

PRIVATE AGENDA

In just under a year, a former Apache and El Paso deal-maker has put together better than \$1 billion in private equity and is shopping for mature, declining assets with possibly \$2.6 billion of total buying power.

INTERVIEW BY
STEVE TOON

Lisa Stewart, chairman and chief executive of Sheridan Production Partners LP, says the private fund will operate without the pressures that inhibit a public company.

After leaving El Paso Exploration & Production in September 2006 as president, Lisa Stewart hit the road. Her goal: To drum up cash for a new venture, tapping pension funds, endowment funds and foundations to buy mature oil and gas assets and enhance their operating efficiencies—without the shareholder pressures and focus on reserves that inhibit a public company. In a joint venture with private-equity firm Warburg Pincus and three trusted colleagues, the former Apache Corp. acquisition-specialist formed Sheridan Production Co. LLC in Novem-

ber 2006 and set out to raise the capital. Eleven months later the new chief executive returned home with \$1.3 billion in private funding for Sheridan Production Partners LP, and three weeks later closed on her first cash acquisition.

Stewart's roots are in the business, having spent her young life checking on rigs with her dad, who was a drilling engineer. Even now, she says, she is more comfortable in steel-toed boots and blue jeans than a business suit. She got her B.S. in petroleum engineering from the University of Tulsa in 1981, and went to work for Cities Service Oil and Gas, (now Occidental Petroleum), even while an undergrad doing reservoir modeling.

In 1984 Apache came calling, and she began a life-changing relationship that lasted 20 years. She worked out of the Tulsa office as a reservoir engineer, given the authority to make determinations if the company would participate in well projects. She was promoted to the corporate office in Houston, where she served in a number of areas, ultimately as vice president of business development and E&P services. There she grew strong relationships with Eric Harry, Jim Bass and Tim Blaine, who would later join her at Sheridan as her management team.

Stewart left Apache for El Paso E&P in



2004, where as president she oversaw the restructuring of the E&P business.

Oil and Gas Investor recently visited with Stewart.

Investor What prompted you to form Sheridan?

Stewart Almost every public E&P is focused on the growth of their production and reserves. Having been in the public world for a long time, the reality set in on me that the U.S. has become a very mature area. Most of the basins in the U.S. are on decline, and there is a need for a structure and a way to own those mature assets that are a drag on the ability for public

E&Ps to grow their production and reserves.

When I think about mature assets, I don't mean assets that are two days away from needing to be plugged. They are in fields that no matter how much capital you spend or how many wells you drill, you're probably not going to create an inclining production profile; rather, it will be on decline. And so I still think there are a lot of assets in the U.S. that fit that profile, that need to be owned, and quite frankly there's a lot of life left in them.

Investor How is the Sheridan model different from a traditional E&P company?

Stewart The only thing our investors are looking for is a rate of return. They expect us to buy assets, to operate them efficiently, and to generate both a return of capital and a return on capital. So we won't have stated production targets next year that we have to meet, which is different from the public companies. We won't have that pull between "Do we drill this well because it helps me make my production target?" when maybe the economics aren't as good as what I should expect. And, too, there's no real compromise between a pure rate-of-return play and public market pressures.

Investor So rate of return is emphasized over growth?

Stewart Absolutely. In fact, our investors ex-

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Sheridan's management team includes Stewart's former Apache colleagues (from the top) Eric Harry, executive vice president of acquisitions and general counsel; Jim Bass, executive vice president and chief operating officer; and Tim Blaine, chief financial officer. The Sheridan team completed its first property purchase three weeks after funding.

pect that our production will decline over time. And we will return cash to them on a regular basis so they are basically exiting the properties as we are producing them. They are getting their return of capital, and ultimately their return on capital, out of the cash flow. So their exit strategy is one of the return of cash on a regular basis.

Investor That model sounds very much like what the MLPs are creating, which of course are publicly owned. Is your model intended to parallel an MLP?

