Privcap/Report

Energy Game Change Conference

A collection of thought leadership, and of the people behind it, presented at Privcap's full-day energy event

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About Privcap
Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap offers communications services to market participants.

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Andrea Heisinger
Editor,
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Riding Out Low Oil

As private equity energy specialists convened for Privcap's second-annual Energy Game Change conference, networking and absorbing as much knowledge as possible were of paramount importance—more so than at the previous year's event.

Why? Because the reality that oil prices weren't going to recover to the $100 highs of 2013 (or even to the $50 highs of the latter half of 2015) was setting in. The event's location, at The Houstonian Hotel in Houston, was at the center of the oil and gas universe, and thus, drew some of the brightest minds in PE focused on the energy sector.

A panel of GPs from Ridgewood Energy, Energy Capital Partners, and Lime Rock discussed how they're weathering the volatility while armed with capital. Mike McMahon, co-founder of Pine Brook, talks about how "the rocks" are of utmost importance in a bumpy market. And LPs took the stage to talk about the growing popularity of co-investments and direct investments in energy deals.

As March began, oil prices were climbing again and guesswork continued about when a true recovery would set in. I hope you'll join us once again for Energy Game Change 2016, taking place at the Houstonian in Houston on Dec. 8, to hear more about opportunities for PE in the energy sector from both GPs and LPs in the thick of it. And stay tuned to our Energy Insider newsletter and to Privcap.com for announcements leading up to the event.

Andrea H

In This Report

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Energy Technology Jump-Starts the Sector

Neal Dikeman
Senior Venture Principal,
Shell Technology Ventures

Walter Ulrich
President & CEO,
Houston Technology Center

Paul Siegele
President and Chief Technology Officer,
Chevron Energy Technology Company

Ken Evans
Global Vice President,
SAP

Ramanan Krishnamoorti
Chief Energy Officer,
University of Houston

In the opening panel of Energy Game Change, five experts explained how technology innovations have changed the game for offshore drilling, and where the smart money is being allocated as a result

Paul Siegele, Chevron Energy Technology Company: When you think about the role technology has played in the deepwater or in the heavy oil, or most recently, in shale, it's telling for how it has allowed the advances of the energy industry and predictive of what kinds of advances would be made into the future.

The combination of horizontal wells and fracking in shale has increased the endowment of the United States production base dramatically. Three or four years ago, the U.S. was producing 6 million [barrels] a day. We're producing 10 million [barrels] a day now, because of the shale.

It's quite clear from the record that technology is going to be a key enabler for the future. The rate of technology [advances] and the cost to deploy [it] has really come down tremendously. And it's enabled wind and solar [power] to be economic without subsidy, which is amazing.

Ken Evans, SAP: This digital energy revolution that's happening is really driven by five key technologies. This hyperconnectivity like we've never seen before—not only just human-to-machine but machine-to-machine—is driving that. Oil and gas companies have used it for seismic processing for years. But fracking productivity is now following Moore's law.

And now [there's] the ability to share not only technology but to start thinking about network business processes such that companies can come together and take the digital oil field to a connective oil field. Also, with 3D printing, think about the productivity from an offshore perspective if you have a printer that could actually print the parts you need instead of having to worry about the logistics of going back and forth to shore.

Ramanan Krishnamoorti, University of Houston: Clearly, disruptive technologies are the way that the oil and gas industry will be transformed. But they are small disruptive technologies when integrated with existing systems that are transformative.

The issue of interchangeability between original equipment manufacturers is a paradigm that the industry is going to embrace because that's the way to cut cost. That comes back to another issue in that same realm, which is supply chain. How do you get

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the supply chain to be optimized when you look at offshore technologies?

The last trend that you observe globally is one of micro [power] grids. People have thought about distributed, individual home-based storage, and people have thought about grid scale storage. Both of those paradigms don't work for micro grids. And micro grids are the way of the future.

Walter Ulrich, Houston Technology Center: Neal, what's an investment that you've made at Shell Technology Ventures that might have [made an] impact down the road for them?

Chevron's Siegele

Neal Dikeman, Shell Technology Ventures: One of the first startups that we invested in was a company called Magseis. It's an ocean bottom seismic company. The reason we invested in this company is because it had a team that understood seismic, [and] had came off three different successful seismic tech companies for the last 10 years. And they sat in front of me and said, "We are going to cut the cost [of] ocean bottom seismic in half. And then we're going to keep going." And there was no other vendor in the market talking to us about cost reduction, about fundamentally changing the cost structure.

But what gets even more interesting, and part of the reason Shell was interested in it, is if this company breaks through, they will fundamentally rewrite the landscape for every other seismic company in the business, because you got to compete. All it takes is one of these new tech companies to change the paradigm.

Can you describe the digital energy network and how we're going to get there?

Evans: The digital energy network is about [taking] the level of collaboration in the industry that already exists, and being able to dramatically take cost out of [the] supply chain. Many of the service companies today need direct access to that operating data.

Then the second dimension is thinking about the Uber-like model and the Airbnb-type models that are going to be applied to the oil and gas industry. In Oklahoma there's a company that started up the Uber for sand delivery. And the same thing's happening for water, and those are the types of network models that are going to expand.

"The combination of horizontal wells and fracking in shale has increased the endowment of the United States production base dramatically."

– Paul Siegele,
Chevron Energy Technology Company

Crude production [oil] in the U.S. has been robust despite a huge drop off in rig counts. To what extent can those productivity gains continue?

Siegele: Companies over the sweep of time have concentrated on the sweet spot, which has high yields and high productivity. [There's] another offsetting factor that's really not well known because a shale endowment is huge, but the sweet spot is not that big. Think about the productivity improvement of a well that was drilled eight years ago, and now they've got an 800 percent improvement that they could go back and just re-frack those same well bores. So you could have zero rigs drilling, and we're still going to see a huge gain. ■

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Trends in Energy Fundraising

Fundraising today is not what it used to be. With so much volatility in the energy markets, IR professionals find themselves spending a lot more time educating LPs as investors continue to reconsider portfolio construction.

