PGIM PRIVATE CAPITAL

# ENERGY MEZZANINE FOR INSTITUTIONAL INVESTORS

THE PURSUIT OF OUTPERFORMANCE

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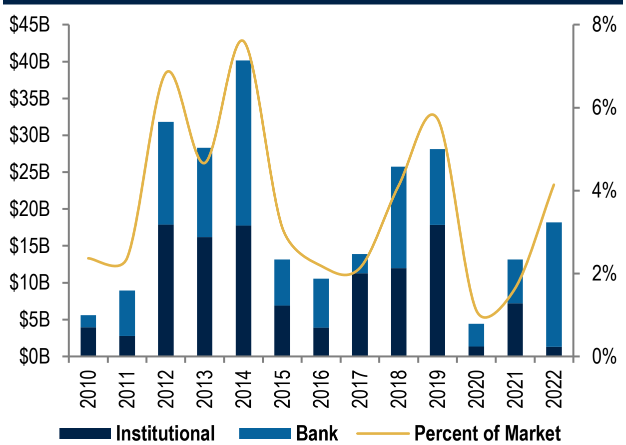
# Industry Trends Impacting Capital Availability

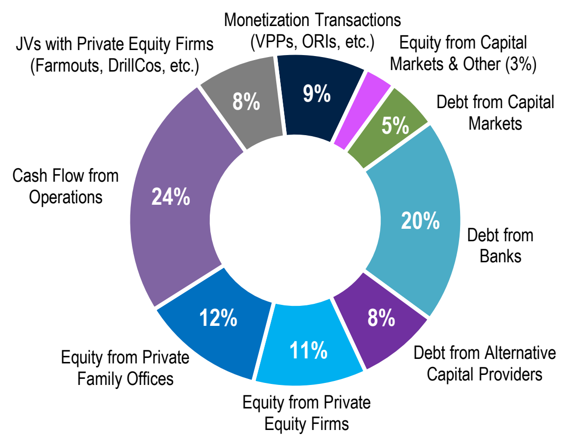
**A fundamental shift in capital sources available for upstream energy companies to fund various business operations began several years ago. What began initially as a short-term response to sector volatility is quickly migrating towards a long-term secular trend.** Historically dominant funding sources, consisting primarily of commercial banks and public and private equity, have continued to withdraw from the sector. **The acceleration of this trend** has served as a catalyst for recalibration of asset values, investment return expectations, and opened the door for alternative sources of capital - importantly, institutional forms of capital - to fill a growing capital funding gap.

This shift has also created an opportunity **for investors to consider** different risk return **investment** profiles within the industry and will likely be a trend that continues for some time. Recent surveys of domestic upstream independents highlight the increasingly important role that debt from Alternative Capital Providers is now rivaling the traditional bank market.

**Oil & Gas Leveraged Lending[1]**




**Where are Producers Planning to Source Capital from in the Next 12 Months?[2]**




Source: Enverus and S&P LCD Quarterly 4Q22. 1. As of 12/31/2022. Leverage loan is a loan that (1) is rated BB+ or lower, or (2) is either not rated or rated BBB– or higher but (a) has a spread of LIBOR+125 or higher and (b) is secured by a first- or second-lien. Bank includes portions of a transaction that are typically allocated to banks (TLA and RCF) whereas Institutional includes facilities that are typically allocated to institutional investors (TLB including 1L/2L). Note 2: Haynes and Boone, LP. Respondents could select more than one option. Haynes and Boone, LP collected 329 responses.

# Filling the Funding Gap of an Essential Industry

Broad industry trends involving capital availability, coupled with shifting views on the pace of energy transition, conservation, and the evolution of demand, has led the capital that historically funded those activities to reevaluate where to re-deploy and what form of capital minimizes volatility risk and maximizes investor returns. Experienced institutional capital, which is well-positioned to navigate the elevated priorities surrounding responsible investing and climate concerns, has begun to fill the funding gap with capital tailored to address the needs of an essential industry.

In response, institutional interest in conventional energy continues to channel away from equity-led capital gains-oriented investments and towards opportunities that demonstrate lower volatility of returns and losses and higher visibility of cash yield and investment return protection. This trend fits well within an industry itself that is maturing; reducing prioritization of year-over-year growth and focusing on the sustainability of production and visibility of free cash flow.

**Investors** in the energy sector are increasingly seeking investment opportunities providing yield, dividends, distributions, and return of capital. For investors seeking the investment protection of a debt claim but with contractual yield in the low-teens and equity-linked performance upside, evolving market conditions are increasingly supportive of mezzanine debt and other "structured" capital as a very relevant source of funding for middle-market upstream companies increasingly focused on sustainable production, cash flow stability, and conservative use of leverage.

