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AN INTERVIEW WITH WIL VANLOH, CO-FOUNDER, PRESIDENT, AND CEO OF QUANTUM ENERGY PARTNERS

Technical and operational expertise makes for a simple, effective strategy

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EDITOR'S NOTE: As a provider of private equity to the global energy industry, Quantum Energy Partners holds more than $5.0 billion in assets under management and targets investment opportunities between $50 and $500 million. Wil VanLoh, co-founder, president, and CEO, recently took time from his day to answer some of our questions about the company.

OIL & GAS FINANCIAL JOURNAL: Quantum is celebrating its 10th anniversary. Tell me about the company's beginnings and how it has grown in the last decade.

WIL VANLOH: Toby Neugebauer, A.V. Jones, Jr. and I came together and closed our first fund in July of 1998. It was a $101 million fund. Toby and I jumped over to the other side of the fence. We were working as investment banking advisors raising capital for E&P companies. We developed a nice track record doing that and decided we wanted to do it for ourselves instead of as an intermediary.

Of the private equity firms active in the mid '90s, none had technical or operating expertise at the partner level. One of the things Toby and I felt very strongly about was that in energy, particularly in E&P, there are a lot of things you can do to assets once you buy them. The funds that were investing in private equity at the time were basically looking at it as underground real estate.

If you buy a building there's not a lot you can do to it. You can freshen it up, try to lease it out, but there's not much you can do to significantly increase the value of that building. In the oil and gas business, there are a lot more things you can do to an asset. You can shoot 3-D over it, you can drill step outs, you can do infield drilling, you can re-frac wells, you can do workovers, you can find pay uphole, you can waterflood, you can find additional reserves deeper – so many things can be done to enhance the value.

We felt the funds we were taking deals to didn't really appreciate the entrepreneurs that could do more to the assets. They wanted to back teams that were going to buy long lived properties, say in the Permian Basin or Mid Continent, lever them up, try and cut costs a little bit, pay down debt over four or five years and sell them without doing much to the assets.

We partnered with AV [Jones]. He himself had a great technical background as well as having started and run a number of his own companies. He brought Jeff Jones to the mix as well, who had been his right hand technical guy for the last 20 years. That's how we started Quantum. The four of us kicked it off.

We started looking for deals by combining our financial, structuring and analytical expertise with their technical and operational expertise, and pursued a simple investment strategy – find proven entrepreneurs, align our interests, and help them become the best they can be. We didn't want to pay people's tuition; we wanted to back people where they'd been successful in the past.

It's a very simple business strategy – harder to execute it, but it's a simple strategy.

OGFJ: Several members of the Quantum team have been CEOs and division heads of energy companies. How does this work to your advantage among competing equity funds?

VANLOH: I think it really helps in a lot of ways. There are a lot of setbacks in the industry, a lot of times its three steps forward and two steps back. There is a lot of evaluating why something happened to understand it strategically and change things going forward. Having guys that have actually run these companies is a huge value added for these CEOs. They have a sounding board that really speaks their language.

For us, from an investor side, it allows us to do a level of due diligence on the front end that is much more thorough than just the financial teams can do. It allows us to see opportunities, but it's a double-edged sword. It means we're going to say no to some deals that others might do because they don't understand the technical and operating nuances. The flip side is it allows us to say yes to deals that others perceive as too risky or challenging.

We probably see 300 plus deals a year. We have 20-25 active portfolio companies that are top notch teams doing things very well.

At the end of the day it's about making the best risk-adjusted return you possibly can. The teams that we back want a partner that is going to add value. They see how our technical and operating partners can help them make better decisions which ultimately results in them building a better company and making more money.

OGFJ: What is Quantum's involvement after the investment agreement is signed?

VANLOH: We don't think of ourselves as a financial sponsor. We think of ourselves as a partner. That's a big nuance. Clearly some funds advertise and brag about giving money and staying out of the way. We don't want to get in your way, but we want to help you be the best you can be.