Chuck Bauer
Head of Investor Relations and Fundraising, EnCap Investments

Cathleen Ellsworth
Managing Director and Chief Marketing Officer, First Reserve

Chris Rowley
Partner, Mergers & Acquisitions and Private Equity, Vinson & Elkins LLP

Key Thoughts

LPs Have To Closely Manage Their Portfolio
"If you liked oil at $80, you should love it at $40. That is the sentiment amongst investors, it is just that now they are re-evaluating where their portfolio is—where they need to add and whether they can consolidate managers, etc."
Chuck Bauer, EnCap Investments

Co-Investors Should Be Cautious
"A lot of folks who co-invested in energy deals [are] saying, 'Oh gee, it is great because I lower my fees,' but choosing a fund manager and making direct investment is not necessarily the same skill set."
Cathleen Ellsworth, First Reserve

Share More With Investors
"We are in the client business. The more information I can provide them, the better chance I have [for] success at getting an allocation or a commitment from the investor."
Chuck Bauer

Respecting LPs' Forward Calendars Is Critical
"LPs probably already have the first six months of 2016 locked down, so if you are expecting to get a commitment out of them in the next six months, you may be too late. It is not because you are not a great fund and and [a great] opportunity."
Chuck Bauer

Volatility Presents Opportunity
"The [energy] market is dislocated. Prices are down, which seems to be a great opportunity to put money to work."
Chris Rowley, Vinson & Elkins

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Gal Luft
Co-director,
Institute for the Analysis
of Global Security

How the U.S. is *Strengthening* its Energy Security

Kenneth Medlock
Senior Director,
Rice University's Baker
Institute for Public Policy

Experts from Rice University's Baker Institute for Public Policy and the Institute for the Analysis of Global Security discuss the latest geopolitical and price turbulence and their effect on North America's energy economy. They also look into the macro outlook of the energy sector, the significance of crude oil, and the future of the liquid natural gas market.

Kenneth Medlock, Rice University's Baker Institute for Public Policy: Between the years 2003 and 2006, the price of natural gas in the United States was higher than anywhere else in the world. And that sort of speaks to the myopia that a lot of us approach energy markets with.

There will be cycles, but it's important to understand what the long-term trends are because that will ultimately tell you how the ship will run, so to speak. But between 2003 and 2006, the shale gas revolution was born.

In 2008, United States oil production turned around and it actually rose between 2008 and 2014, more than anywhere else in the world and actually, three years consecutively, increased at a pace that we've never seen before.

The simple fact that we're talking about exporting crude oil is remarkable because it's not something that really anybody had thought about for a long, long time. And so now we're in a different sort of paradigm where the United States is actually a source of supply for the world.

Gal Luft, Institute for the Analysis of Global Security: China is very happy because the manufacturing costs are going down to balance some of the increase in production costs in terms of labor, and finally they can build what they wanted to do a long time ago—the National Strategic Petroleum Reserve. And as we're talking now, there are sites where they're working 24 hours a day to build those giant drums, hundreds of them, to buy cheap oil and store it so they can use it when the price of oil goes up.

If I talk about oil at the moment, yes, the price has collapsed, but [there are] also issues that are not related to

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supply and demand fundamentals—for example, the fact that the dollar is very strong and the euro is very weak.

But the fundamental thing that hasn't changed is that the global transportation sector—cars, trucks, ships, planes—which underlies the global economy is completely and totally devolved into oil.

Medlock: As demand for power generation grows, there is an interest to move to more environmental fields, if you will. And so that's where some of the demand for natural gas will come from.

Now, the U.S. will likely still export LNG (liquefied natural gas). It's one of the lowest-cost producers of natural gas on the planet, which is far away from the Asian markets. So that basically means we have to compete for that margin. Then…we're also competing with a lot of projects that are coming online in places like Australia over the next few years. So expect the liquefied natural gas market to be pretty flush for the next decade or so.

Luft: We have to invest in alternative ways of moving gas internationally. For example, in configuration of compressed natural gas ships. The technology is there—turning gas into various forms of liquids, like methanol, which could be moved around the world as a commodity chemical. There are many ways of doing it, but if we stay only with LNG, what we're doing is essentially we are saying only very large markets, like Japan, Korea, can enter this play. But we keep out all the smaller players—many of them are island countries where they still generate electricity from oil, which is crazy.

Medlock and Luft are introduced by Privcap's David Snow

"As demand for power generation grows, there is an interest to move to more environmental fields."

–Kenneth Medlock,
Rice University's Baker Institute for Public Policy

Medlock: What impact did the lasting restrictions on exports of U.S. crude have on price?

Luft: I see this whole issue of exporting crude oil not as an ethical issue, not [as] an economic issue. The United States is dependent on the rest of the world for…100 percent of 20 commodities minerals and [for] another 40 commodities, we are 90-something percent, dependent on foreign input.

So basically, we are relying on the rest of the world to share their surpluses with us. And finally, we have something that we can share with the rest of the world. At the same time, we put all kinds of restrictions on exports. What do you think that looks like to an outsider? ■

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Who Will *Survive* the Oil & Gas *Shakeout?*

Vance Scott
EY

Energy companies with larger reserves and well-by-well cash flow analysis are better positioned to weather the storm of low oil prices, while companies with fewer reserves on hand will feel the pressure to meet operating costs and dividend and debt obligations, says EY's Vance Scott

While the price of oil fluctuates, many private equity firms have earmarked dry powder to take advantage of distressed opportunities in the sector. However, those opportunities have yet to materialize, according to Vance Scott, EY's managing director and head of the Parthenon Oil and Gas Group.

