



From the Ground Up

A great idea for a company is nothing without a great financing structure and a means to adapt

The Company: Scavenger Energy has a plan to extract bypassed hydrocarbons from previously producing, shut-in wells. Big energy players regard these deposits as uneconomical pockets of “leftover” oil and gas. Raza Hasanie, Scavenger’s founder, CEO and sole employee, sees them as an opportunity for the taking.

The Situation: The company is currently nothing more than a business plan. Hasanie has no significant assets and no track record as a CEO. He needs a financing structure that will support his company’s launch, satisfy investors’ concerns about a business led by a rookie entrepreneur and reward him fairly if it succeeds.

ON THE KITCHEN COUNTER of Raza Hasanie’s Calgary home, there were a dozen neatly bound copies of a business plan, ready for distribution to prospective investors. Hasanie, a geologist, had developed the business concept while studying for his MBA.

The plan outlined an oil-and-gas opportunity that could exploit suspended wells to yield a five times to 15 times return on investment, and called for roughly \$1 million in seed-capital funding. The business model was a common one for hundreds of small-scale companies and independent operators: Scavenger would bid on mineral rights for sites with intact wells, equipment and infrastructure left over from previous drilling activities, and extract smaller deposits left behind by large-scale exploration and extraction operations. These bypassed opportunities weren’t individually big enough to meet the investment hurdle rates set by large energy firms, but

could offer excellent returns for a company ready to pursue many bypassed wells in parallel – precisely Scavenger’s business model.

But there was a hitch: The company existed only in the pages of Hasanie’s business plan. Scavenger Energy had no employees, no operations and no customers. Its CEO, freshly graduated from business school, had no resources of his own to invest in the

This case study was jointly prepared by the Centre for Business Venturing at Queen’s School of Business and *Financial Post Business*. Case studies are an important element in the transformational learning method used at Queen’s School of Business

firm. In fact, Hasanie was still working a day job at IBM's geological software group. And while he was a skilled earth scientist, he had no experience leading a start-up company.

Hasanie needed to work his personal networks to get in front of investors. But even if he could find angels to pitch to, it would be a tough sell: The young entrepreneur would be asking investors to take a million-dollar gamble on an unproven founder with little to offer but some technical know-how and an idea.

HASANIE'S FIRST CALLS were to a handful of well-connected supporters. While completing his MBA at school in Ontario, he pitched the Scavenger concept in a pair of business-plan competitions, netting him some \$15,000 in prize money and providing an introduction to two seasoned angel investors and an Ottawa venture capitalist. The VC provided Hasanie with introductions into a small circle of Ottawa investors, to whom Hasanie made his first pitch.

That pitch took place in the national capital during the summer of 2004. Not one potential investor could boast of any experience in the energy industry, but everyone's ears perked up when a particular phrase rose above the technical lingo: "5x to 15x returns."

The story they were being told was about overlooked opportunities. There were millions of barrels of oil left behind in the Alberta oilfields, Hasanie explained to his audience, ignored and all but forgotten by Canadian energy companies. Hasanie himself had exploited one of these wells while with a small Calgary firm, and turned the company's \$30,000 investment into \$300,000 in natural gas production.

It wasn't just dumb luck: With the right software and technical expertise, public-domain information could be used to zero in on only those wells with a high chance for hydrocarbon recovery. Hasanie did enjoy some good fortune

too, however – because the oil and gas industry is built on high risks and stratospheric rewards, few energy-industry titans were eager to pick through the modest remains of shut-in wells when they had larger, more attractive opportunities to pursue.

The only people interested in these overlooked opportunities were independent operators and very small-scale companies, which would pursue wells individually and within certain geographical boundaries – the oilpatch version of a lifestyle business. Each individual well would ultimately yield under half a million dollars – enough to keep slow-growth individual operators comfortable, but far less than needed to attract the interest of the energy giants. By pursuing large numbers of these small opportunities, Hasanie hoped to develop a low-risk, high-margin business – profitable after the first operation, and reaching after-tax net annual income exceeding \$3.5 million by the third year.

The Ottawa investors followed up Hasanie's pitch with several rounds of meetings and due diligence. Their interest had been piqued, and by the end of the summer, they had informally committed \$500,000 in financing to launch Scavenger.

THAT HALF-MILLION WOULDN'T be enough. The same summer, in parallel with his Ottawa meetings, Hasanie met with a number of Calgary oil-and-gas investors and consultants, hoping they'd validate his concept and maybe lead him to some industry "grey hair" who would join his advisory board. Following a meeting with one energy-sector private equity lender, Hasanie dashed off an e-mail to a former professor, a trusted adviser. "He's concerned that I'm only looking for \$500K," he typed. "He was thinking upwards of \$5 million would be needed. I'm not sure we need that much, but he did make some good points about the cost of

delays or problems in the field. The first shut-in well I did with my previous company went flawlessly, so I hoped Scavenger would have similar luck. That might be a bit naive."