We also bring deal flow to the table. We aren't involved with 50 or 60 portfolio companies like some of our competitors so we don't have conflicts very often. Of our 10 highest returning portfolio companies, half of them can say the defining deal that made the company successful was a deal that we brought to the table. That's not something that a lot of other funds can say.

We are going to be more involved. We look at it as a true partnership and not as "here's some money, we'll talk to you once a quarter or twice a year." We want to help you build a great business.

If we commit $150M to a company, unlike in the

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traditional LBO world where they pull that whole $150M down to go buy a business day one, we make, and most of our peers do also, equity lines of commitment. We commit $150M, but they may only pull down $5M day one. That's just to pay overhead. The rest of the money gets pulled down over the next one, two, three years as they have acquisitions, as they have drilling programs. When a portfolio company has an acquisition or seeks approval for a drilling program, they run it by our technical and operating guys.

There's ongoing involvement on the financial side as well. Many of our companies have a really strong controller, but they don't need a CFO. They're not in the capital markets all the time like a public company. They really don't need a capital markets-oriented CFO, they need a super controller-type CFO.

We help our companies out with everything from structuring and negotiating senior and subordinated debt facilities, to designing and implementing commodity and interest rate hedging programs, to running financial models on merger or acquisition opportunities. It's a complete team approach.

OGFJ: How are current economic conditions affecting the availability of capital in the oil patch?

VANLOH: Last month we met with most of the commercial banks that lend to the upstream and midstream sectors. Nobody really wants to make a new loan until next year. That's almost universal. Of 20+ banks we talked to, I would only characterize about three or four as really being "open for business." That's pretty staggering.

A lot of banks used to have up to a $75M hold limit before they started syndicating out. The new saying is that '25 is the new 75.' Most banks don't want to have more than $25 million exposed in a single credit, whereas before they'd have 75 or even up to 125 million.

The second lien and term B markets are completely dead. I don't think you can get a deal done in the private market for that right now. We're telling all our portfolio companies that they have to look at everything they're doing right now in terms of passing their return hurdles based on 100% equity financing.

A lot of the money in the acquisition game is made through leverage. Say you buy something for $100M and put $65M of debt and $35M of equity on it. If you increase the value of that asset 35% from $100 to $135 million, you've doubled your equity because you only have $35M of equity in it. If you have to put $100M of equity in and you only increase the value by 35%, instead of making 100% return on equity you've made 35% – a third.

Also, there have been more broken deals than I've ever seen before. Amongst our portfolio companies we were trying to sell, in the last 60 days we've had buyers walk executed purchase and sale agreements on more than $600M in transactions and have pulled another $600M+ in sales we were trying to move because no buyers turned in bids. The market is literally in gridlock right now.

You've seen companies like Chesapeake doing very creative joint ventures. Companies like Chesapeake with great legacy positions can do that, but there are a whole lot of companies that can't.

Most of the public companies over the last five years have transformed themselves from conventional companies into resource companies. The bad thing about resource companies is that they consume massive amounts capital for many years before they ever turn cash flow positive. We've seen companies acquiring vast amounts of acreage at record prices with very short lease terms. Historically they have had great access to the public equity and debt markets – going back multiple times a year and planning on that being available to them going forward. And now it's not. The clock is ticking on lease expirations and the capital markets are closed.

Selling assets is not a great option right now because commodity prices have fallen so much and new capital is generally not available. This has caused a massive dislocation of what buyers are willing to pay, or can pay, and what sellers are willing to take. In general, you aren't seeing a lot of distressed opportunities right now, but you're going to start seeing bank borrowing bases redetermined in the first quarter of 2009, after which you

If you try to go out and do a deal right now, you might be a hero, or you might be like the guy trying to catch a falling knife – you may grab it, but you may lose your fingers doing so.

could start seeing some companies forced to sell assets.

Historically we rarely got approached by public companies, but lately we have been getting many calls from them. You know things are really bad when this starts happening as private equity is the most expensive money out there.

