Privcap/Briefing

Context for Private Capital Investment

Q4 2014

LP Appetite for Energy

With Experts from Eaton Partners and FLAG Capital Management

LP Appetite for Energy

The past decade's North American energy boom has presented a variety of opportunities for private capital investment. The past five years have seen energy-focused GPs raise unprecedented amounts of capital, with energy taking up increasing space in institutional portfolios. Experts from Eaton Partners and FLAG Capital Management took part in a Privcap webinar discussing investment trends and bright spots for PE in the energy sector, as well as why lower oil prices may present opportunities in some areas.

Jeff Eaton
Partner
Eaton Partners

Eaton leads worldwide origination at Eaton Partners. Previously he was at Constellation Energy Commodities Group, leading principal transactions for their natural gas structuring and trading division. He received degrees from Duke University and Duke's Fuqua School of Business.

Jim Gasperoni
Partner
FLAG Capital Management

Gasperoni oversees the global real assets program at FLAG Capital. Previously, he was managing director of real assets investments for Brown University and part of the real assets investment team both at Princeton University Investment Company and Nassau Capital, a private firm investing on behalf of the university. He also worked at Corporate Realty Investment Co. Gasperoni received degrees from the University of Massachusetts (Lowell), the Massachusetts Institute of Technology, and Boston College, and is a CFA charterholder.

Privcap: We are learning about one of the most exciting opportunities for private equity: the energy market. We have two experts in both LP fundraising and energy, Jeff Eaton from Eaton Partners and Jim Gasperoni from FLAG Capital Management. Why don't we get into the meat of the conversation? Jeff, you have an interesting overview of what's going on in the private equity energy fundraising market.

Jeff Eaton, Eaton Partners: No surprise from everything you've read, [private equity] fundraising has been strong. We're still nowhere near where we were pre-crisis, but we've seen robust growth in the asset class over the last several years.

A lot of this has been driven by the performance of the equity markets over the last several years, causing increased allocations to private equity. Risk appetite's come back, so that's led to a pretty strong fundraising market.

The point I'm trying to show here is that this is energy and infrastructure fundraising. And infrastructure's been kept in here because more and more you'll have an energy component to what they're doing. We had significant growth in overall private equity fundraising; we've had much more significant growth in fundraising for energy and infrastructure.

Jim, based on your firm recently raising an energy fund of funds of its own, can you give us the state of the fundraising market for energy managers?

Jim Gasperoni, FLAG Capital: There is an awful lot of appetite for natural resources more broadly, and specifically for energy.

Today, if you go to a consulting or advisory firm, they have specialist research folks. They are highly attuned to their clients' needs. If you looked at the fund-to-fund universe a decade ago, there'd be far fewer specialist fund to funds like us. So this is also a part of the ecosystem of energy investing that's grown to serve limited partners' needs.

Jeff, based on your experiences helping people raise funds around the world, is excitement something that you're also seeing when talking to LPs about the energy opportunity?

Eaton: Yes, we're seeing robust interest in energy. What we're also seeing is that LPs have gotten more sophisticated, more enthusiastic, spending more and more time and attention on the space. They're getting more specific in what they want.

We've raised several successful energy funds in the last 12 months. When I look at where the success has been, it's with managers focused on more specific strategies. We closed a very successful fund that was oversubscribed that focused solely on deepwater Gulf of Mexico exploration. Ten years ago, it just would've been viewed as too far out there, too niche. And yet that fund was adopted by a broad set of LPs.

To what extent can actual energy operators go out and raise a private equity fund despite not having previously managed a fund? Which of those kinds of energy operators will be able to raise a fund and which will not?

Eaton: Imagine the institutional investor on the other side of the table and operator X comes in with an investment opportunity. With diligence, you can ascertain and validate the expertise of that particular team. You know then you have to take the next step and say, "Where is that particular institution in its portfolio development?" That's something that a lot of managers need to understand Is this is their maiden voyage into private energy? They may tend towards a more diversified platform that maybe has been around for a while, that can demonstrate a number of different metrics about how they can manage third-party institutional capital.

If you turn it around, you have a sophisticated institutional investor that's been investing in the energy space for a while, and they are looking to finely tailor the edges of their portfolio for specific opportunities, specific geographies, or maybe to orient part of their portfolio between oil or gas.

What we have here is a combination of institutions that have been investing in real assets for a very long time, some of which predominantly still have real estate as part of their portfolio. They're now increasing in energy.

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> **"We're reading the headlines about all the big funds raising bigger and bigger funds, but under the radar a bunch of new fund managers are successfully raising funds very quickly, so both can exist."**
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> — Jeff Eaton, Eaton Partners

Jeff, which types of GPs with operating backgrounds will make good private equity fund managers? And which are not quite ready yet?

Eaton: We're seeing more of the most sophisticated energy investors looking to go direct. We're seeing LPs get more comfortable with the asset class. They're getting more experience in it. And so they're looking to get closer and closer to the asset. And oftentimes that means backing an operator and not a fund manager.