Scavenger's approach was incredibly economical, avoiding the immense costs of drilling, testing and surface-rights negotiation usually borne by traditional exploration companies. "We're not even going after low-hanging fruit," Hasanie joked in his presentation. "This is picking up the berries off the ground." But Hasanie quickly discovered that everyone felt he needed more – whether it was oilpatch veterans saying \$5 million or his conservative advisers in Toronto, who suggested a minimum of \$2 million.

Scavenger's expenses would come from its analysis process, land purchases, facility-use negotiations and the cost of extraction. Using publicly available data, Scavenger would identify sites with the right mineral rights and infrastructure available, and then select those with a reasonably high recoverable amount of natural gas. With sites identified, they would bid on the land in an auction, negotiate usage rights for the facilities and hire independent contractors to reopen the well. Commodity price increases could lead to volatility in labour markets and in auction prices for mineral rights. Moreover, it was entirely possible that problems with decades-old well equipment could push up costs. "I do need to take into consideration that field problems will ultimately occur," Hasanie wrote to his adviser, "and I should be prepared to 'spend' my way out of trouble when needed."

Hasanie worked in consultation with his advisers and experts to arrive at a more realistic target for his fundraising. After three rounds of revised financials, it was clear he would need to expand his financing round beyond his early supporters in Ottawa – and would need to be seeking some \$2 million in financing, with at least \$750,000 in the immediate term.

INNOVATIVE IDEAS.
RELEVANT EXPERTISE.

HASANIE RETURNED, HAT IN HAND, to his alma mater. He met with prominent alumni over drinks at the storied National Club in Toronto and was reunited with one of the judges from his business-plan competition. That judge, a serial entrepreneur and angel investor himself, wanted to help: "What I wanted to do is to give the business a chance to succeed," he explains. "So I helped him get the right supporters with the right resources." With Hasanie ready to seek a larger and more complicated financing deal, he'd need top-notch legals. The B-plan judge introduced Hasanie to a senior partner and the

family and close friends were all willing to invest, but the angels were not necessarily keen on that idea: It would secure founder commitment, but it would also add complexity and risk to the capitalization structure. The investors were concerned that a cluttered list of investors would make governance and the structure of an eventual exit more difficult.

Secondly, the investors were nervous about the lack of operational experience – Hasanie had never run a company, they noted. Lacking oil-and-gas experience themselves, they wanted a director from the energy industry, some-

The Outcome

THE SOLUTION CAME FROM a prospective investor, a private-equity fund manager, who floated the idea of a limited partnership structure. In such an arrangement, the general partner, which would bear all the venture's liabilities, would be a thinly capitalized company incorporated in Delaware. Each of the angel investors would be a limited partner (LP) – and all the small friends and families would pool their resources through a subscription agreement to

Hasanie had no "skin in the game." He had sunk a few thousand dollars into registering his business and doing research, but the investors wanted to see more on the line for the young CEO

chair of Stikeman Elliott, a white-shoe Toronto law firm. The partner agreed to help Hasanie with complimentary legal work.

Hasanie's new evangelist also helped introduce him to potential investors. Meeting at his alma mater's satellite office in downtown Toronto, Hasanie pitched to a host of high-profile business leaders, venture capitalists and angel investors. They, too, were attracted by Scavenger's risk-and-reward profile. But they also had a range of serious concerns.

First, Hasanie had no "skin in the game" – he had sunk a few thousand dollars of B-plan prize money into registering his business and doing preliminary research, but the investors wanted to see more on the line for the young CEO. Hasanie noted to the investors that his

thing Hasanie hadn't been able to secure.

Finally, there was a considerable challenge in terms of ownership and founder incentives. While there was interest on all sides to keep the founder happy and focussed on growing the business, the angels couldn't justify giving the founder a fifth of the business simply for having the idea. They needed Hasanie to invest upfront – or find a way for him to earn his equity stake.

Hasanie, grappling with the feedback from investors, wrote again to his former professor to convey his concerns. "It looks like my ownership of the company is going to be significantly reduced from what I had expected," he confessed. "Once the investors and lawyers get their hands into the agreement, my stake is going to be pretty diluted."

form the last LP. Corporate lawyers drew up the structure, drafting the limited partnership agreement and subscription letters. The investors agreed to a structure where Hasanie could gradually earn his equity, which worked as follows: At inception, the corporation would be issued a promissory note by Hasanie in exchange for an equity stake in the company. As the founder met his milestones, the amount owed under the note would decrease. Once the company had a "liquidity event" – a sale, IPO or conversion into an income trust – Hasanie would be able to cash out by converting his shares.

The financiers' investment into Scavenger would be made in three rounds, based on the achievement of key identified milestones – targets based on things like the number of land

Each year, our companies work with thousands of entrepreneurs and business owners to help them pursue their dreams. If you're like the companies featured in the Financial Post Business New Ventures Case Series or you're launching a company, expanding your business or exploring new products, services and markets, look to our companies for the resources and experience to guide your growth and success.



