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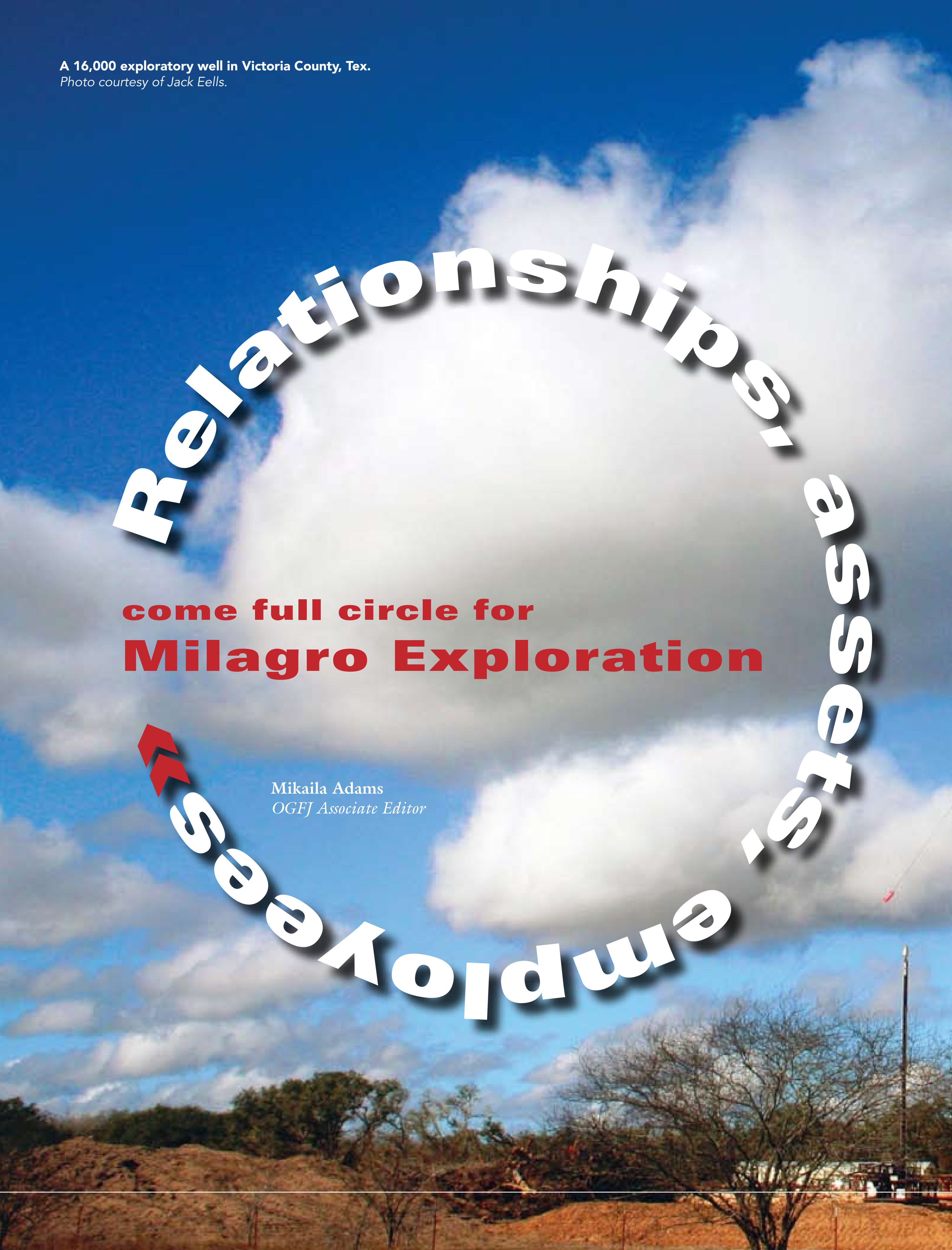
Milagro Exploration centers success around relationships, experience

Milagro Exploration's senior management team (from left): Bob Cavnar, Rick Piacenti, and Jack Eells.

INSIDE

Petroleum investing
2008 hurricane forecast
Rodman Energy formed
OGFJ Canadian 100 update



A 16,000 exploratory well in Victoria County, Tex.
Photo courtesy of Jack Eells.