OGFJ: What, if anything, has changed about the way Quantum operates in the current economy?

VANLOH: If anything, we've gotten more disciplined. We definitely felt like there was going to be a big storm and we've been hunkering down the past 12 months for that storm. We didn't think it was going to be this bad. We raised Fund IV a couple years ago and have now fully committed the $1.3B fund, but we've only pulled down $300M. We have $1.0B that hasn't been pulled down because we and our portfolio company management teams maintained a very high level of discipline and didn't get caught up in the market fever created by the massive rise in commodity prices and cheap money.

One thing that is different is that we're talking to public companies now. Six months ago an asset was being valued in a public company higher than it was in a private market transaction. Today it's just the opposite.

You can go in and buy any resources play public company and basically buy it for PDP value and you get all the acreage and locations for free. It's amazing when you think about what these companies have paid for all that acreage. The valuations are so compelling that you can't not look at them.

In addition, we're spending a lot more time making sure we have a grasp on the liquidity of our portfolio companies. We're talking to our banks a lot. We're also talking to our portfolio companies a lot – making sure they're healthy. If there are issues we want to recognize them sooner rather than later.

As far as what we're looking for in a deal, that hasn't changed in 10 years. We're staying very disciplined to what our investment criteria is. Right now you have to be extremely careful – so many things look good, but it's like the banking world six months ago. For those private equity funds that bought WaMu and other banks, they're now writing off 100% of their investment. If you try to go out and do a deal right now, you might be a hero, or you might be like the guy trying to catch a falling knife – you may grab it, but you may lose your fingers doing so.

We're approaching this with a lot of caution and excitement. There will be a lot of great opportunities for our investors, but we don't see the bottom yet. Until the policy direction out of Washington gets more defined, until we start seeing some stability in the capital markets, until companies go through borrowing base redeterminations and first quarter numbers come out…we're open, but we're not overly eager to commit to things.

OGFJ: What do you see as the immediate future in the M&A space? Will companies sell assets for capital to proceed with core projects? Who will buy the assets?

VANLOH: I don't think you're going to see a lot of companies going into bankruptcy in the first quarter of next year, but as the year progresses and if commodity prices stay where they are today or go lower, you're going to start seeing some situations like that.

Our early read is that there is going to be some pretty big opportunities to do pre-pac bankruptcy transactions. Pre-pac is where you pre negotiate with the creditors – a more orderly way of going into bankruptcy. We've had a few in the last 30 days, including one that is a public company. The longer prices stay down and the longer the capital markets stay closed, the bigger and bigger an issue that is going to become.

Most of your public companies have already intellectually made the leap into thinking "we're no longer a conventional oil and gas company, we're an unconventional company," yet a lot of those companies still have a majority of their production coming from conventional reservoirs. They've been great cash cows, funding a lot of these resource plays, but they're funding them with cash flow plus capital markets. There are only a few public companies that truly have strong enough balance sheets where they're 100% self-funded. Now that commodity prices have tumbled, they're either going to lose all these leases they've paid up for, or they're going to have to sell conventional assets in order to fund the capital programs on these unconventional leases.

We think next year will be a nice buyers market for conventional properties. Unconventional assets will be the last thing that people want to sell. The truth is that at $6.50 gas, most of your unconventional basins in the US are uneconomic. Take the Barnett Shale for example – the core of the Barnett may be economical all the way down to $4.50, but when you start getting into the counties in Tier 1

and Tier 2, the play is completely uneconomic below $6.50. It's a real dilemma. Do companies drill wells knowing that today, on a full cycle basis, they're uneconomic?

As far as the buyers, I think you'll see a couple classes. Obviously private equity backed companies will be very active. Private equity funds have raised record amounts of capital and are eager to find a good home for it.

