The Interview - Derren Geiger, Cornerstone Acquisition & Management: “We maintain a long-term bullish outlook on energy-related commodities”

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Derren Geiger, chief operating officer of Cornerstone Acquisition & Management and portfolio manager of the Caritas funds, which invest in portfolios of private oil and natural gas royalty interests located within the continental US, says a number of factors make this a particularly advantageous time to acquire oil and gas assets.

GFM: What is the background to your company and funds?

DG: Cornerstone Acquisition & Management was founded in 2004 with a mandate to acquire and manage portfolios of private oil and gas assets for the Caritas funds. Cornerstone comprises a diverse and experienced team of finance and career oil and gas industry professionals. I lead a team of seven members who have spent the last five years evaluating, acquiring and managing more than USD100m of private energy assets.

The Caritas funds invest in portfolios of private oil and natural gas royalty interests located within the continental US. Cornerstone focuses its acquisition and management efforts wholly on onshore in long-life, low-declining conventional basins and reservoirs. Cornerstone targets annualised returns of 10 to 15 per cent through oil and gas production cash flow receipts, hedging receipts and payments to mitigate the impact of commodity price volatility on monthly yield, and underlying portfolio appreciation and depreciation.

The Caritas funds comprise the Caritas Royalty Fund, launched in July 2004 and with current assets under management of USD12.5m; the Caritas Royalties Fund (Bermuda), also launched in July 2004 with assets of USD38.4m; and the Caritas Royalty Fund II and Caritas Royalties Fund II (Bermuda), both launched in September 2005 with USD10.6m and USD14.4m in assts respectively.

Centaur Performance Group is the investment manager of the Caritas Royalty Fund and Caritas Royalty Fund II, while Centaur Performance Group (Bermuda) is the investment manager of the Caritas Royalties Fund (Bermuda) and Caritas Royalties Fund II (Bermuda), while Cornerstone Acquisition & Management Company, which shares ownership with Centaur Performance Group, is portfolio manager/investment consultant for all four Caritas funds and manages all investment aspects and operations of the funds.

I joined Cornerstone in 2005 after serving as a senior analyst at Preservation Capital Management, a commodity-focused hedge fund manager. At Preservation, my responsibilities included analysing and recommending investment in companies within the commodity and cyclical sectors, including energy, metals, agriculture and chemicals.

Previously I was a senior consultant with American Express TBS in corporate finance, directing numerous privately-held and public company valuations, having performed business valuation appraisals for corporate litigation matters and distressed company situations at Navigant Consulting.

GFM: Who are your key service providers?

DG: Our auditor is Rothstein Kass, our US legal counsel is Holland & Knight and our offshore legal counsel: is Conyers Dill & Pearman. Our administrator is GlobeOp Financial Services, while banking and hedging services are provided by BNP Paribas.

GFM: How and where do you distribute the funds? What is the profile of your client base?

DG: The funds are distributed to qualified investors worldwide through Caritas onshore and offshore Caritas investment vehicles. The client profile of the funds is diverse, incorporating investment capital from both institutional clients (pensions, endowments, funds of funds an d investment companies representing some 19 per cent of assets under management), private clients (high net worth individuals and family offices, making up around 44 per cent of assets) and employee capital (some 37 per cent).

GFM: What is your investment process?

DG: Cornerstone targets royalty interests that are located 100 per cent onshore in long-life, low-declining, conventional basins and reservoirs. Cornerstone avoids offshore and Gulf Coast assets due to the potential for negative implications relating to weather, primarily hurricanes, which can significantly reduce oil and natural gas production and cash flow. Cornerstone focuses on assets and geographical areas where it is relatively cheap to extract the commodity and that possess adequate well performance for historical assessment and confident forecasting.

Cornerstone evaluates several potential acquisitions on an ongoing basis. As portfolio manager I initially screen all potential acquisitions to assure they possess the desired qualities. Assets that pass the initial screening process face a multi-faceted qualitative and quantitative assessment by the entire Cornerstone team.