"Many of the companies are in a leveraged position and have protected themselves on the price side with 12-to-18-month hedges," he says. "And other companies reset some credit positions, which also gave them some flexibility, and those are probably the key drivers as to why we haven't seen as much action as others have predicted at this point in time."

Scott adds that in the past the smart money went to exploration companies that were successful in locating hydrocarbon. But with the relatively new shale dynamic that is happening today, the winners are going to be those that can operate effectively and do very good sequenced operations in drilling and production programs. "Private equity has begun to understand that, and many of these companies have the right teams lined up and ready to go," he says. "They just need convergence around what's going to happen with oil prices and be able to close that window so that the deals can actually start happening."

To that point, the management team profile that will add value to distressed energy companies has evolved since 2014. While fundamental management skills aren't any different, the ability to process information and make decisions quickly will be a key benefit to creating value. Understanding the geology, as well as the way a company deals with capacity, will continue to be an important aspect of a successful E&P organization.

EY has done extensive research into the kinds of energy firms that are poised to be successful and the kinds that are bracing themselves for hard times ahead. Scott says that by looking at cash flow, credit and hedged positions relative to the obligations on interest, and payments and dividends, the picture becomes substantially clearer. But he also points to the size of a company's reserves as an indication of how long it can sustain such a low-cost environment.

"The larger the reserve base, the stronger the position will be to weather the storm that we're in," Scott says. "We call it 'reserve resilience.'"

The feeling is that those companies will be under greater pressure to cover debt and dividend and to meet their operating costs on both development and operating expenses.

For some companies, master limited partnerships have been a major source of capital, but the low price of oil has had a negative affect on investors. Scott says he doesn't see those stocks going away anytime soon, particularly in the midstream. "As long as interest rates remain what they are, that construct will not go away," he says. "And it does have a structural advantage from a tax position. I would not have the same opinion on the upstream side, however." ■

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Energy Deals Take a Different Shape

The flow of transactions has slowed since late 2015, but that doesn't mean they have ceased completely

Gary Rygh
Managing Director, Barclays Capital

Vance Scott
Senior Managing Director, EY

Grant Davis
Managing Director, Tenaska Capital Management

Key Thoughts

Power Portfolios Are Beefing Up
"You've seen a fair amount [of activity] this year as the publicly traded companies are searching for growth and filling out the portfolios they have. We've seen new capital come into the power side that we haven't seen in a few years, given how the market's been."
Gary Rygh, Barclays

There's a Reason for the Lack of Distress
"Many of the companies hedge their production into the future. Some are fairly leveraged, their maturities don't come due until the coming year… They're hesitant to let go of the good rocks, if they're in a distressed position, and are looking for how they can market assets, particularly midstream, and still maintain operatorship."
Vance Scott, EY

Regulatory Uncertainty Affects Utilities and PE Alike
"It's very difficult when you have this constant litigation going on as to where things are going to shake out…There's a lot of power and pressures aligned in favor of renewables, so that train's not stopping any time soon. But you also have practical implications—you just can't shut down the nuclear plants, the coal plants and the gas plants."
Grant Davis, Tenaska Capital

The Record Deal Year is Misleading
"Us folks here in Houston are hanging our heads and shaking [them] because there just hasn't been that much action. There's been a bit in the midstream, and you've read [about] the big mergers in the papers, but on the E&P side it's been primarily asset deals—people looking and moving in and out of positions rather than in and out of stock as a way of moving forward."
Vance Scott

Distress Has Only Just Begun
"There's a lot of capital ready to pounce. There's a lot of distress debt taking place now. You have, I think, three dozen bankruptcies so far this year in terms of E&P companies. That's $12B in debt."
Grant Davis

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How **Oil Prices Impact** Fundraising

A partner in the Houston office of Eaton Partners, weighs in on what LPs are thinking amid oil price turmoil, the appetite for funds focused on renewable energy, and the focus on the distressed opportunity

Privcap: The energy fundraising market is one of the largest sectors of private equity. Oil is down. Has that affected fundraising?

Jeff Eaton, Eaton Partners: Without a doubt, it's affected fundraising. If you were to look at the numbers for 2015 as a whole, it's going to look like we've had a pretty good year. I would argue—in fact, the numbers would back this up—that a lot of that money was raised in the first half of the year. And the third and fourth quarter are probably going to be pretty low compared to [2014] fundraising. A lot of that has to do with oil prices.

Now all the analysts are predicting low oil prices for all the way through 2016. That's definitely changed the mood and slowed down things.

What are investors telling you?

Eaton: They all embrace the fact that oil prices are cyclical, and there will be a recovery. So there's a lot of interest in getting in at these lower prices. The question is, what should they do? So it's just causing a lot of thought and further analysis—more so than just backing the same old generalist energy fund that's been around year after year.

Do you think that there's been too much focus among investors on the distressed opportunity?

Eaton: There's been a fair amount of money raised for distressed, but a lot of those funds trying to raised distressed-focused funds have been less successful. It's taken a longer time.

In years past when people tried to raise distressed funds, the distress went away quickly. Now when people see...that this prolonged period of lower prices is really going to lead to distress, they are taking a more serious look. But then they're looking at managers who don't necessarily have a track record of doing distressed because there hasn't been that much distress, historically. So it just creates further complexities in underwriting some of these managers.

Will lower oil prices affect the performance of funds that have already been raised? And is that going to be an impediment for some of these managers to raise their next fund?

Eaton: Unrealized marks are trending down pretty substantially over the last couple quarters. So there's no doubt that is happening, and there's no doubt that that will impact an LPs underwriting of a manager.

So, [looking at] a manager that's had a significant decrease in performance—and granted, it's going to be across the board in energy—[you have to look at] relative performance from manager to manager. That's going to cause LPs to not necessarily pause, but to have to spend more time scrutinizing those marks and getting comfortable with them. ■

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'The Rocks' Are Key in *Bumpy Commodity Markets*

A co-founder of Pine Brook discusses how to position portfolio companies for success despite a steep drop in oil prices, what distressed opportunities are like, and how to deal with execution risks.