For the larger transactions, the majors clearly want back onto the US onshore in these resources plays. They've got massive amounts of cash. And they can borrow. The banks will lend to Exxon or Chevron. Some of your really big companies like Oxy and Apache have been waiting for something like this. As for the others, roughly 95% of your public companies aren't going to have a balance sheet to aggressively acquire. They're going to be defending their own turf for the next 12 months.

OGFJ: Will backlogs keep the oil service business in good standing?

VANLOH: I think it depends on which part of the service sector you are talking about. For example, offshore-focused, and particularly deep water focused, companies are in pretty good shape because these projects are typically long lead times and the credit quality of who their contracts are with – the majors and NOCs, but I'd be pretty concerned about your land drillers. I don't think your Apaches, your Devons, or your Chesapeakes are necessarily going to default, but I wouldn't put it past them to renegotiate. I think there is some retrading that will get done.

You're also going to see some people say "sue me – the alternative is I'll have to go into Chapter 11." The worst thing for the service companies is to have a lot of that happening. They need these companies to stay active drilling. I think you'll see service companies work with them on prices to try to keep the rigs running and their people employed. People have been in such demand. If you've got crews that you've now worked out all the kinks with, you don't want to let them go.

There are lots of contracts rolling off for land-based drilling companies, so I think that you will see their earnings fall. The industry has already laid over about 100 rigs in the past month. There's probably going to be somewhere between 400 and 800 rigs laid over by the time this thing really bottoms out.

OGFJ: What about the contract drilling business? What is the near-term and long-term outlook?

VANLOH: It's going to be really tough. Any "dumb iron" – services where there's no barrier to entry – isn't going to look real pretty for the next 12 months. Things like pressure pumping and rig building…those are two areas that are going to be hit pretty hard. Some of your higher-end services, what we call "smart iron," like directional drilling, specialized motors, or patented protected technology will probably do better, but if you lay over 400 to 800 rigs, those services will be used less also. It just won't be as bad for some as it will be for others.

OGFJ: Many/most hedge funds have been suffering in this financial crisis. In recent years, these funds have provided huge amounts of capital for the O&G industry. Is this likely to dry up?

VANLOH: Yes. Hedge funds have been caught in the epicenter of this financial storm. Look at the swings. Three weeks ago energy stocks were down, on average, 20% – 25% in one day! Over the next two weeks they gained back all their losses and then some. Then a few days ago, they plunged 20% to 25% again in one day. It's psychotic behavior. There is no fundamental change that happened to cause that. It's purely liquidation by hedge funds.

Now you're seeing wholesale liquidations of these funds. In 12 months time, when you look back, I think more than 50% of your hedge funds that were in business January 1, 2008 will be gone – thousands and thousands of funds, gone. Hedge funds tend to be momentum-type investors. All commodities have been a great momentum play for the last several years. The charts are hyperbolic; but hyperbolic both ways, unfortunately.

A lot of the funds use leverage, so a 30% to 50% pullback can wipe out their whole fund if they're levered two to one. I think the hedge funds have been taught a nasty lesson. They did a lot of deals that no one else wanted to do. They funded billions of dollars in PIPE (private investment in public equity) deals without doing one lick of due diligence. It was all about momentum and not getting left out, because everything was going to keep going up. Many of them didn't have a clue what risk they were taking. They invested in mediocre management teams that will do okay in a bull market, but as soon as you get into a bear market, they will be the first to get slaughtered.

Once the dust settles, and life gets back to normal, whatever that ends up being, I think you'll see a lot less activity, especially the speculative activity among hedge funds in the energy space.

OGFJ: What does the future hold for Quantum?

VANLOH: When we started we were purely an upstream investor. Now we're active in midstream as well. We will look at anything in the industry, so I see us getting a little more diversified in energy areas that we currently don't have a lot of activity in right now. But first and foremost, we're an upstream and midstream fund.

We have some carefully thought out strategies that we're pursuing right now. We know where we want to be and what areas don't have what we're looking for.

OGFJ: Thanks for taking time to talk to us. OGFJ

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