Relationships, assets, employees come full circle for Milagro Exploration

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OGFJ Associate Editor

What a year 2007 was for privately-held Milagro Exploration LLC. The small company, then held together by fewer than 15 employees, raised $825 million in debt and equity to purchase the Gulf Coast Division of Petrohawk Energy Corp.

The assets acquired in the transaction included nearly 1,000 wells producing over 104 MMcfe/d net to Milagro and an extensive library of over 6,000 square miles of 3-D seismic.

Milagro Exploration was formed in 2005 by the former senior management team of Mission Resources Corp. The company is led by co-founder, president, and CEO, Robert L. Cavnar; executive vice president and CFO, Richard W. Piacenti; executive vice president and chief exploration officer, John (Jack) L. Eells and senior vice presidents Tom Langford, Marshall Munsell and Mike Gatlin.

The size of the transaction in relation to the size of Milagro at the time was astonishing. “We were a little company of 14 folks with a $40 million balance sheet trying to jump on a $800 MM deal,” said Cavnar.

How did they do it? Relationships and experience. “It made an impossible deal doable. If we didn’t know each other it would have never happened; we never would have gotten through the first step,” he confessed.

Relationships, experience, and lessons learned

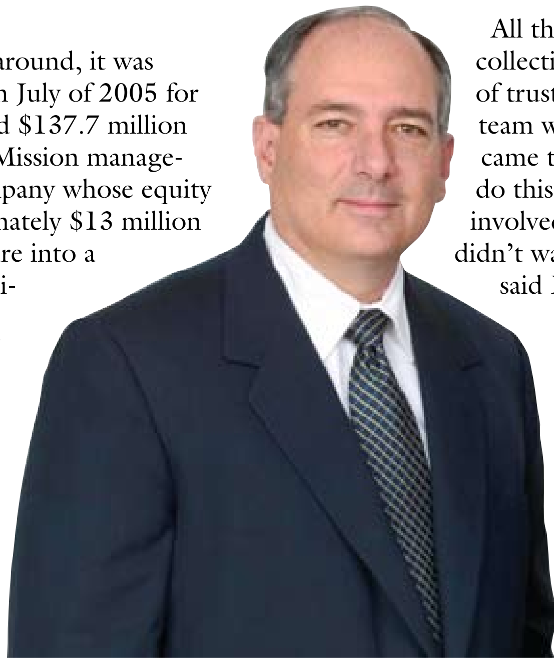
The ‘first step’ can be traced back to the days when Cavnar, Piacenti, and Eells were hired in the Fall of 2002 to strategically reposition Mission Resources. “What fixed Mission was changing the model and changing the assets. We went from relatively low margin production, to much higher margin production by turning over from high cost crude properties to gas properties and implementing a successful exploratory drilling program. While Rick was fixing the balance sheet, Jack [Eells] was fixing the exploration program, and Marshall [Munsell] and I were turning over the asset base,” explained Cavnar. Munsell served as senior vice president of land and administration at Mission and is now running the land department and the acquisitions and divestitures program at Milagro.

Once the company was turned around, it was sold to Petrohawk Energy Corp. in July of 2005 for 60% Petrohawk common stock and $137.7 million cash. In less than three years, the Mission management team had transformed a company whose equity market capitalization was approximately $13 million with a stock price of $0.55 per share into a company whose equity market capitalization was approximately $350 million with a stock price of $8.27 per share at the time of its sale to Petrohawk.

Two years later, the Milagro team had come full circle and was once again applying the "know-how" that was used to revitalize Mission. This time the knowledge was incorporated into the purchase of Petrohawk's Gulf Coast division. "It's all the same muscles. All the same set of skills. It's the same thing here, in fact, many of the assets are high-return assets from Mission that we just bought back from Petrohawk," he said.

Another lesson learned from the Mission days was to "stay away from the offshore," joked Piacenti. "It costs about four times as much to do something offshore as it does to do it onshore," he explained.

"Weather, hurricane issues – if something goes wrong you have to get helicopters, boats, etc. You can get a similar production profile with your deep onshore Texas assets with the same high-rate wells, and you can get to it in a pickup truck," he added.