While we think that trend will continue, it's not for everybody. And being a good oil and gas operator and a good investor is different than being a good fund manager.

Gasperoni: To his point about the skills that a manager needs to possess to be able to manage third-party capital and institutional contacts, we shouldn't underestimate simplicity. There are diversified energy and natural resources funds that have the full continent of skills. In order to replicate the type of exposure that that can provide with one commitment and one relationship, you might need a half-dozen operator-type relationships. There's a monitoring component to that sort of portfolio that not every institutional investor is set up to do efficiently.

Most private equity people in the energy space that I've spoken to go well out of their way to say that their success/failure is not driven by commodity prices. What would keep a private equity and energy VP up at night if oil prices went a certain way?

Eaton: The good thing is most LPs take a longer-term view on things. Their asset allocations don't change overnight, so we'll continue to see interest in the space.

From a short-term perspective, think about all the uncertainty that's just gone on in a buyer's mind where they're seeing they negotiated a price [for oil] and then, all of the sudden, prices are down 20 percent and maybe going lower. Are they going to get cold feet about sticking to that original price they may have agreed to two weeks ago? I would think they would.

There's no way this does not impact certain things, M&A activity, maybe some stress on some companies in the short term. We'll see managers try to take advantage of that. Why I'm not overly panicked about this, given the fact that we do a lot of energy fundraising, is that LPs are going to be committed to investing in this space because of all the stuff we talked about earlier. So over the medium and the long term, fundraising should remain strong.

During the last global financial crisis, a lot of LPs stopped investing. There was panic, and people basically sat on their hands for a year, if not two. What resulted was people missing opportunities, and it added more volatility to their portfolio. [LPs] realize that they can't just stop investing when volatility increases or risk increases. They may invest less, but they've got to be consistent in making commitments or they're going to miss opportunities.

Gasperoni: When underwriting a private equity opportunity, one of the things outside of a manager's control is the direction and range of energy prices. So you tend to focus on all the other things that, where there's a lever, they can pull. In the situations where you do have declines in energy prices, what you hope is there's sufficient support from a value perspective at the asset level, and that the manager has been able to create some downside protection, whether that's through hedging, through actual operational efficiencies, or through boosting the productive capacity. You would hope that, to the degree that there is diminution in value of your investment, it's not a one-to-one with energy prices.

If you think about building to a long-term target over multiple years, today's decline in energy prices is, in

LPs Earmark for Energy

Jeff Eaton, Eaton Partners

We've seen LPs increasing allocations to energy on a high level. More and more LPs are forming separate energy/natural-resource allocations. Ten years ago, maybe that was part of a general private equity allocation.

It used to be that a lot of international LPs couldn't or wouldn't invest in U.S. energy investments, for instance, because of tax reasons. We're now seeing them actively looking for energy investments. They still face the tax issues, but they're basically coming to the conclusion of "How can we ignore such a large part of global GDP and a lot of the growth that's gone in the U.S.?" So they're now looking at net of taxes, how their returns look. And they look pretty compelling.

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essence, producing the opportunities of tomorrow. On a steady-state basis, the way to smooth out your exposure to energy prices is to invest for the long term.

The largest private equity players are taking on a disproportionate size in the market, although there are many small specialists on the other side of the market. Do both of you see that taking place in the energy private equity market as well?

Gasperoni: There are a couple of valid reasons for a larger energy fund. If you go back a little more than a decade, there's certainly an element of deal inflation. Not simply because you know the multiples being paid have gone up.

If you look at some of the larger funds that are active and think of them as individual verticals, either by geography or by discipline, a $2B fund that invests in power, that invests in upstream oil and gas, that invests in pipelines and storage, is in effect an aggregation of $400B, $500B funds.

It's difficult for very large investors to get comfortable with investing in funds that are lower than $500M from a time-spent perspective. And some of these larger funds serve a useful role for institutional investors in that regard. There are probably pockets of inefficiency at the very small end of the range that other specialist funds can step in and take advantage of. And that's what we're seeing playing out in real time.

Eaton: We're reading the headlines about all the big funds raising bigger and bigger funds, but under the radar a bunch of new fund managers are successfully raising funds very quickly, so both can exist. And that trend will continue.

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> — Jim Gasperoni, FLAG Capital

LPs want different things. As a fund manager gets bigger and a fund gets bigger, an LP who may have been there early and liked them when they were making $50M to $100M investments may not be as interested when they're making $500M or $600M investments. They also might not be as interested because their influence is less, as they've become a smaller portion of the LP capital.

We have a great question about energy investors, which has largely been a U.S.-North America conversation. Are there good opportunities around the world to invest in and back energy managers who are going to make returns that will be competitive with the population of energy managers in the U.S.?

Gasperoni: The biggest issue for opportunity outside the U.S. on a dedicated basis to date has been lack of variety and opportunity to select a high-quality management team, to focus specifically on those opportunities.

Historically, if you wanted to access those opportunities, you're investing with a manager that's sitting in Houston, New York, or maybe London or Toronto. And what we're starting to see is a nascent growth of managers that are focused on those opportunities. That's something that we're keen to keep an eye out for—and that's not just upstream.