There are four integral parts of every oil and gas investment: origination, due diligence, bidding/acquisition, and closing. In origination, Cornerstone's business development efforts and status within the oil and gas community lead to both internal, relationship-based deal flow and external deal flow through divestment and auctions.

Once properties are brought in-house for analysis, Cornerstone employs its due diligence effort that includes general, financial engineering and land analyses. The first involves a general overview of the assets being offered, including the basins where they are located and the operators developing the properties.

If the properties are located in areas that Cornerstone initially finds attractive with strong operators, continued due diligence will take place. Cornerstone evaluates property packages from all parts of the oil and gas spectrum, but due to its stringent requirements only a small proportion of packages pass general analysis and move into financial analysis.

During the financial stage, Cornerstone's analysts load all of the available historical production numbers and future assumptions into proprietary models. Running different commodity price stress scenarios at various acquisition costs, the analysts determine whether the sellers' expectations are reasonable, and whether the opportunity warrants a full engineering analysis.

Upon running the financial models, Cornerstone's engineering team will assess historical reservoir performance, well-hole pressure, lifting costs, water disposal, area studies and geological implications. On larger packages involving hundreds or thousands of wells, a third-party engineering firm may be contracted to assist in the analysis. If the engineering team recognizes value within the asset, it moves into the final stage of land analysis.

Once Cornerstone decides to bid on a property, the land team analyses how best to negotiate the closing. The team confirms that the seller has proper title and determines how the properties will be conveyed to Cornerstone if it reaches an agreement. Once the property has passed the extensive due diligence, a purchase and sale agreement is drafted and price negotiations begin.

GFM: What is your approach to managing risk?

DG: Cornerstone mitigates risk by adhering to property discipline, acquiring assets that are relatively conservative, diverse and predictable. Acquisition discipline involves ‘buying right’ through proper modelling and commodity price stress-scenario forecasting. When acquiring a portfolio of properties large enough to potentially launch a new Caritas fund, an independent petroleum engineering company will analyse the properties, as will BNP Paribas, to determine how much they would lend in order to acquire the assets. A third aspect is prudent hedging, locking in forward fixed commodity prices over months or years to minimise return volatility.

While risk management is primarily monitored by the portfolio manager on an ongoing basis, Cornerstone has instituted an investment committee that meets routinely to review potential portfolio and fund-related risks.

GFM: How has your performance compared with your expectations?

DG: Cornerstone’s objective is to generate net returns of 10 to 15 per cent per annum for the Caritas funds, although the Caritas strategy has generated average annualised returns in excess of 20 per cent since launch. Cornerstone maintains a long-term bullish outlook on energy-related commodities, justifying no imminent changes to the overall strategy of the funds.

GFM: What opportunities are you looking at right now?

DG: At present, there are a number of excellent opportunities in terms of acquiring oil and natural gas assets for differing reasons. On the natural gas side, we are seeing a significant amount of acquisition and divestiture activity with a currently depressed natural gas price. Some of the largest acquisitions over the last year have centred on natural gas shale exposure as the ultimate amount of extractable volumes are massive and, at lower natural gas prices, can be purchased at a relative discount.

Cornerstone focuses on the other end of the spectrum, choosing to acquire and manage conventional gas assets. Large, publicly-traded energy companies need to deal in large volumes to move the return performance needle – we don’t. With those large volumes come large expenses and large risks, elements Cornerstone tends to shy away from. As the new shale plays garner more of the attention, exceptional opportunities have developed to purchase attractive conventional gas assets from those selling non-core assets.

On the oil side, domestic oil-focused rig count is at a nearly two-decade high, which is an indication of confidence in sustained elevated prices. Capital expenditures have increased among exploration and production companies, which often look to sell royalties to help fund drilling operations with a higher risk/reward profile.

Finally, a positive impact for the entire whether market over the past year has been access to capital. As the lending market has thawed, deal flow has returned in earnest.

GFM: What events do you expect to see in your sector in the coming year?