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All the years working together and the collective experiences have led to a circle of trust that is unwavering. "We are a team when we make decisions. All of us came together to make the decision to do this deal. There was a lot of effort involved, and if one person said they didn't want to, we wouldn't have done it," said Piacenti.

As history shows, the team decided to go for it. "We felt if ever there was a time to do a deal like this, this was the deal," he stated.

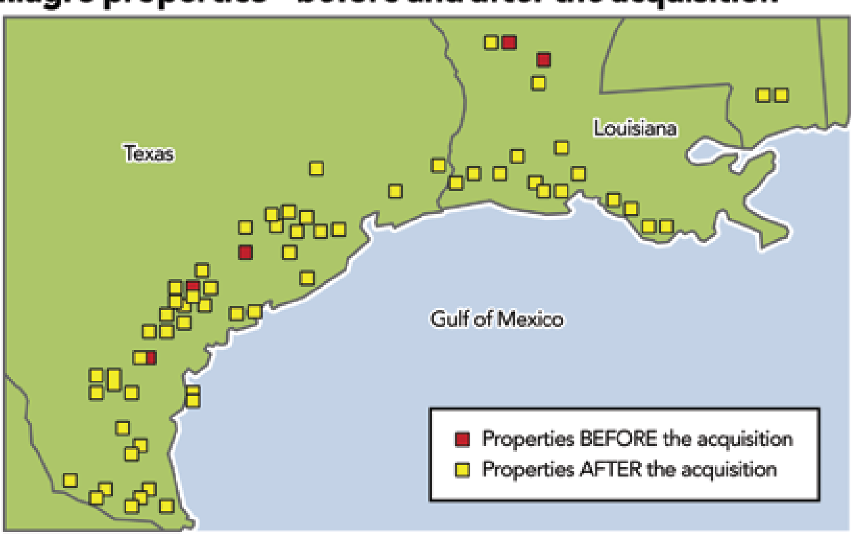
"The" deal Cavnar's relationship with Petrohawk's CEO, Floyd C. Wilson, may well have been the catalyst that got the wheel turning. That relationship and the fact that Milagro was a partner in a handful of Petrohawk wells gave Cavnar the 'head's up' that the company was looking to sell the Gulf Coast assets.

A few unnamed private and public companies were also after the assets. According to Cavnar, the valuations put on the assets by these companies were closely grouped below the number the Milagro team put up. "We had the best number," he assured. With that, and the previous association with Mission, and subsequently Petrohawk, the A&D decision-makers put their trust in Milagro. "The Petrohawk guys knew we had the ability to close the thing," said Cavnar.

The opportunity came about when, after a number of other transactions, Petrohawk decided to transform itself into an MLP base that involved longer-life, relatively low-return, but very steady cash flow low-capital type properties like those in West Texas, Oklahoma, Kansas, etc. In order to facilitate this transition, Petrohawk needed to sell off the properties that didn't match those criteria – the Gulf Coast.

Being a private company, those were the type assets Milagro was interested in. While many companies prefer the longer Reserves Production (RP) ratio of 10-12 years, the guys at Milagro didn't mind the relatively short, seven-year RP ratio. "It was ideal for us because we saw a lot more value in those properties as a stand

Milagro properties – before and after the acquisition



alone company than Petrohawk shareholders saw as part of an MLP structure," said Cavnar.