BDO Dunwoody LLP
Chartered Accountants
and Advisors

www.bdo.ca | 1-800-805-9544



www.rbcroyalbank.com | 1-800 ROYAL® 2-0

purchases and number of operating wells Scavenger could accumulate. The larger angels would place additional financing into the company at each capital call, while the smaller investors would place their full investment into a trust account to be disbursed to Scavenger as capital calls were made. This arrangement ensured that smaller investors could be included without the usual concerns about failure to contribute to future financing rounds.

The structure of the Scavenger deal was a neat manoeuvre. It allowed Hasanie to have a serious stake in the company's future without the investors overpaying in equity for the idea alone, and it allowed him to earn his equity without any significant resources upfront. The staged-financing approach meant that investors were only on the hook to contribute so long as reasonable progress was being made, helping to attenuate the risk of an inexperienced CEO. It brought \$200,000 from small investors to the table, aggregated into a manageable single unit within the limited partnership. In short, the deal's structure allowed investors to be confident in the opportunity, fed adequate amounts of cash into the company and kept the interests of financiers and founders carefully aligned.

The first round of financing closed in May 2005. It seeded the company with \$750,000 and committed the investors to two additional rounds based on milestone attainment, for a total of \$2 million.

A YEAR LATER, Scavenger faced a very different market than the one imagined in Hasanie's original business plan. The white-hot energy sector had driven land sale prices through the roof. Mineral rights could cost as much as five times what Hasanie had anticipated, as companies aggressively sought out new prospects and large energy conglomerates defensively purchased lands adjoining their large operations. The independent contractors needed to start and operate the wells were in high demand and short supply, making staffing a serious concern.

On the flip side, refinements made by Hasanie to his prospecting software could help the young company take a stab at a far larger and more lucrative play. With higher costs and the potential for larger-scale projects, Hasanie's next challenge would be deciding whether to stick with his original low-risk ethos, or to follow the go-big-or-go-home ethic currently driving the bullish Canadian energy sector.

The Expert View

By Susan Eaton

Vice-President of Exploration
Darian Resources Ltd.



I LOVE THE SCAVENGER NAME. It succinctly communicates the company's focus on capturing bypassed oil and gas deposits. The extraction of bypassed deposits that Hasanie's plan focussed on tends to be lower-risk and less capital-intensive than new drilling. Hasanie has only just had time to get the business rolling, but he's already facing a problem that afflicts many young companies. In short, he's finding that the realities of the industry today are dramatically different from those on which he based his business plan. In Hasanie's case, land prices have soared, while the upturn in the energy market has meant that fewer companies are leaving hydrocarbons in the ground, making the hunt for opportunities more competitive.

Let me start with a few observations in hindsight. If Hasanie had found a director, adviser, mentor or energy-industry "grey hair" early in his planning process, he might have been alerted to the risks of commodity price cycles. A veteran director or adviser might also have helped to set realistic financing goals early on, and might have opened doors to Calgary and Vancouver investors. This could have put money into the company faster and earlier, and given Hasanie a chance to exploit this opportunity before the prices began to skyrocket.

That said, it's not too late for Hasanie to start adding more talent and "grey hair" into Scavenger Energy. The increase in land prices means that Hasanie needs a well-connected veteran more than ever. If he wants to pursue projects without having to compete for land in a hot market, he'll need to aggressively seek out joint venture partners who already hold the

mineral rights to the land. The networks and technical ties a veteran could provide would prove invaluable in this search process.

The second person Scavenger needs is an experienced and pragmatic engineering vice-president. Whether added as an employee or a partner, Hasanie needs to supplement his geological know-how with someone who is experienced in screening the field infrastructure and evaluating the economics of business opportunities. In my experience, approximately one in four well recompletions fail – or experience significant cost overruns – due to mechanical malfunctions or unforeseen problems with the borehole. With only \$2 million in his pocket, Hasanie doesn't have much flexibility to deal with failures. He needs a drilling and completion engineer who can bridge the gap between head office and the contractors in the field.

Hasanie's investors were wise to set a series of hurdles for him to unlock his subsequent financing. Seeing progress on projects and operations can help to mitigate their risk. Beyond that, however, Hasanie and his backers need to focus on two key industry metrics: finding and development (F&D) costs per barrel of oil equivalent (BOE), as well as operating costs per BOE. These metrics are of primary importance, since they are the yardsticks that will be used by potential purchasers to measure Scavenger's success and to set valuation for a liquidity event.

I very much like Scavenger's LP structure. It's not a frequently used structure in Calgary, though perhaps it should be. Hasanie has managed to bring in small investors without the risk of dilution or diminished appeal for institutional investors. Hasanie is an enthusiastic entrepreneur and has been successful in communicating the opportunity to the "uninitiated" in Toronto and Ottawa. Strong founders and smart structures are tremendously valuable assets, and these will doubtless help Scavenger survive. But if Hasanie wants his new venture to succeed, he needs to expand his network of strategic and technical advice and guidance to include an experienced engineer and a seasoned veteran of the Canadian oil and gas industry.

Note: The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The views represented here are solely those of the case authors and are based on their own professional judgment. Certain names, scenarios or identifying information may have been disguised to protect confidentiality.