DG: We believe deal flow will remain robust going forward, allowing Cornerstone the opportunity to significantly add to its asset base. In terms of commodity prices, crude oil has for quite some time been highly correlated to the broad equity indices, trading more as a financial asset than a consumption commodity.

This trend will probably continue with supply/demand fundamentals determining floors and caps with regard to the respective price range. As inflation currently remains in check, the near term provides an attractive time to increase exposure to hard assets – prior to potential currency and inflationary headwinds anticipated over the next several years.

Deal flow should be equally strong for natural gas-weighted assets. Recent price weakness has granted those with a bullish long-term view the opportunity to acquire assets prior to any expected natural gas price and/or asset value advance. Near term, the US is working off a supply overhang as a result of industrial demand deterioration combined with uncharacteristically mild seasonality.

The onset of the large shale plays has also placed pressure on prices, but a few stars are aligning for potentially higher prices in the months ahead. The hurricane season has kicked off with the most active storm forecast since 2005, and summer cooling demand has been boosted by the warmest June on record in several parts of the US. The drilling moratorium in the Gulf of Mexico will curtail some offshore gas supply, and onshore regulation in the shale plays appears to be tightening as a result of recent blowouts and spills, which could begin to inhibit onshore supplies.

Any of these factors has the ability to push natural gas prices higher in the near term. On a long-term basis, natural gas is gaining significant market share in relation to coal for electricity generation and is increasingly making headway in the mass transportation sector.

GFM: How will these developments affect your own portfolio?

DG: The current developments within the oil and gas markets are viewed as very positive for the Caritas funds. As deal flow steadily improves, Cornerstone will look to add aggressively to the underlying asset base. Active development continues within the acreage footprints of the current portfolios, providing continued growth within the existing Caritas funds. Furthermore, Cornerstone fully expects to take advantage of commodity price opportunities to add to our multi-year hedge positions in order to protect future returns.

GFM: How do you assess investors' current expectations?

DG: Investors are generally very upfront concerning expectations of Cornerstone. In general, our investor base places a high value on transparency and consistency. The Caritas strategy is quite unique, which requires investors to spend more one-on-one time with management regarding the strategy, the assets and the Cornerstone team. We have found this beneficial in fostering the relationship on both sides.

Caritas' investor base tends to be sticky. Once investors enter any of the funds, they tend to be long-term holders, and we believe communication is a primary reason. In June 2009, the Caritas funds experienced their only significant drawdown. Management clearly communicated that the performance was due primarily to temporary dislocations in the market, which would soon normalise and place the funds on a path for continued growth, and backed up that position by investing significant amounts of their own capital into the funds. Those investors that chose to remain in the funds have been rewarded with a year-on-year return of approximately 25 per cent.

GFM: What differentiates you from other managers in your sector?

DG: The Caritas funds provide energy and hard asset commodity exposure in a relatively liquid, low-volatility investment vehicle that is not overly correlated with the broad equity indices or spot commodity prices. Cornerstone provides experienced and prudent asset management, with interests directly aligned with investors. For a fund that invests mostly in private market assets, our liquidity terms are very generous: one-year lock-up, and semi-annual liquidity with six months notice.

GFM: How do you view the environment for fundraising over the coming 12 months?

DG: Investors are seemingly caught in the headlights, not knowing which way to turn. European sovereign debt contagion, double-dip recession fears and the 'everything is correlated' phenomenon are weighing on most investor's portfolios. That said, we expect a positive fundraising environment for the Caritas funds over the next 12 months due to our recent and long-term performance, low volatility of returns, and low correlation to other asset classes.

Cornerstone is proud that we were able to navigate our way through the first half of 2010 minefield, especially in an environment where energy-focused funds across the globe have suffered, with the average fund in the sector down 2 per cent through June and several shutting their doors for good.

GFM: Do you have any firm plans for further product launches?

DG: We plan on continuing to make acquisitions of royalty interests that adhere to our stringent requirements. Smaller, more frequent acquisitions will be bolted onto the existing Caritas portfolios, whereas a property package of significant size would likely lead to the launching of a new Caritas fund.

- Fund Manager Interviews

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