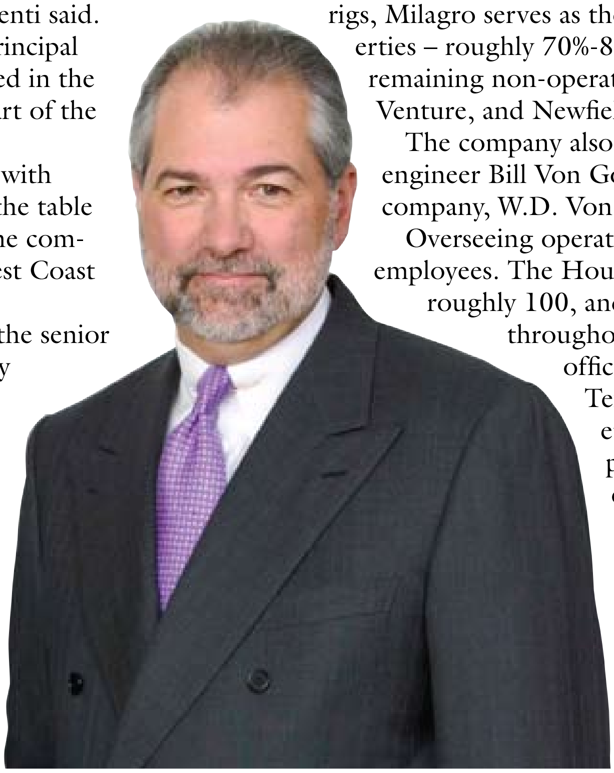
The stage was set and the Milagro team went to work. They started by calling up Jon Hughes and Randy King at Merrill Lynch who represented Petrohawk. Both were formerly with Petrie Parkman when Cavnar and Piacenti called upon them to help turn Mission around. Guggenheim was another player in the Mission days. "They came in and helped us restructure the balance sheet by representing us on a high yield debt issue and leading a second lien debt facility," Piacenti said. In addition, the Guggenheim principal Todd Boehly was already invested in the small Milagro, so was already part of the equity team.

Piacenti credits Guggenheim with bringing the other investors to the table and making the deal happen. The company brought in ACON and West Coast Energy Partners.

In addition to Guggenheim, the senior credit facility was co-arranged by Wells Fargo and Porter & Hedges LLP acted as the company's outside legal counsel.

The lead equity investor for Milagro was Washington, DC-based, and Texas Pacific Group affiliate, ACON. Jon Ginns was the principal ACON contact who worked closely with Cavnar and Piacenti in coordinating the large amount of financing needed to secure the assets. Ultimately, the small, privately-held exploration and production company prevailed and purchased Petrohawk's Gulf Coast Division in late 2007.

Roughly a third of the properties being sold by Petrohawk were previously owned by the guys now buying them back. "We knew the assets so well; it was a once in a lifetime opportunity. It gave us the opportunity to grow very quickly to a very competitive size without the traditional learning curve. We even knew the people. Many of the people we got in this deal worked for us before," beamed Cavnar.



"We knew the assets so well; it was a once in a lifetime opportunity. It gave us the opportunity to grow very quickly to a very competitive size without the learning curve of learning the assets. We even know the people. Many of the people we got in this deal worked for us before." **—Bob Cavnar, CEO of Milagro Exploration.**

Current operations and production

Milagro now owns in excess of 264 bcfe with an additional 400 risked bcfe of potential reserves identified on the 162,700 net acres owned or controlled by Milagro.

Currently, the company is producing just over 100 MMcfe/d, primarily onshore (see map), and expects that number to grow. The few offshore assets held by the company are minor and slated to be sold. Production consists of roughly 75% gas and 25% crude.

All production work this year has been done through an average of five to six rigs – all contracted. The company owns no rigs. "I like sticking to what I understand. Even though I've worked on drilling rigs for years, I'd just as soon not own them," said Cavnar.

While it may not have a full stake in company-owned rigs, Milagro serves as the operator in most of its properties – roughly 70%-80%. Some of the partners in the remaining non-operated properties include El Paso, Venture, and Newfield Exploration.

The company also utilizes the services of reservoir engineer Bill Von Gonten and his Houston-based company, W.D. Von Gonten & Co.

Overseeing operations for Milagro are its 135 employees. The Houston headquarters employs roughly 100, and the rest are scattered throughout the company's four field offices in Edinburg, Tex.; Victoria, Tex.; Giddings, Tex.; and Lafayette, La. Many of the oil and gas professionals, including geoscientists, engineers, and landmen now employed by Milagro were formerly employed by Petrohawk and before that Mission. Similarly, the Lafayette and Giddings offices were part of the original Mission assets.

Challenges

According to Piacenti, the structure of the deal itself wasn't as complicated as dealing with the number of players involved. "There were three different equity providers and two debt providers so we're basically negotiating with them all time over most of the same agreements," said Piacenti. "Basically we had seven sets of lawyers on every agreement we were looking at," he continued.