Stewart No. MLPs that are publicly traded will have the same or similar pressures that the public E&Ps have. They will be expected to raise their distributions over time. Growth and adding assets into their companies will be a big driver for them. For us, the focus is on making really good investment decisions and operating those assets very well and returning the cash. It is not modeled after an MLP structure in any way. It's just a different form of ownership that takes the public side out of it.

Investor Do you feel like you have an advantage over not being an MLP?

Stewart From an economic or acquisition perspective there's not a lot of advantage of either one of us over the other. There is a high likelihood we would go after similar assets in some ways, although the MLPs are focused on having very long-life assets, so their reserve-to-production ratios have longer-term targets. For us, since we only have one criteria, and that's rate of return, short-life assets can be every bit as attractive to us as longer-life assets.

Investor How is Sheridan funded?

Stewart We went to endowments, foundations and pensions both public and private. We have about 31 investors. We raised \$1.3 billion in equity.

We have a group of very high-quality investors who understand what our strategy is and understand that our goal is to buy assets with an appropriate rate of return going in and to add value to them through our operations.

Investor Over what time period did you raise the funding?

Stewart I left El Paso a year ago, and we did our final close in August 2007, so 11 months from start to finish writing the business plan and everything. It was a hard 11 months; I'm not going to kid you. We're really pleased.

Investor Are there many acquisition opportunities in this market?

Stewart We have closed our first transaction. We did this at the end of August. We bought assets from a private company and a number of follow-on private individuals as we collected working interests in some of the assets we were buying in the main transaction. The transaction was approximately \$165 million. It puts us into a position where we are now an operator, which is important. We are currently operating in Texas and New Mexico. About two-thirds of

the value is in the Permian Basin and about a third of the value is in the Austin Chalk Trend in Central Texas. Altogether, there are about 200 producing wells.

Investor What are the proved reserves and production?

Stewart We're producing about 1,200 barrels of oil and around 4.3 million cubic feet a day net. It is more of an oil package. We think this is a very high-quality set of assets, more oil-prone and a fair bit from waterfloods. We think there's a lot of potential and we're drilling our first well there already.

Investor How did you choose Warburg Pincus as a partner in this?

Stewart Certainly their reputation played into it. Warburg Pincus has a long history of backing good management teams in our industry. I also had known one of the principals, Chansoo Joung, in Warburg Pincus' energy practice group for a long time. He and I began talking about this a while ago as they had the idea that capitalizing a private company differently would make some sense to buy mature assets. I think it has been a great fit for us. Chansoo Joung and Jeffrey Harris, another Warburg Pincus managing director, have been very supportive of us during formation, instrumental in further developing our business plan and helped us when we went out and raised the equity. They were a fabulous partner to have.

Investor Is this a new business model?

Stewart It's not completely new. There are a couple of other dedicated oil and gas funds. There are a few tweaks in the Sheridan model. We will do no exploration within our fund; the others are not as opposed to it. We are leveraging the skill sets of the team in evaluating acquisitions very well, and integrating them and managing operating costs and production.

Investor Speaking of the team—you, Jim Bass, Eric Harry, Tim Blaine—how did they come to join you at Sheridan?

Stewart All of us shared time together at Apache. Tim even was on our audit account at Apache, so we've known him a long time. I've worked with Jim for 20-some-odd years since the early 1980s; he was one of the first people I ever worked with at Apache. And Eric was the other half of my deal team for a long time at Apache. They both joined me at El Paso.

The four of us have incredibly complementary skill sets. We know how to work together, so we have the advantage that we already are a team because we've been together for a long time.

Investor Will you supplement purchases with debt?

Stewart Yes, we will. The debt aspect of it is important to us in a number of ways. One, obviously, we can put more assets under management if we use a little bit of leverage. And we will. We have a reserve-backed borrowing facility in place, and we utilized this in our first transaction.

We're targeting about 50% equity and 50%

debt in funding any deal, and that will depend obviously on the type of assets that we buy. We will also use hedging to protect our returns.

Investor Describe the properties you seek.

Stewart Mature is our mantra. Fields or basins that are on decline that don't provide a large growth profile.

