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The Economics of U.S. Energy

Two experts examine the impact of energy trends on the U.S. middle market

> "Energy has gone into a very revolutionary phase over a very short period of time."
>
> – John Breckenridge, Capital Dynamics

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> – Joe Brusuelas, RSM

WITH EXPERT COMMENTARY FROM: RSM and Capital Dynamics

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➜The Real Economy: Investing in Energy

Power Play

The dramatic drop in oil prices is having a ripple effect across the economy, creating significant opportunity for middle-market private equity firms. John Breckenridge of Capital Dynamics and Joe Brusuelas of RSM discuss winners, losers, and the impact of the coming "tsunami" of capital.

John Breckenridge
Managing Director
Capital Dynamics

Joe Brusuelas
Chief Economist
RSM

➜ BIO

Breckenridge is a managing director on the clean energy and infrastructure team at Capital Dynamics. Previously he was a managing partner at Bregal Energy, where he led a team focused on power generation and natural-gas-focused investments. He received a bachelor's degree from the University of Vermont.

➜ BIO

Brusuelas produces economic reports for the middle market and key industries within it. Prior to RSM, he served as a senior economist at Bloomberg, director at Moody's Analytics, and chief economist at Merk Investments. He did his doctoral work in political economy and public policy at the University of Southern California and holds master's and bachelor's degrees in political science from San Diego State.

CONTINUES ON NEXT PAGE

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Privcap: We're talking about the middle market and specifically the role that energy plays. How has the energy sector impacted the overall U.S. economy? Are there other ripple effects?

John Breckenridge, Capital Dynamics: Changes in energy over the last several years have dramatically impacted the economy in ways that I'm not sure everybody is completely familiar with. Most recently we've had a drop in oil prices, and we're seeing an impact on the U.S. consumer of potentially $300M a day.

Then if you look back at what's happened in the gas market over the last five or six years, the impact on the average U.S. household is in the thousands of dollars per year, which, compared to other impacts in the economy, stands on its own. And that's all driven by what's happened with horizontal drilling and hydraulic fracturing and what it's done to the oil and gas market. Energy, which had been a stable, predictable industry for the last 100-plus years, has gone into a very revolutionary phase over a very short period of time.

Has the drop in oil prices changed the equation for consumers?

Joe Brusuelas, RSM: Sure. If you look at energy and energy-related industries, they account for about 1 percent of GDP—but it's about 9 percent of total capital expenditures. When you look at the rapid decline in the price of oil and the knock-on effects on gasoline, the impact is quite dramatic.

By my estimation, this should boost household disposable income this year by roughly $150B. That's a giant tax cut. And we're already seeing that that significantly increases the demand for services. It hasn't quite translated into demand for goods yet, but that will come later this year.

That [adds up to] $2,200 per household. After a long period of slow job growth and sluggish wage growth, this is big-time relief for a beleaguered middle class that needs that increase in terms of disposable income. And that bodes well for the overall U.S. economy.

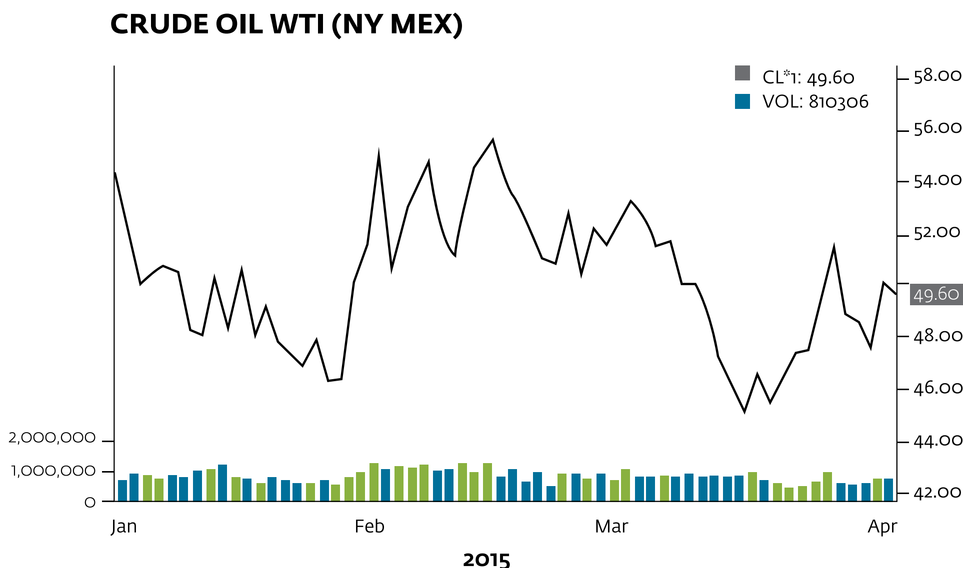
In the energy sector, there are many different types of companies, and they're being affected in different ways. Who's winning and who's feeling pain?

Breckenridge: The initial reaction people have is that this is bad for the upstream oil and gas players. I'm not sure that's true. You've had an upstream oil and gas industry where welders and truckers were making $150,000 a year. That's not the healthy, competitive market that's best for the industry overall. You've also had a situation where, as an investor, you could pretty much throw anything at upstream oil and gas and you were going to get a nice return.

Now the market is requiring people to become efficient, to be discriminating in terms of where they put their investments, so we think that's a better environment overall.

When a lot of people think about oil, they think about Big Oil and major international companies. But in the U.S. there's a huge collection of middle-market companies in energy. What's going on there?