David Snow, Privcap: Are we in a bull market for energy right now?

Michael McMahon, Pine Brook: It's very difficult to continue to invest, particularly in North America, to generate the type of production—forget about growth. My own view is capital-intensive businesses, they're cyclical and they self-correct and I do believe we're pretty close to the bottom.

What are the distressed opportunities out there like?

McMahon: When you look at the energy sector, somebody said there's a company filing [for bankruptcy] almost every day. When you look, certainly at the companies who have filed early, there are three reasons that contribute to distress. Number one, bad management, number two, bad capital structure, and number three, bad rocks. You can fix the first two, but you can't fix the third.

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Let's get a bit deeper into what you call a "zombie energy company." What attributes will it have such that even a smart private equity firm can't fix it?

McMahon: It really comes down to the rocks, and if you go back to the '80s, we've seen this movie before. There [is] a whole host of companies, public and private, and they just hung around. Why? Because management teams and directors don't like to put the stake in the heart of these companies. Now, it's going to be a little bit different because private equity controls a number of companies and, candidly, we can't just sit there and let the meter run. You'll see a number of these companies both public and private actually go out of business at a much more rapid rate than people anticipated.

You've also said that when oil was much higher than it is today, you were seeing deals getting done. What was behind the decision-making in that atmosphere?

McMahon: One of the key factors that contributed to that bull market was totally unrestrained capital access. If there's money available, people will find a way to use it. It was driven more by the North American shale play than anything else. Early movers actually figured out that in certain basins, there really were good rocks. The fast followers or the slow followers, when they got into the game, they were confronted with a dilemma—to pay up, to get into the core of the core, you actually degraded your economics.

What is the sweet spot for an opportunity in today's environment?

McMahon: One of the things we've learned through the lens of our management teams is that when people evaluate rocks, we actually now start to classify them in five different categories. Tier one is the core of the core. The economic issue is, can you get control of those? Even in this environment, there are very few really good core rocks that are coming up and when they do come up, they get priced at very attractive returns to the seller.

Michael McMahon
Co-founder and Head of
Energy Investments,
Pine Brook

"When you look at the energy sector, somebody said there's a company filing [for bankruptcy] almost every day."

–Michael McMahon, Pine Brook

With so little room for error when trying to make these projects economical, can you talk about execution risks?

McMahon: Number one, very good G&G (costs for geologists, surveys, and other drilling activities). Even in the sweet spots, one of the things we've learned is that they're not homogenous. Understanding how the rocks change within a particular play, even one or two sections away is critical. The second thing is well control, well design. If you look at the difference between landing a well in the right zone and steering it to stay in the target zone, that is a huge difference in the results.

The third is, what's the fracking formula, how long are the laterals, how much do you use pressure, how much profit? Also, logistics are important. Then, most important is what Napoleon looked for in his generals: someone who's lucky. ■

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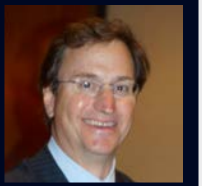
Families Invest for the Long, Long Term



Bobby Hatcher
President, CEO,
Cockrell Interests

Timothy Smith
President & CIO,
Petro Lucrum

Two investment executives from Texas-based family offices discuss how similar they are to well-resourced private equity firms, and how different

Key Thoughts

The Best Families Offer More Than Just Capital
"We sponsor management teams that may not require a lot of capital until you get to a different phase of development. In terms of shared services, in addition to capital, [our investees] have to suffer through our back-office management, accounting and regulatory. We don't have any other mandated shared services other than back office."
Bobby Hatcher, Cockrell Interests

The Focus is Often on the Long Haul
"If it's a great asset with long-term characteristics, we typically want to have that flexibility. That's why we are focused on co-investment with other family houses, in particular. So we're looking with the short-term horizon initially at three to six years. We also are looking at certain situations that can be much longer-term 10, 20-year assets."
Timothy Smith, Petro Lucrum

Mineral Rights are for the Long Term
"We have found the best way to own minerals is to have them for about 100 years. Deal flow today is phenomenal, but execution is abysmal. Our notion is 'Keep buying minerals right now'—it's much cheaper to pick them up and hold them versus try to use the drill bit, so we're pricing things accordingly and, therefore, we're losing on every deal we've looked at."
Bobby Hatcher

Family Businesses are Ripe for Deals
"We are seeing a big generational shift within oil and gas. Even in family-run businesses, in most cases the ones that have been heavily operated or concentrated are now in the position not necessarily just to pass [on] to the next generation as much as they may want to monetize, create a liquidity event. We're [telling them], 'You don't have to sell [to] us 100 percent, we're willing to come in and buy 60-70 percent.'"
Timothy Smith

Cash Flow is Critical
"Just about everything we're looking at has a cash flow element. We want to make our returns behind the drill bit. Sometimes that isn't a short-term horizon, depending on where we see the value or where the market's at. And so we are definitely looking to be able to generate a large portion of our return on the exit."
Bobby Hatcher

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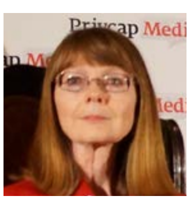
Volatility? *Bring it On*

GPs armed with capital explain how they target opportunities in a variety of market conditions, including in a landscape that forces energy players to scale back and weather economic headwinds

Doug Kimmelman
Senior Partner,
Energy Capital Partners

Bob Gold
Senior Executive,
Ridgewood Energy

Will Franklin
Managing Director,
Lime Rock Partners



Leslie Haines
Editor,
Oil and Gas Investor

Leslie Haines, Oil and Gas Investor: What is your macro view right now in energy?

Will Franklin, Lime Rock Partners: Overall, we're positioning ourselves with a feeling that we are in a lower-for-longer macro environment. The sense, obviously, is that day-by-day we're getting closer to the bottom. But you've got to be careful for those false bottoms—we saw one earlier this summer.