It may be easier to describe what we wouldn't go after, for example, the Barnett shale, which is a very hot play right now. We might be interested in the Barnett 10 years from now when it's on decline. The Austin Chalk Trend was once the hot play. Now it's perceived to be a later-life asset that's on decline, so it fits our profile.

We will buy gas or oil and will strive for that balance. We will focus on predominantly oil-producing states, so you can expect to see us in Texas, Louisiana, New Mexico and Oklahoma.

Investor Conventional versus unconventional—do you have any preference?

Stewart No. I think "unconventional" has taken on a new meaning in the industry. I don't typically view tight-gas sands as unconventional because that is what I grew up dealing with in western Oklahoma. So if you put tight gas in the conventional category, I think we would tend to be more on the conventional side, both oil and gas, because that tends to be where you've got more asset maturity.

Investor Would you consider coalbed methane or shale?

Stewart I would, depending on the asset. If there's a big acreage play and a little bit of production, and you've got to take that production out over time to develop the whole field, it's probably less interesting to us. A good example would be the Black Warrior Basin in Alabama—relatively mature; that would fit our profile.

Investor Why the emphasis on mature?

Stewart We're trying to capitalize mature assets that are on decline with a capital structure that matches it. Our capitalization is the right match with those assets. Mature assets are very predictable from a reserve perspective, and offer opportunity to bring operating efficiencies so you can enhance the rate of return as you work on the assets.

Investor Do you have any interest in offshore?

Stewart We would consider the Gulf of Mexico shelf if we found the right package. The Gulf of Mexico tends to be relatively short-life, and the MLPs don't particularly want shorter-life assets. We feel like that difference is potentially an advantage for us.

Investor Do you expect to compete with the upstream MLPs for your onshore assets?

Stewart Oh, we will. We will look at similar assets. That's absolutely a reality. But you have to stick to your technical evaluation of the assets, and if we lose one to an MLP because they saw the technical evaluation differently than we did, then so be it.

Investor Have the MLPs run up the price of mature assets?

Stewart The MLPs have to look at their cost of capital just as we do. We will—similar to the MLP—use hedging to protect commodity price. If you look at the last 10 years, the trading price of the underlying sale of oil and gas assets is directly tied to the selling price of the commodity. It's a pretty efficient correlation. Clearly, assets are selling at a higher price today than they were five years ago when commodity prices were lower. That really goes to our belief that you have to protect that commodity price.

Investor Will there be other funds?

Stewart I can't predict what will happen once we've invested the first fund. Assuming we are successful, our vision is to have a second and third fund and continue to grow through successive capital raises.

Investor What is your exit strategy?

Stewart The exit strategy really is just producing out the assets and returning the cash to the investors. Like anybody who runs a portfolio of assets, we will continually review our asset portfolio and potentially sell things that fall to the bottom over a period of time.

The fund is set up for a 15-year life, so there will be assets over that 15-year life that will need to be plugged, that we will sell. Whatever's left from a reserve and value perspective at the end of the life will most likely be sold.

The one alternative our team is not focused on is doing an IPO and taking it public.

Investor So no interest creating an MLP?

Stewart No. I am not one of the 88,000. I'm not one to follow the crowd.

Investor Why now? What prompted you to form Sheridan at this time?

Stewart The obvious answer is I'm not getting any younger. I want to have sufficient time to really build a company and leave a unique mark on something. Where the market is was a big factor as well.

It has become increasingly apparent to me over the past several years that companies that are predominantly U.S.-focused have a very hard time organically growing their reserves and their production. And so there is a need in the market for a place to house those assets that are a drain on the public companies.

Commodity prices are high; it's a good time for public E&Ps to sell. Yet, we believe our strategy works in any price environment because of the connectivity between the commodity price and the selling price. I think the time is right and the U.S. basins are going to continue to mature. We felt like it was a good time.

Investor How did the company get its name?

Stewart We decided it needed a name that meant something to me, so I named it after my beloved yellow lab, who was born in Wyoming and Sheridan was the nearest big town. She was a gift to me from Raymond Plank, chairman of Apache. The name had an oilfield connection and sentimental value to me. Our logo has a dog in the "A." She pretty much wants to put her name everywhere now. □

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