Brusuelas: What you're seeing in the middle market is what you're seeing overall. You're getting a shakeout of the marginal producer, the modern equivalent of the wildcatter who's a little more risky. When funding dried up around Thanksgiving, we started to see some signs that consolidation would happen, and that's what is happening. We're seeing a little market discipline in the energy industry. It will probably take another 12 months to adjust, and then we'll be back to where we



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Joe Brusuelas of RSM and John Breckenridge of Capital Dynamics

should be. We'll end up with a much better, fundamentally based oil-production system.

Do you expect the energy sector, including the broad swath of the middle market, to continue growing despite the headwinds of commodity prices?

Brusuelas: What we're seeing is an opportunity to remove inefficient rigs from production. New rigs with new technology are resulting in greater production. We're going to be down 300,000 barrels at the end of the year, but fast-forward into 2016 and the estimate is we're going to be up 600,000 barrels from where we were. That's a million-barrel swing, even though we're reducing production. We're on the path to a much better, more efficient energy sector.

From an investor's point of view, isn't efficiency bad? Isn't inefficiency good, because you're able to find players that haven't yet been affected by what's coming down the pike?

Breckenridge: Our focus is in power generation, so let's talk about that for a moment. You've got fuel switching going on in power generation that's almost unprecedented. There are a lot of gigawatts of coal being retired, and that means larger numbers of new natural gas plants that need to be built to fill that gap. So you've got huge opportunities in that regard.

In the upstream oil and gas sector, the prices have adjusted very quickly. So now you've got opportunities to buy into assets, and obviously there are a lot of investors who are thinking it's a very good time to be buying in that sector. As investors, we see the change as a really interesting opportunity.

Are there particular subsectors in energy that will be most affected by the commodity changes?

Brusuelas: Renewable energy. From an economic point of view, this is good, because we were a little bit over our skis in terms of pushing renewables before they were ready, before they had found a real market-equilibrium price. I'm not comfortable putting in a structure of subsidies that will often be difficult to remove. There is actually a market out there, and it will be separate and distinct from government trying to jump-start something with public money.

Are you worried that the lower price of oil will slow the creation of jobs? Or are the jobs simply going somewhere else?

Breckenridge: We're investing in all types of power-generation projects—be it natural gas, wind, solar, biomass, hydro, whatever—and this retirement of older, inefficient plants has created a construction boom in gas-fired plants. Not to mention the fact that the renewables sector has been a driver of growth for some time.

To what extent do interest rates and lending impact the energy sector?

Brusuelas: Lower rates are better for development. What's more important

CONTINUES ON NEXT PAGE

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is growth. We're going to have low rates for a long period of time for a couple of reasons. Primarily, the tectonic plates are shifting globally among the central banks. We've quit purchasing assets. We're probably going to raise rates this year. Of course, the European Central Bank and the Bank of Japan have basically entered into an open-ended asset-purchase program.

We're going to see a tsunami of capital coming. And it's not just going to flow into dollar-denominated asset positions. It's going to drive down yield. It's going to bolster markets and the value of the dollar. But for the first time since the 1980s, we're going to see a substantial spillover in foreign direct investment, and my gut tells me a lot of that is going to pour into the energy sector. And that's something we need to see over the long term. That bodes well for our economy.

It's easy to come up with an estimate of gas prices' impact on the household, but it's a little more difficult with industry. But let's look at one public company. Delta Airlines is going to have $5.7B in savings just because of the lower cost of jet fuel. That will turn into reinvestment and hopefully lower prices. You spread that out across the industry—we won't necessarily see it this year, but later this year and especially in 2016—and you're going to see a real cost saving in the industry. And that's going to result in a pretty big pickup in cap-ex, which has been the missing ingredient in the entire puzzle of the recovery.

Joe mentioned a tsunami of capital coming in from many places, possibly overseas. John, anecdotally, are you having conversations with groups that see a long-term opportunity to put a lot of capital to work in energy?

Breckenridge: The tenor of the conversations I have with a lot of our overseas investors has been very interesting recently. Even a year ago, they didn't understand the U.S. energy sector. They knew something was going on, but didn't fully understand it from a distance. There's a much clearer understanding now. And the second thing is, people are now saying they do want to have dollar exposure. We're getting a significant amount of increased interest on both of those.

Brusuelas: What's important to understand is not only are you seeing capital flow into the country—enormous capital in the fourth quarter—you're seeing a change in the way central banks are holding dollar denominations. Basically, in 2009, central banks held about 28 percent of their reserves in euros. That's now down to 22.5 percent, and that was at the end of the third quarter, before we saw the real appreciation of the dollar.

When we get some of that data from the Bank of International Settlements and the IMF this year, you're probably going to see a drive toward 20 percent. That's an enormous change and signals what the people who actually manage the global economy expect to happen. So you should expect a stronger dollar for a long period of time.

John, as an investor in power, what's your take on the shutdown of three major nuclear power plants?

Breckenridge: Add nuclear power plants to the even larger shutdown of coal plants and this is all part of the fuel switching. You finally get to the point where a nuclear plant operating with almost no fuel cost still costs more to operate than a gas-fired plant with gas at these prices. It all originates from this incredible amount of gas that we've discovered in this country that's going to be powering this economy for the next 40 or 50 years.

For investors in the energy sector, there has been a trend among some for private equity funds to become very large. You also have some of the very large investors in the sector doing more and more direct investing. So you see, for the larger assets, a very competitive market. Our particular focus is in the middle market, because even though it takes almost as much work to do a middle-market deal as it does to do a large deal—even more work in some cases, because it's not quite as clean a transaction—you get paid more for the same amount of risk, because the competition is less. So the middle market, for us, continues to be a very attractive place. ■

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