THE NON-OP MODEL IS IN THE DRIVER'S SEAT

The non-op business model is no longer just a passive vehicle. Here, three non-op companies' stories exemplify clever funding strategies in a market still recovering from the downturn.

By Tyler Jones

Capital availability has changed for all players in the oil and gas value chain over the last several years, with investors demanding more discipline and capital markets being less open than they were in the past. This new environment encourages finding creative solutions for funding operations; one solution is non-operated companies' strategies to allocating capital. Non-operators (non-ops), however, have traditionally been viewed as passive investment vehicles.

Non-op companies such as Northern Oil & Gas Inc., Panhandle Oil & Gas Inc. and Pivotal Petroleum Partners LP have benefited from this greater emphasis on capital discipline and the associated deal flow. The non-op model is no longer just a passive investment vehicle. Their detailed understanding of plays and their approach to capital allocation offers investors strong internal rates of return (IRRs) with less asset-level risk than their operating partners face.

Goldilocks in the Bakken

While the Permian Basin has received a great deal of attention in recent years thanks to its strong economics, non-op companies such as Northern Oil & Gas have found an opportunity to grow substantially, both organically and through acquisitions this year, in the heart of the Bakken oil play in North Dakota. The Denver-based company recently completed three acquisitions, nearly doubling its production year-over-year to 33,250 barrels of oil equivalent per day (boe/d) by the fourth quarter of 2018, and it thus increased its core future drilling inventory to nearly 400 net locations.

"Capital flowing towards the Permian and other basins has helped us on the acquisition front," said Brandon Elliott, Northern Oil & Gas CEO. With much of the market's attention focused elsewhere, Northern has been able to approach deals with a competitiveness and degree of insight few others can match.

"Odds are, we've participated in 20% to 25% of the wells on an acreage package already," Elliott said. "We have participated in more than 4,000 gross wells to-date. That gives us an advantage when we analyze future wells and when we evaluate acquisitions."

With its knowledge of the Bakken, its decision to put capital toward acquisitions, and facing few competitors of scale in the basin, Northern is able to uniquely position itself to bid on acreage it understands well, according to Elliott.

"When we set about repositioning the company, we took on some debt structures that required us to grow into our balance sheet, and acquisitions played a big part of our success at that. The acquisitions we have completed give us a unique combination of growing free cash flow and future drilling locations while deleveraging the company. That's a difficult combination to execute upon," he said.

From fourth-quarter 2017 to second-quarter 2018, Northern's market capitalization increased to $1.6 billion from $56.6 million, while debt was reduced to less than $850 million from $1 billion.

Its three major acquisitions were paid for with a combination of cash and stock, which has increased shares outstanding, but per-share metrics are expected to improve markedly, with earnings per share projected to have increased nearly 100% in the fourth quarter of 2018 from the second quarter, giving full effect to the closing of its three transactions.

BRANDON ELLIOTT
CEO, Northern Oil & Gas Inc.

"Equity investors have been excited to get involved in the recapitalization of Northern," Elliott said. "People appreciate that we have always had a very good business model, but we didn't have the capital structure to execute on our strategy previously. With this recapitalization, we think we can generate strong economic returns with free cash flow that we can allocate as appropriate. While our organic growth alone this year has been stellar, it is really just the residual effect of our returns-based philosophy, and not growth for growth's sake."

That capital will go to work wherever the company feels it will generate the best IRRs, Elliott added. How expensive or inexpensive a well might be is unimportant as long as the production generates the appropriate returns.

With advancements such as pad development and new completion designs, the company continues to find growth opportunities. With working interest and associated data from more than 4,000 wells in the Bakken, Northern's team feels that it knows the basin just as well as, if not better, than anyone.

"Because pads require a high capital commitment, we've been able to pick up incremental gains where minority interest owners are not able to commit that kind of capital and might be forced into non-consenting if they don't sell down their interest." This, along with the company's legacy position and recent acquisitions, is helping to make Northern the dominant Bakken non-op company, Elliott said.

"We are proud of what we've accomplished so far, but there's more to do." There's more appreciation from investors for a company that can consolidate working interests in this basin. And now we have the balance sheet to continue to grow, using disciplined capital allocation over the next 12 to 24 months."

The non-op model with added sizzle

While Northern remains laser-focused on the Bakken and Three Forks plays in North Dakota, other companies, such as Panhandle Oil & Gas, are taking a more diversified approach by participating in plays across the country. The company holds interests in the Eagle Ford, Permian Basin, Scoop/Stack and Bakken, among other plays. It hopes to maximize value through selective participation in the most attractive projects across this portfolio.

"The diversity of our assets distinguishes us," said Panhandle president and CEO Paul Blanchard. "We can allocate capital to plays as we see fit."

The company has made several acquisitions it thinks will pay off down the road, such as Bakken acreage and Scoop/Stack assets outside the hottest areas of these plays. "We're looking for contrarian acquisitions," Blanchard added. "We are able to capture value where we see long-term opportunity."