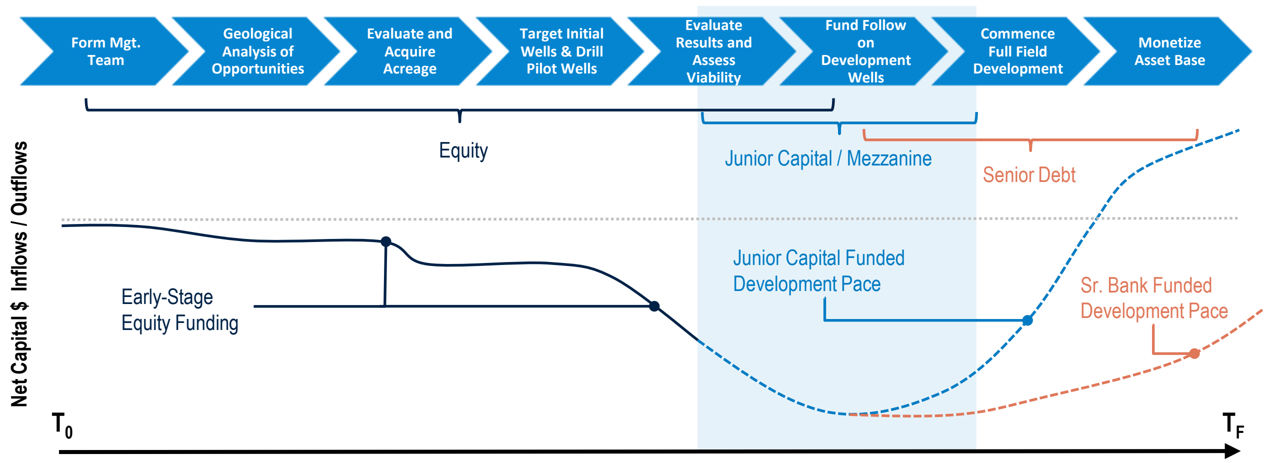
# The Importance of Junior Financing In the Current Environment

As traditional senior debt lending participants retreat, underwriting parameters and lending advance rates have also contracted. This tracks a broader recalibration of assets' underlying market values as investors prioritize visibility of proven cash flow. With senior debt advance rates declining, the role of junior capital (mezzanine / preferred equity) as an equity bridge has become more common; particularly for assets that are moving deeper into the lower risk, but more capital-intensive field development drilling phase.

Junior capital as a form of financing is most often used to augment senior borrowing capacity in connection with the acquisition of a more mature PDP dominant asset package by junior operators or to accelerate development drilling efforts during advantageous price environments. Increasingly, equity owners are looking at this form of capital as a means of avoiding down-round common equity valuation events for short 2–5-year term funding needs that exceed senior borrowing capacity. Private equity sponsors are also seeking additional junior capital options to fund their development pace as the M&A market is increasingly rewarding PDP weighted asset valuations and fund sponsors are facing both investment life and fund portfolio concentration limits.

With contracting senior advance rates and fewer market participants, debt and equity roles across the entire capital stack are being recalibrated. Rather than simply adding more debt to operator balance sheets, junior / mezzanine investments are largely being asked to fill funding voids created by a bank lending market in retreat; but with greatly improved yield and cash-on-cash return expectations.