Looking back, Piacenti noted that even the negotiations weren't the most difficult part. The real 'wrench in the spokes' was the short timeframe in which to get the deal done. Work on the deal began around Labor Day. Petrohawk's bid deadline was Sept. 26 and the bid had to be good through Oct. 10. "After our offer was accepted we had from Oct. 16 to Nov. 30 to close the entire transaction," he continued. The guys at Milagro performed all the due diligence work, formed all new partnership documents with three new equity providers, secured two debt

Milagro geostaff reviewing maps.
Photo courtesy of Michael Hart, Hart Photography.

deals, and produced a seller note with Petrohawk –all in six weeks. The guys "worried every day" wondering if they'd pushed enough to get it all done in time. "Without Tom's [Langford] help, we could not have gotten through all the agreements," said Piacenti. Langford served as Mission's senior vice president - general counsel and continues to serve in the same capacity at Milagro.

Once the deal was done, another bump in the road was staffing the 'back office.' "This was an asset deal, not a company. The deal came with zero back office," said Cavnar. While many familiar production faces came along with the transaction, the accounting and back office stayed with Petrohawk. Still on a roll from the fast-paced dealings, Piacenti pulled another trick out of his hat and hired a back office in 60 days.

The challenge now is one on the minds of many in the industry, employee recruitment and retention. (See "Industry facing critical shortage of engineers, other professionals," Oil & Gas Financial Journal, October 2005 and "Schools, companies talking shortage of energy professionals," Oil & Gas Financial Journal, September 2006.) For Milagro, the main concerns are keeping landmen in front of the rigs, and finding skilled engineers – especially reservoir engineers.

When looking for field folks, the company usually recruits based on experience and geography. According to Cavnar, some of the land is complicated and skilled manpower is a must and Milagro has it.

Looking for engineers has also proved a challenge. "The big firms have gobbled them up. It makes it tough for an independent, but we have a way of finding the people we need," said Piacenti, who believes it is imperative to create a favorable working environment. With a management team that "speaks straight" to employees, a casual dress code (Hawaiian shirts? Check!), a 9/80 schedule that enables employees to have every other Friday off and fairly standard pay scale with management pool units provided to all, the atmosphere at Milagro makes a good case for a "good quality of life, and a fun place to work," Cavnar reiterated.

Finally, when searching for top-level professionals, "we tend to go after more gray hair," joked Cavnar, "This is a business that requires a lot of experience so we go after those folks." The company does elicit the services of a headhunter, but also recruits based on personal relationships. "We recruit because we know them; it goes back to knowing folks in the industry," explained Cavnar.

Future

Milagro has proven it can move and grow quickly. The trend looks to continue with a 2008 CAPEX budget of roughly $200 million. While the company says it does intend to grow through the drill bit, the guys are looking for 'quick hits' it can make with strategic acquisi-

Milagro geostaff viewing maps on the 'map wall.'
Photo courtesy of Michael Hart, Hart Photography.

tions.

Cavnar and Piacenti have been involved in both private and public companies, and recognize the strengths and challenges in both. While they acknowledge the flexibility and patience that accompany the private side, they don't feel one is easier than the other.

Once again, relationships and communication are key. When operating a public company, you must have a relationship with the SEC and the analysts. Running a private company requires developing a rapport with the private equity investors. In each case, they want to be "continuously updated and know what you're doing," said Cavnar.

Having experienced both sides, is an IPO on the horizon for Milagro Exploration? According to Cavnar, "If the best thing is to go public, we'll go public, if someone comes along with a lot of money and it makes the best sense for the equity holders we would do it. We really don't care…we're not in this for a job. We're in this to build value for our investors," he stated.

After mentioning the possibility of selling the company, Cavnar talked of the possibility of keeping the company private. "If staying private makes sense we'll stay private. If the opportunity for a merger comes along…we'll go whichever direction brings the most value. If someone comes in and can do a better job, great, if I can run it better, I'll do it. We'll respond to the market when its time to respond."

How's that for coming full circle? OGFJ

Have a comment or an idea about the future of Milagro? Email me at Mikaila@PennWell.com

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