Doug Kimmelman, Energy Capital Partners: I don't think anyone in this room knows where oil and gas prices are headed. There are too many externalities, and we all get too caught up in the U.S.-centric view of things where the shale oil is maybe 5 percent of global production. So there's a lot of things going on outside of our border that none of us really has a very good view of. Everybody gets focused on "I need to find the right time to be long in the commodity." Well, there are a lot of other ways you can invest when volumes are high and prices are low. It will be a very difficult year with a lot of distress.

What are your LPs telling you? Do you find you're doing a lot of hand-holding?

Franklin: It's mostly business as usual. My general sense is that investors understand the volatility of the market, and that this is a portion of their portfolio. And we talked about how we tried to position our portfolio, recognizing this is all we do and, therefore, thinking about volatility and thinking about appropriate balance sheets going into any deal in this industry. And for the most part LPs seem to appreciate and understand that.

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> "Some people wait a career for an investment environment like we have right now."
>
> –Doug Kimmelman, Energy Capital Partners

Bob, you're in a unique position focusing on offshore only. What are you seeing from your LPs?

Bob Gold, Ridgewood Energy: The interesting thing about what everyone in private equity does is,if you invest now, you don't intend to harvest for a number of years. And you could make the case that the very best thing for someone who just put money into a fund—putting aside their legacy investments—is for prices to stay low for a couple of years. If you believe in the cycle, or even if you don't believe in a dramatic cycle but just an upturn, costs are coming down, in a sense, even faster than prices.

Can you describe the last deal you did?

Franklin: We've had a remarkably active year. We've closed three deals this year, and have a fourth one that will likely close in the coming couple of weeks. And three of those are real asset deals.

More recently, we did a deal late summer where we actually worked with a team for about nine months developing a business plan—it's shale-related, but it's the embers of shale. So Lime Rock's capital is really positioned to take advantage of shale, which we do believe is the incremental resource.

In this low-price environment, what is deal flow like compared to when oil was $80 or $100?

Kimmelman: Some people wait a career for an investment environment like we have right now. You want to see dislocation in the capital markets, and dislocation [is] sometimes for irrational reasons. We have so many sectors of energy that are just getting chopped down because there's a "just get out" mentality.

Not only do I talk about power generation, I talk about the world of clean energy and renewables. Some of that is having to do with capital markets, yet public policy is right there supporting it with continuation of contracts. So there are plenty of things within the broad umbrella of this world called energy, so it's going to be an extremely active investing year for those that have dry powder.

What about offshore in the Gulf?

Gold: We have an interesting model where we create the most value by drilling exploratory wells, spending $100M and finding 40 or 50 million barrels. We've had a lot of success. But in this environment there is an opportunity to buy projects where the exploratory risk has already been taken, but they still require several-hundred-million dollars to develop.

Will, how has your portfolio been performing over the last year, and how do you protect the value?

Franklin: In 2014 we returned about $780M of capital and we only deployed about $150M of capital. Looking back, it feels really smart or lucky, and it's really a bit of both. But that takes you to the portfolio you have left that you're managing through the downturn. If you look at the E&P side, we had basically exited out of all of our producing assets with the exception of CrownRock, which is a company that is Tier 1 assets in the Permian, which just continues to knock the ball out of the park.

Doug, on the midstream side we all talk about the bottlenecks in the Northeast and the incredible amount of gas there. Can you talk about that?

Kimmelman: We're in the pipeline construction business in one of our portfolio companies. In 2017, we're almost full in terms of backlog of building pipelines. Still, 30 percent of the United States does not have access to natural gas. And it was too expensive to build the hookups. Well, at $2 gas, it's not too expensive. A lot of infrastructure is still yet to be built. ■

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Looking at Energy *Beyond* North America

Although it may seem that everyone's focused on oil and gas in North America, there is plenty of activity in other parts of the world. Kerogen Capital's Jason Cheng talked with Privcap's David Snow in a lunch keynote interview about some of these opportunities.

"So just take the current [oil] price, hold it flat. Can you generate the returns you want to generate? They're the sorts of deals you should be doing."

–Jason Cheng, Kerogen Capital

The focus on the impacts from the prolonged dip in oil prices has been squarely on North America, but plays in the U.K. and other areas of the world are also affected in different ways, and those effects are causing those in the private equity space to pause and reconsider their strategies.

In light of the low oil prices, it's tempting to to go from an alpha business strategy to a levered business strategy. But, from the perspective of Jason Cheng Cheng, co-founder of Kerogen Capital, it's best not to give into those temptations, and instead remain consistent from an underwriting perspective.

Everyone has the expectation that oil prices will rise, he says, and therefore, are loading up on assets to "ride the oil price going up." But the smart move is to stay focused when looking for alpha, and maintain the ability to generate expected returns in the current oil price environment. "So just take the current price, hold it flat. Can you generate the returns you want to generate? They're the sorts of deals you should be doing."

The first deal that Kerogen did in the low oil price environment was in the U.K., Cheng says—a shallow water conventional play at the "very low end of the cost curve." The firm was not as excited when the industry saw $100-per-barrel oil prices. "It was high cost, high tax, very competitive, low-sourcing capital," he says. "And in the last 12 months, you've seen a lot of those things reverse."

While the firm has assets in the U.K.'s North Sea, Cheng also shared insights into the rising oil demand in Asia. There's concern about China's economic growth and its impact on oil and gas production. One of the things that Cheng says surprised him in 2015 was that oil demand has continued to grow in China, notwithstanding the economy, and that much of the growth in car consumption was in SUVs. "[In] the consumer-driven oil products like gasoline…jet fuels account for about 90 percent of that increase [in demand]. A few years ago it was about 30 percent."