Eaton: Again, this gets back to more specialization, more specific focuses, as LPs have gotten more mature. It would be ignorant to just focus on the U.S. The U.S. isn't the only country that's producing oil and gas and other forms of energy.

We're actually seeing a lot more non-U.S. investors looking outside the U.S. The U.S. investors have a narrow-minded focus. And so they focus primarily on the U.S., but we'll see an increasing interest in going abroad. But people have to get comfortable with the legal systems in these countries, with the ability to get money back, with the tax systems. There are a lot of intricacies that go into investing in different countries. ■

Investing for the Long Term

Jim Gasperoni, FLAG Capital Management

It's hard to ignore the excitement that's going on in the U.S. and Canada in the energy markets. There is a view, supported by a lot of credible and capable managers, that there are interesting returns to be had over the next three to seven years.

From that perspective, if you were to tactically or even opportunistically think about ways to enhance your portfolio return over the next five to seven years, whether you're an institution or a high-net-worth individual, there are a lot of reasons, if you have the ability to be selective, to feel like this could be a good time to invest in energy.

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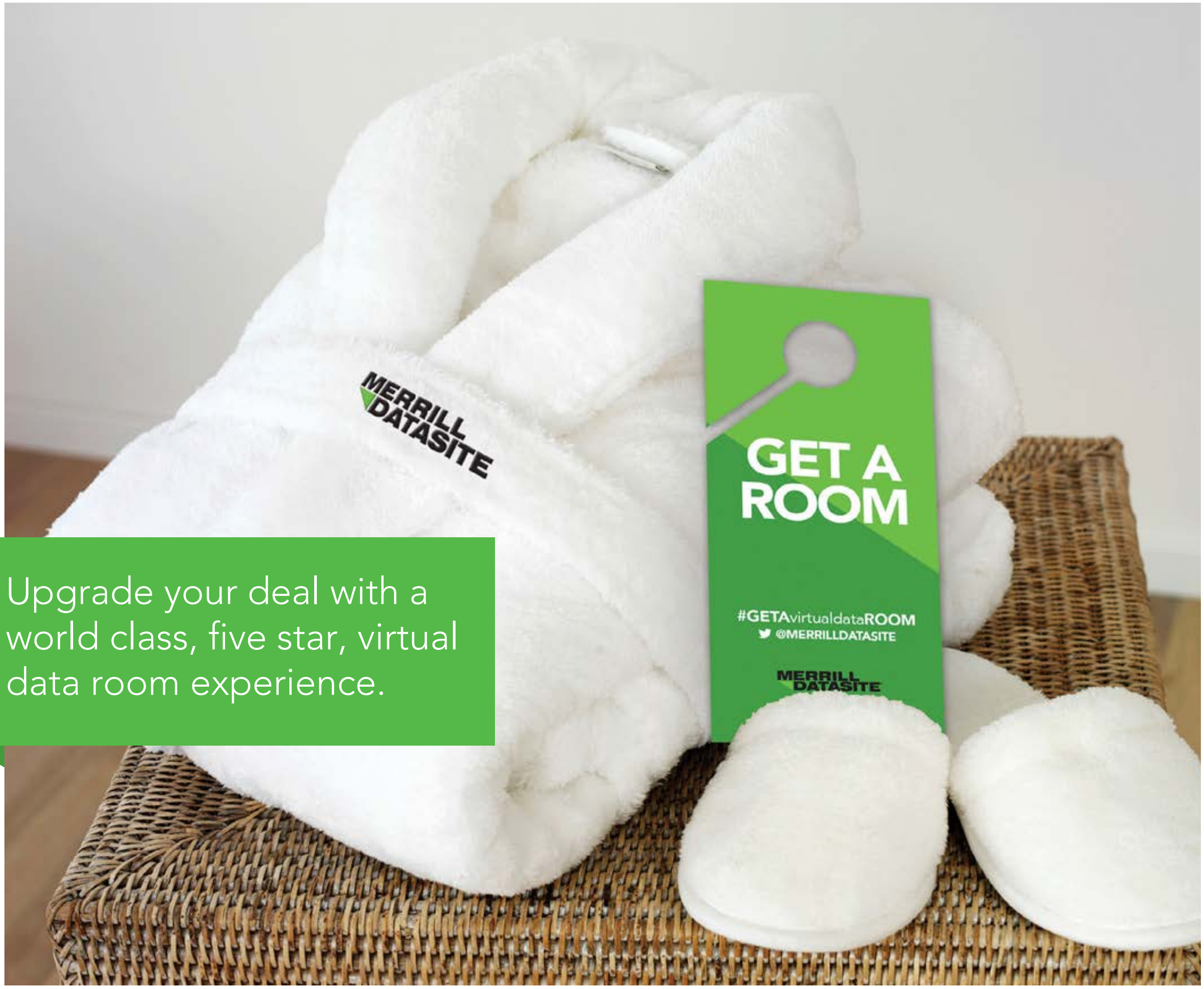

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