If any person has a 13D on file with respect to the target of a take private transaction, significant care must be paid to complying with Section 13D disclosure rules
- Generally, Schedule 13Ds are required to be filed by investors that may seek or do exert influence over the management of a public company if the person or group collectively own 5% of the outstanding stock of the company
- Schedule 13D requires disclosures of plans or intentions with respect to the issuer, including with respect to any take private
- Schedule 13Ds must be "promptly" amended to disclose, among other things:
  - Changes in plans with respect to acquisitions of target securities
  - Formation of a "group"
  - Entry into agreements, arrangements or understandings with respect to acquisitions of issuer securities
- SEC has stepped up enforcement in connection with late 13D amendments

THANK YOU

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