There is, however, the risk of a hard landing in China, but Cheng notes that the transition from an export-driven, investment-driven economy to a consumer economy is already happening and that it's the right approach. The concern is "if they try to increase demand too quickly, they go back to the old model and it creates all sorts of inefficiencies and, potentially, asset bubbles."

The discovery of vast shale reserves in the west of China isn't necessarily a cause for excitement just yet, Cheng says. Most of the country's shale plays are in remote, mountainous areas lacking access to water resources, and there are questions over the geology and commerciality of pipelines. "[There's] the cost of that, given that China probably needs to be socialized by the government in order to make that work," he says. "Gas prices also need to be deregulated. There's quite a lot of hurdles before that [opportunity] can really grow." ■

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The Rise of the Pledge Fund in Energy

Smaller GPs that enter the energy market without a strong track record or name recognition often have difficulty raising blind-pool funds. Mark Proctor of Vinson & Elkins says these emerging managers are increasingly turning to a pledge fund structure.

Marc Proctor
Vinson & Elkins

There are many challenges that emerging private equity fund managers face, including a minimal track record or not being a well-known name. One thing that can be added to that list—at least in the energy space—is the difficulty of raising blind-pool capital. A possible solution? The pledge fund structure.

Mark Proctor, a partner in private equity for law firm Vinson & Elkins, says "you're seeing a bifurcation in the market" where the larger, more well-known names continue to fundraise and build their track records in energy. Meanwhile, smaller players in an increasingly competitive field may have trouble raising capital—especially from institutional investors—without a solid track record to show. Enter the increasingly popular pledge funds.

As Proctor explains it, the pledge fund involves a GP going to several investors and making an agreement to show them a certain number of deals, with the understanding that the LPs will look at those deals in an expedited timeframe. "And then if they invest in those deals, you agree upfront on what the economics will be and whether or not you're going to cross-collateralize those deals for purposes of the carried interest," he says. "We've seen a tremendous amount of interest in those structures. And that's going to be a trend as money keeps flooding into the industry."

While there are some single-asset pledge funds, Proctor says that's not the norm. Usually it's a collection of entities or a fund meant to invest in multiple deals, he adds, "but where—instead of the GP having all the discretion to put the limited partners into every deal—the GP actually has to go to the limited partners with each deal, get them to buy into that deal and then those who are interested participate in the deal; those who are not sit the deal out."

The investor base for pledge funds tends to be slightly different from that of a traditional PE fund, he explains. The smaller investors like family offices and less-massive pension plans that want the ability to say no to an investment, are common. The more traditional investors tend to stick with the larger PE deals and the blind pools being raised by the more established firms, Proctor adds.

There is a final sticking point to the pledge fund structure: Like some GP groups that prefer to have committed capital at the ready when they need it, there are also sellers that are wary of the structure. Their reason? They don't have confidence that the purchase capital can be rounded up. ■

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The Offshore Opportunity

As opportunities in offshore drilling continue to open up, private equity investors need to consider a number of factors before jumping into the deep water. Production costs, available data, and capital are just a few of the points investors should be concerned about.

Jim Sledzik
Senior Partner, and President, Energy Ventures

Greg Matlock
Partner, EY

Lucius Taylor
Principal, ArcLight Capital Partners

Key Thoughts

High Startup Costs Can Be Deal Killers
"If your costs are higher up front, it doesn't really matter how much more oil and gas you can get out of the ground. If it costs more to do that up front, it is likely not going to happen."
Jim Sledzik, Energy Ventures

Fundraising For Offshore Vehicles Demands Creativity
"From a structural perspective, and especially as it relates to your investment thesis and where you're going to invest, we're seeing our clients much more willing, at least on the fund side, to be accommodating. We're doing things around the margin to improve the returns to investors to entice that fundraising."
Greg Matlock, EY

Everyone's Fundraising Experience Is Unique
"We actually saw a groundswell of commitment come in while crude was down in the $45 range from a lot of our LPs. For a while we were pretty worried about their view of the energy market, in general, but the view was 'If we're going to invest in an energy-focused fund, we might as well invest while the commodity is low and opportunity is high.'"
Lucius Taylor, ArcLight

Watch For Mexico's Deepwater Opportunities
"Mexico is one of those basins in the deepwater that's untapped and nobody really knows what's down there [because] it hasn't been imaged. The fiscal regime of the Gulf of Mexico has driven a lot of investment by service companies to build these seismic libraries, which makes it much more inexpensive to get access to fantastic technology."
Jim Sledzik

Old Technology Is Driving New PE Investments
"A lot of the imaging technology that was developed a decade ago has actually made it possible for private equity-backed companies to move into places like the Gulf of Mexico in the deep water. Eight, nine, 10 years ago, our fund would have never considered going into the deep water. I don't know that many [firms] would have."
Lucius Taylor

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Chris Rowley
Mergers & Acquisitions and Private Equity, Vinson & Elkins LLP

Chris Tehranian
Principal, Meketa Investment Group

Marietta Moshiashvili
Managing Director, TIAA

Vaughn Brock
Director of Special Projects, Teachers Retirement System of Texas (TRS)

Limited Partners *Go Direct* in Energy

Institutional investors discuss the growing trend of co-investing and directly investing in energy deals, and factors to think about when deciding whether to partner with operators or managers

Chris Rowley, Vinson & Elkins: What drives the decision between whether you're going to make a fund investment, a co-investment, or increase your allocation to something through a co-investment or a direct investment?

Chris Tehranian, Meketa Investment Group: Most of our clients, they do utilize the legal fund—obviously with secondaries and other options within that as well—and separate accounts. For some of our larger clients that are looking to deploy more capital, it's more of a solution-based approach in terms of leveraging their relationships with partners like GPs and other management teams and focusing on ways to approach these various investments in different angles.

Are people going to come to you with a specific investment idea or target?