The major differentiator for Panhandle is not only its diverse assets, however, but its strategy of acquiring the mineral interests associated with assets in addition to working interest in wells. This unique strategy started in 1926 when Panhandle offered one share in the Panhandle Cooperative Royalty Association to homesteaders in Oklahoma in exchange for one-quarter of their mineral rights.

"In any given well, we're always going to have a competitive advantage with more cash flow and much higher return profiles, because we get that non-cost bearing royalty interest in addition to the working interest, and if we don't participate with a working interest we still receive the royalty," Blanchard added.

Because of the wealth of assets and knowledge the company holds, Panhandle is able to identify overvalued minerals in its portfolio, or assets with limited optionality. By divesting itself of such assets, the company is able to further maximize its operations. In 2018, the company reported selling 462 marginal wells, thus reducing lease operating expense 9.6% with just a 1.8% reduction in cash flow.

"We are making continuous refinements, but I think this model has merits in perpetuity," Blanchard said.

Panhandle sports an impressive record, too, paying a quarterly dividend for the last 50 years. Blanchard often remarks that the company maintains a long-term outlook and is constantly driving toward strong returns while mitigating risk. For 2018, that strategy prompted Panhandle to put the majority of its capital to work in the Eagle Ford, and it expects the trend to continue into the future.

"On the acreage we own, the Eagle Ford is very low-risk. It has been successfully drilled on the limits of our acreage, and so what remains is very low-risk in-fill drilling. That, along with the improvement in oil prices, makes the rates of return some of the best we see in the company," Blanchard said. Adding to improving commodity prices, Panhandle's operating partner in the play plans a continuous drilling program, and Panhandle holds a 16% working interest in the projects, compared with a typical 5%, making the impact several times greater for the non-op company.

PAUL BLANCHARD
CEO and president, Panhandle Oil & Gas Inc.

Opportunities for win-wins

Market sentiment shifted during the 2015 commodity price downturn, creating new opportunities in the non-operated space. Equity has become more difficult to raise in today's environment with eight IPOs totaling $1.3 billion in value year-to-date through October 2018, compared with 16 IPOs with total deal value of $4.8 billion for the same period in 2013. Follow-on offerings have similarly slowed, with $4.6 billion in additional capital raises year-to-date compared with $15.9 billion for the same period in 2013.

Investors are demanding that companies return capital to shareholders and spend within cash flow, a significant departure from the growth-driven mindset that pervaded markets prior to the downturn. This has, in turn, reduced access to capital for companies throughout the supply chain.

EDWARD HERRING
Co-founder and managing partner, Tailwater Capital LLC

Tailwater Capital LLC co-founder and managing partner Edward Herring said, "The need for companies to live within cash flow has discouraged operators from buying assets that are not cash-flow positive. As such, private-equity-backed companies need additional capital to develop their assets and may not be capitalized for it."

Tailwater, an energy private-equity firm, holds non-operated interests across the Lower 48 through Pivotal Petroleum Partners, which it founded in 2013. Pivotal gives Tailwater insight into the upstream side of the business, offering the firm a greater depth of knowledge with which to guide its strategy of debottlenecking resource plays.

Earlier this year, Northern Oil & Gas acquired 4,100 boe/d of production from Pivotal for cash and stock, but Pivotal continues on.

"Following the 2015 correction, access to debt and equity capital is dramatically constrained for public companies. Previously, companies may not have needed private-equity money; today, they are much more interested in working with us," Herring said.

"More than $1 trillion of upstream capital has been put to work since 2005, and what we're seeing now is, there is a need for more infrastructure to support the associated growth. With our non-op interest and our midstream investments, we're able to provide those infrastructure solutions and capital to the upstream sector."

Reaching that point took time and an evolution of Pivotal's model, Herring added. "The largest risk factor when we initially looked at starting a non-op was the perception that they were passive. Even when you had good assets, there was a sense that you did not control the pace of development."

To address that concern, Pivotal went through several iterations of its business model. When the 2015 downturn hit, Pivotal was able to partner with operators who had good rock but lacked the capital to fund their operated and non-operated development programs. By providing them capital for their non-operated development programs, Pivotal created line-of-sight on future development, and that model has continued changing to allow for even more control.

"Today, we are looking at many joint ventures, including programmatic drilling joint ventures or 'DrillCos,'" Herring said. "We carve out acreage, we build a plan around it and we provide capital to develop it. This allows operators to get their acreage into development and to live within cash flow." By following this model, Pivotal can support operators rather than create competition by leasing up nearby acreage. "We are being creative and providing solutions for our partners in this more capital-constrained environment."

By taking an approach that allows its partners to further their exploration goals, Pivotal can steer future development in a way that is beneficial to it and the operator in the well. "We look to have conversations with operators as partners and not just as financial participants. We rely heavily on creating partnerships where all parties can win," Herring added. ■