

LOST IN TRANSLATION

DEAL STRUCTURES THAT ARE COMMON IN THE VC COMMUNITY
DON'T ALWAYS WORK WELL IN THE ENERGY SECTOR

BY ALLAN T. MARKS

A clash of cultures is in the offing for many investors in energy companies.

New energy ventures are increasingly seeking capital from a broader range of investors, including traditional energy lenders. The expectations and the deal structures that are typical in the venture capital technology community are at odds with those that have historically prevailed in the energy sector.

To see how these cultures can clash, let's assume that a group of venture capitalists in the high-tech field form a startup based on a new, proprietary process for converting coal into clean-burning gas. The VCs form a company called ConverCoal and, over the next three years, raise \$40 million in three rounds of equity financing. They use the capital to refine their process and build a prototype plant. It works. The process successfully produces gas from coal—and at a cost that makes it commercially viable and with cheaper solutions to carbon emissions. The risks remain as to whether the technology will work on a commercial scale and how best to market it.

At this point the owner-founders could sell ConverCoal, but their return would be limited. The sale price might have contingencies or be discounted for the inherent risks. And licensing the technology depends on proving it works commercially. So, to get ConverCoal to the next level, they will have to build a larger plant. And to do that, they'll need \$250 million of new capital. Where to get it?

They could sell more stock, but

they're reluctant to dilute their own equity. Plus, startup capital is expensive. So they go to the lenders they know well: banks accustomed to lending to technology companies. But those banks turn them down because they don't know much about the energy field. Eventually investors find a bank that does.

That bank, after due diligence, agrees to the loan, but only if it gets two things: a lien on all ConverCoal's assets (technology, property, plant, equipment), and a highly restrictive covenant package. The bank imposes strict limitations on changes in control, construction and operation of the new plant, and budgets.

Another possibility is investment from a private equity fund. Private equity may be less expensive than equity from public offerings or other sources. Too much capital is chasing too few deals. And private equity deal structures can be less restrictive than the terms of secured bank debt. But private equity investors may be less patient—seeking a quicker exit or the right to stop funding—than banks, which hurts access to additional capital.

Next stage. ConverCoal builds its larger plant. Once in operation, the plant and its cash flows can support more debt to finance further expansion.

The technology is now proven, and there are economies of scale in the business. The financing options may be constrained, though, by the terms of the financing that were put in place initially.

So the company refinances, borrowing four or five dollars of debt for every dollar of equity, paying off the initial

investors. That debt is secured by the assets of the plant and is to be repaid with revenue from the plant's operations—revenue derived from long-term contracts or hedges. This process is repeated several times as ConverCoal leverages future cash flows from each project. Eventually, ConverCoal creates a holding company that can then sell additional equity and structurally subordinated debt in the form of bonds.

Interests of debt and equity now diverge. The bondholders have a low tolerance for risk and no incentive to encourage the company to take more risks by expanding further. The bonds' return is essentially capped.

ConverCoal's stockholders, though, seek upside and share price appreciation. For that to happen, the company must generate steady, quarter-by-quarter increases in earnings. And how can the company achieve this objective when all of its contracts are fixed-price? Only through constant expansion, new plants and new debt. This can stress liquidity if the company stumbles.

At each stage, the company's financial strategy should be tailored for maximum flexibility by anticipating the tensions among different classes of debt and equity investors at each stage of the company's growth. Management also has to balance shareholders' growth demands with the need to maintain debt capacity and liquidity. ■

Allan T. Marks is a partner in the Los Angeles office of Milbank, Tweed, Hadley & McCloy LLP.



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