Tehranian: Yeah, when we develop the investment policy, usually it gives a bit of a range in terms of how much capital you can spend in one year across co-investments and fund investments and what-not. But at the end of the day, it's a little bit more opportunistic than that. We've been in mandates in which we source investments. We both execute on and monitor. In other cases, we're just used for due diligence purposes.

Marietta Moshiashvili, TIAA: We have a direct effort due to the fact that infrastructure and energy are deemed their own asset classes, and there is a special profile for the risk taking associated with our investment strategy. There is a protection to the downside in our investments, and we are obviously taking risks. Having a level of control over entry, and exit, is also very important.

Vaughn Brock, TRS: The allocations at TRS happen through the allocation committee every few years.

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Rowley, Tehranian, and Moshiashvili listen as Brock answers a question.

“In times like these, you really test the management teams in the boardroom when you are managing and E&P company,”

–Marietta Moshiashvili, TIAA

Then, within each sleeve, there’s some latitude on how we allocate between the subsectors. But the process starts with a premiere list, where we research managers and decide which managers that we would like to invest with. Then it’s a process of maintaining those relationships until a fund emerges.

If you’re talking with people who are bringing opportunities, how quickly are you telling them that you can operate?

Moshiashvili: It all depends on the actual opportunity, and how mature it is in terms of the announcement, as we find ourselves sometimes saying we need to know X, Y, Z
before we can respond. But you always have to remember that when you co-invest, it’s obviously good to make sure that you have a widened interest. And similar strategy on longevity and the term of the investment because once you decide to invest, you are giving up full governance control over the investment to the managing partner.

In terms of authority to make investments, how is it working in each of your cases?

Tehranian: We have a mixture of clients in which five investors are discretionary. So we actually make those decisions in terms of executing on deals, which make it very easy, and you can move fairly quickly on that. In other cases, it’s evolved over time.

Another thing to consider—in terms of the governance once an asset is made—is can you have control? Can you sit on the board? Some of our

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clients are from the Employee Retirement Income Security Act (ERISA) and others prescribe to ERISA, which makes things very difficult in terms of being on these boards and having the dual agency issues in terms of fiduciary responsibility. And so we've had to develop a bit of a product around managing those types of issues, giving them the type of controls they want, the oversight, the transparency, but not always the typical board role.

How is the current energy environment changing things in terms of looking at allocations or different types of funds and opportunities?

Brock: Last year we actually put together an energy-focused team from different disciplines within TRS and brought in some different general partners to discuss it with us. With this decline in oil price and with distress in the oil patch, we thought there was going to be lots of opportunity. So we have not really pulled the trigger aggressively, and we have a lot of capital already out to general partners. And we've actually created some new separately managed accounts to take advantage of the opportunities, should they occur.

> "Occasionally we have to hire experts to help us assess a co-investment opportunity because in the energy space, there's just a lot more specialization to understand."
>
> –Vaughn Brock, TRS

Moshiashvili: Given the opportunities right now, we're shifting our E&P strategy from value-add to more production-based. We're shifting towards JVs with midstream operators, given what's happening in that market. On occasion, we will consider various opportunities depending on particular details of a particular investment. But depending on the sector, you find yourself benefiting from one or the other trends if you have the flexibility of investing across the board.

What do you all see as the greatest challenges in terms of designing your investment programs and putting the capital to work?

Moshiashvili: This is a very resources-heavy sector. We have a geologist on staff, and an engineer who looks at our infrastructure investments. We also look for alignment with operators because we need those investments to be prudently operated and aligned. In times like these, you really test the management teams in the boardroom when you are managing an E&P company.

Brock: The energy complex is still the biggest asset class in the world. And so there's apt to always be opportunities there in the good markets and in the bad markets. They're sometimes hard to figure out. We rely a lot on our general partners for that expertise. And occasionally we have to hire experts to help us figure out how to communicate and figure out how to assess a co-investment opportunity, because in the energy space there's just a lot more specialization to understand. ■

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Has Mexico's Energy Sector Lost Its Luster?

The news that the country, long dominated by state-owned Pemex, was opening its doors to foreign investors was met with excitement, but a lot has changed since then

Eliecer Palacios
Founder, Managing Partner, PetroRock Energy

Patrick Hoogendijk
CFO, EIM Capital

Mark Florian
Managing Director, First Reserve

Key Thoughts

The Country's Shine May Have Worn Off
"Mexico has several challenges right now. You have above-ground risk, geopolitical risks, you have issues in situations like...a services company that was taken into bankruptcy by the government."
Eliecer Palacios, PetroRock

More Patience is Required
"If you look at the speed at which the industry is deregulating, the regulators are getting up to speed... You'll see them moving forward quite quickly. Not at the speed that we would like in private equity; we'd like to see investments being made over the course of a couple of months of due diligence, maximum."
Patrick Hoogendijk, EIM

More Energy Means More Infrastructure
"We see a lot of opportunity, many tens of millions of dollars, of infrastructure investment. And it's a pretty exciting place to be as a result."
Mark Florian, First Reserve

Investments Feature an Undercurrent of Danger
"Issues with the drug cartels are clearly there. They're not as prevalent...as people make them out to be in the media. And so the challenges for building any infrastructure project are larger in Mexico definitely than they are in the U.S.; it requires more de-risking."
Patrick Hoogendijk

Mexico's Government is Walking a Fine Line
"There's appetite, particularly [in] shale... But the biggest challenge is that the government doesn't put capital barriers that crowd out these companies. One of the issues in the first round is that they requested $10M in assets or $2B in equity to participate, and there were only a few companies that could qualify."
Eliecer Palacios

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Eyeing Mexico's Energy Sector? *Mind the Tax Laws*

As Mexico continues to open up the previously government-owned energy sector to foreign investors, there are a number of variables for U.S. PE firms to consider

As Mexico opened its energy companies up to foreign investors, some tax challenges surfaced that many private equity buyers in the U.S. may not have considered.

