EnCap Investments L.P.

Q When EnCap Investments was created 25 years ago, the firm's four managing partners saw opportunity in very uncertain economic times. What formed the basis of the decision to launch the firm?

Both public and private capital were extremely scarce after the collapse of oil and gas prices in the mid-1980s. However, we were aware of several hands-full of institutional investors, principally life insurance companies, that were still willing to entertain an oil and gas opportunity. When we formed EnCap in 1988, our business plan was to become a conduit between those institutional capital sources on one hand and oil and gas investments emanating from the extensive industry contacts we had on the other. We began by forming a mezzanine fund to effectively provide "stretch" bank financing with a mid-teens return objective. We also formed a reserve acquisition fund to pursue attractive oil and gas acquisition opportunities targeting similar returns.

Q What drove your evolution from a firm focused on mezzanine debt and acquisition funds to private equity?

In the late 1980s there were very few mezzanine players in the industry. Ten years later there were more than 30 mezzanine providers, which had the effect of driving returns down and credit risk up. Similarly, the reserve acquisition market was becoming increasingly competitive with new entrants significantly altering the risk-return equation. We believed that private equity would represent a superior value proposition, coupled with the fact that our interests would be better aligned with management teams, so we started our first private equity fund in 1994. In 2001, EnCap Fund III was the first fund to focus on backing start-up management teams that possessed deep experience and expertise in the oil and gas industry.

We believed that partnering with the premier teams in the industry and developing a relationship-driven model would create substantial value for our investors and management teams. Since inception, more than 95% of the $18 billion of capital we have managed has been focused on backing start-up management teams and then re-backing many of those teams on the heels of successful exits.

Seated, L-R: Gary Petersen (managing partner), David Miller (managing partner), Marty Phillips (managing partner). Standing: Murphy Markham, Doug Swanson, Jason DeLorenzo, Jason McMahon. Bob Zorich (managing partner), Wynne Snoots, Sean Smith.

Q How has the private-equity landscape shifted over the last 25 years and how has EnCap changed with it?

EnCap has consistently sought investment opportunities with the most attractive risk-reward profiles, and that has required that both we and our portfolio companies have the ability to adapt to changing market dynamics. During most of the 1990s, our portfolio companies largely pursued acquire-and-exploit growth strategies, which involved "buying right" from the majors and large independents, doing some lower risk development work on the acquired properties, and then selling to public E&P companies. However, around the turn of the century, that strategy became less attractive economically as the same people we were selling to, i.e., the small to mid-cap public E&P companies, began to compete with our portfolio companies for M&A deals. Fortunately about that time natural gas prices, after languishing for over a decade, were approaching $3.00 per MCF and along came something called the Barnett Shale. We did our first deal in the Barnett in 2000 and then proceeded to march from one economically-advantaged resource play to the next over the ensuing dozen or so years. Horizontal drilling and continued advances in completion technology led to further opportunity for our teams in both unconventional and conventional resource plays.

While many private equity firms were slow to respond to these new opportunities, EnCap embraced them. Since 2008, EnCap has sold close to 40 companies that were involved in various resource plays, resulting in gross sales proceeds of roughly $20 billion and some $8.5 billion of distributions to our institutional partners.

Q What are the key drivers of EnCap's success?

Consistency is the hallmark of EnCap's track record. Preqin's Global Private Equity Survey 2012 ranks EnCap as one of the most consistent private equity managers overall and the top manager in the oil and gas industry. In fact, EnCap is the only energy private equity firm that has had six consecutive top-quartile funds. EnCap's funds have also substantially outperformed the S&P Energy Index and energy commodities over the life of the funds.

In total, EnCap has raised 17 institutional oil and gas investment funds aggregating more than $18 billion. Over the past 25 years, EnCap has invested nearly $10 billion in just over 200 companies. One hundred and fifty of those investments have been realized, resulting in returns that have consistently exceeded our targets of a 2.0x ROI and a 25% IRR.

Our ability to attract the highest quality management teams in the industry is central to our success. Over EnCap's long history, we have established a strong reputation as an innovative, value-added source of capital. This has allowed us to attract seasoned management teams with demonstrable track records of success and solid value creation strategies.

Certainly, one of our core strengths is the experience and cohesiveness of our investment staff. EnCap's four founding partners have led EnCap since its inception and have a working relationship that spans almost 35 years. We also have a very deep "bench" with the six partners below the founders having an average of over 23 years of oil and gas industry experience and an average tenure with the firm of 14 years.

EnCap has consistently generated superior returns across multiple hydrocarbon price cycles by applying a low-risk, disciplined philosophy that balances capital preservation and value creation. We ensure that our management teams focus on the most economically advantaged areas and strategies, adapt to changing market conditions, and build asset bases and opportunity sets that are attractive to the universe of buyers.

EnCap takes a rigorous approach to risk management. We monitor investments and market conditions closely and advance capital incrementally as management teams identify compelling opportunities and create value through the successful execution of their business plans.

Q What do you look for in a management team and what differentiates EnCap's value-added contributions to the teams in your portfolio?

We look for teams with a history of successful value creation grounded in strong technical and operational backgrounds. EnCap backs teams with an entrepreneurial mindset and a risk management philosophy that is consistent with ours. We also place the highest value on integrity, honesty and open communication. Today, with a $5-billion upstream-focused fund and a $1.75-billion midstream fund via our partnership with Flatrock Energy Advisors, EnCap is strategically positioned to provide some of the largest equity commitments in the industry to attract and support the best management teams.

Q What are the most attractive upstream opportunity sets today?

From a big-picture perspective, both the upstream and midstream sectors are highly capital-intensive. The IEA estimates that approximately $750 billion per year will be required worldwide to offset production declines and generate new reserves to meet increased long-term demand. We believe that in and of itself suggests there will continue to be significant investment opportunity.

The industry has seen a dramatic shift from vertical to horizontal drilling and the implementation of advanced completion technologies. These techniques were initially tested in emerging shale plays like the Barnett, Haynesville, Eagle Ford and the Bakken. More recent applications include conventional "tight rock" formations like the Granite Wash and the Permian Basin's Wolfcamp formation. Promising new plays like the Utica and the Cline Shale continue to emerge with current development activity focused on oil and liquids-rich areas with superior economics. Many areas consist of multiple hydrocarbon types and offer repeatable opportunities. Stacked pays offer substantial option value and the potential to exploit more mature areas through the application of modern technologies.

Our sense is the foremost opportunities continue to be centered in the economically-advantaged, lower-risk drilling plays. Broadly speaking, the M&A market for oil and gas assets appears to be intensely competitive, but we have had portfolio companies selectively identify and capture highly attractive reserve acquisitions in every fund and we believe that will continue to be the case.