**Capital Outlay Timeline For Typical Oil & Gas Drilling Project**



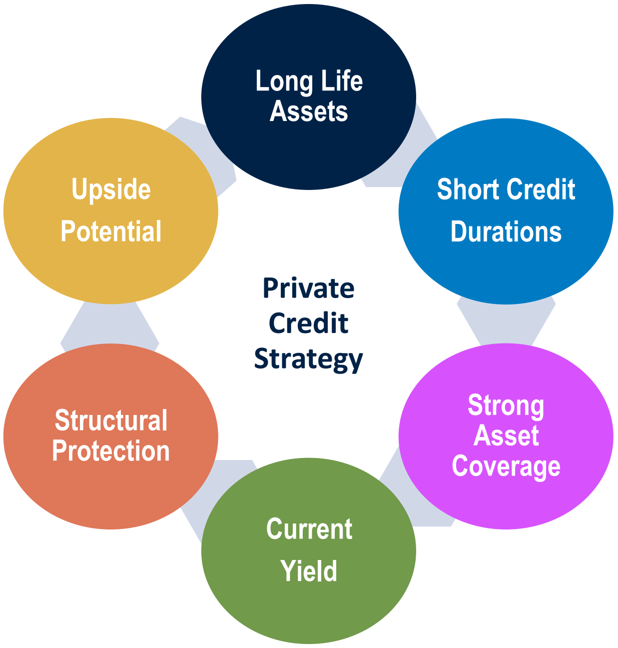

The industry's use of stretch senior direct lending "unitranche" funding structures has also expanded in support of operator development needs, but the simplicity of these structures has limitations that may not make them ideal for many upstream oil and gas companies. Properly structured, a combination of lower-cost senior revolving facility, along with more patient junior capital offers a more tailored capital structure that accommodates continuous funding needs and provides greater transparency of cost of capital for the associated risk.

Properly utilized, junior capital serves as a bridge that allows operators to access capital viewed by senior lenders as sufficiently "equity-like" but is less dilutive than issuing additional common equity. This form of junior capital runs along a spectrum from senior subordinated unsecured to preferred equity.

The scale, well maturity, and capital deployment strategies for upstream assets to be financed ultimately dictate the form of capital most appropriate.  Unlike common equity investments, upstream mezzanine is typically underwritten to allow for full repayment through existing free cash flow within a 3–5-year time frame.  This approach avoids reliance on an enterprise sale for ultimate repayment and also addresses institutional investor concerns regarding energy transition and its impacts on investment performance.

# PGIM Private Capital Is Uniquely Positioned to Address Current Industry Trends

PGIM Private Capital has over four decades of experience investing across the North American upstream, midstream, and downstream energy sectors. We are well positioned to succeed in a market that is evolving; particularly with the retrenchment of capital and shifting energy investment interests across the institutional market. Because our business model has always relied on direct relationships in the marketplace at a local level, we structure and deploy capital with a unique insight. Our "boots-on-the-ground" business development capabilities provide us access to asymmetric levels of information and industry relationships we've built over decades. Ultimately, it allows us to identify well-managed companies that are seeking a capital provider with a similar relationship-based focus.




PGIM Private Capital currently manages over $9 billion of senior, junior and equity capital deployed in the energy sector involving relationships with over 100 energy companies that span the energy value chain. Our senior energy investment professionals average greater than 15 years of experience within PGIM Private Capital. Our legacy relationship network provides access to unique deal flow that is directly sourced and asset class optionality that is underpinned by a strong holistic understanding of the energy market. Experience, insight, and objectivity are the three most important characteristics of sustained investment success. Our business model is structured to maximize these institutional character traits, which has allowed us to differentiate ourselves within the broader sea of sameness in the world of institutional capital.

PGIM PRIVATE CAPITAL

### LEADING ENERGY PLATFORM[1]

**$9.2 bn**

In assets under management with

**122**

Portfolio companies

### SCALE AND COMMITMENT

**18**

Dedicated energy professionals with

**23**

Years of experience for senior members[2]

### STRONG ORIGINATION ACTIVITY

**$7.4 bn**

Invested since 2017

**$1.2 bn**

Average annual investment pace per year[3]

[1] All data as of 3/31/2023. Assets consisting of investments in upstream oil and gas production, energy pipeline, infrastructure, and other regulated assets.
[2] Senior members include Matt Baker, Brian Thomas, Brittany Braden, Callie Hamilton and Brian Lemons.
[3] Average originations per year from 2017 to 2022 across the Energy platform.

## The PGIM Private Capital Difference

We apply PGIM Private Capital's proprietary middle-market investment capabilities to source, underwrite, and manage our investments. With an active presence in our core markets for five decades, our group leverages our multi-billion-dollar energy portfolio and network of experienced investment professionals to make selective investments. We source the majority of investments through direct calling efforts to management teams, building relationships over time. We underwrite investments with emphasis on downside protection and asset coverage including hedging and meaningful financial covenants. Our ability to think about how the reward should be matched up with the risks associated with that form of capital, gives us optionality that many institutions lack.

If you are interested in learning more, please visit PGIMPrivateCapital.com for more information.

## About the authors

**Brian Thomas** is the Executive Managing Director of PGIM Private Capital's Real Assets group. He oversees the private placement and mezzanine investment activity in oil, gas and related energy investment activities worldwide. Mr. Thomas is a Partner of **PGIM Energy Partners**, the middle-market energy fund management business sponsored by PGIM Private Capital. He joined PGIM in 1995. Mr. Thomas received a BBA and an MBA from the University of Texas at Austin.

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