A primary issue, from the U.S. perspective, is what kind of tax structure the investor wants to use: flow-through or deferral. Meril Markley, senior director at RSM US LLC, who talks through such issues with clients, says that misunderstanding the ins and outs of corporate and tax laws is common.

In a flow-through structure, income earned in Mexico is taxed in Mexico but recognized in the U.S. with a foreign tax credit for some or all of the Mexican corporate income tax. And because the foreign tax rate in Mexico is 30 percent and the rate in the U.S. is 35 percent, Markley says it's most likely that the private equity firm's portfolio company would be paying some incremental tax in the U.S. The alternative is the deferral structure, with income generally not recognized in the U.S. until a dividend is received by a U.S. shareholder. Again, the rate differential may cause incremental U.S. tax, but that event is deferred until a time chosen by the U.S. shareholder of the Mexican company.

One of the "key issues that a lot of companies get wrong" when they invest in companies in Mexico's energy sector is failing to avoid the pitfalls of the two shareholder minimum requirement for Mexican companies. As there is effectively no minimum for the second shareholder, it is not uncommon to see a share taken by a Mexican employee. This practice can prove troublesome if the Mexican company or its U.S. parent is ever sold. Instead, it is possible to fulfill the two shareholder requirement in Mexico by having a U.S. company set up an LLC in the U.S. to act as the second shareholder. For U.S. federal income tax purposes, the LLC is disregarded, effectively giving its U.S. parent 100 percent ownership of a Mexican company.

"You end up with two shareholders for Mexican purposes, but you really have 100 percent ownership," says Markley. She adds that it's important how this is done, because Mexico instituted a 10 percent dividend withholding tax, which is reduced to a 5 percent rate if the owner holds at least 10 percent of the shares.

While PE firms always conduct due diligence on companies they're considering bringing into their portfolio, there are some extra issues that could pop up when it comes to energy companies in Mexico. "The first question the U.S. investor needs to ask is whether they acquire shares or acquire assets," Markley says. "Typically, the seller wants to sells shares and the buyer wants to buy assets to leave behind liabilities, whether they're disclosed or undisclosed." Potential liabilities from payroll taxes and mandatory employee profit-sharing are some other issues that should be watched for, she adds.

Mexico is at the forefront of electronic tax compliance, Markley notes. It's difficult to evade taxes in Mexico, thanks to governmental reforms, and there's "a whole new level of very detailed disclosure to tax authorities in auditing companies down the road," she says. "It's a very different new system of requirements for Mexican taxpayers in an effort to assure transparency in corporate tax matters and to discourage taxpayers from undertaking transactions that are not reportable."

"If they haven't invested in Mexico before, there are traps for the unwary," she says. "Since opening [the country to foreign investors], a lot more U.S. companies are dipping their toe in the water and are not aware of the ins and outs. Joining with RSM in Mexico, we help demystify the process of investing in Mexico." ■

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How PE Deals Work for Energy Operators

Two energy entrepreneurs and the GPs that have partnered with them discuss the right way to work with private capital such that risks and successes are shared across stakeholders and what benefits that each side receives from the partnership

Ben Moore
Senior Advisor,
Five Point Capital Partners

Matt Morrow
Managing Partner & COO,
Five Point Capital Partners

Chaden Lassoued
CEO,
Kinetics Energy Services

Bob Edwards
Managing Director,
NGP

Andrea Heisinger, Privcap: What are the good and bad parts of working with a private equity firm?

Ben Moore, Five Point Capital Partners: One thing that's been helpful is an opportunity to network with the LPs themselves.

Matt Morrow, Five Point Capital Partners: If we've created alignment with our management teams, then we have to trust their technical judgment. So it is a bit surprising to hear some of the LPs with different views about hiring their own engineers and using their own consultants. For us, the only engineers that matter are the ones that have their skin in the game and that are going to wake up in the middle of the night, saying, "Holy moly, my well just went down and I'm going to lose my money too."

Chaden Lassoued, Kinetics Energy Services: These are foreign concepts to a guy coming from a corporate environment, like me, because for a company like Schlumberger, they're willing to wait. Through the

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interactions we have with NGP... [you realize] it's a great idea, but maybe eight, nine years from now—the duration of the fund timeframe. So it's critical to have communication and interaction all the time. How do you go about looking at all of the different types of risk on a project?

Five Point's Moore and Morrow; Kinetics Energy's Lassoued

Morrow: We focus on a really particular piece of the overall energy business. Because of that, we have a lot more knowledge about that piece of the business and can understand the risk better. That's one of the things that our portfolio companies like. When they do come to us with some problem that arises—and inevitably, problems arise—we're able to understand and many of us have actually been through those exact same things. If you did lose your well, if your pipeline did have a leak, many of us have gone through those exact issues.

"We're keen about their edginess and specific knowledge and capability that they bring for a particular basin."

–Bob Edwards, NGP

How do you vet the operators that you work with?

Bob Edwards, NGP: Most of the time, we know the management teams that we back. They either come from repeat teams or they will come from an engineer that worked in an adjacent field, as one of our portfolio companies. With 50 [current] portfolio companies and probably 20 portfolio companies that are in some stages of signing up with us again, we're only one phone call away from an intimate diligence call with anybody in the industry.

We ask for track record. We're keen about their edginess and specific knowledge and capability that they bring for a particular basin.

From the operator perspective, what's it like?

Morrow: Every PE firm has its own culture, if you will. Some can be fairly hands-on and some can be fairly hands-off. But for those that are hands-on, it's important to understand stylistically how you as a CEO are going to work with them and making sure you're comfortable because, if it's a relationship that you don't understand well on the front end, it can be risky if things don't [turn out] very well.

Lassoued: In the case [of] NGP, it's clear from day one that, as an entrepreneur or CEO of a portfolio company, you have to be ready to roll up your sleeves. So maybe NGP is sitting on the board, but you have to be able to play that role, and this is an issue for many people, especially coming from a

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corporate environment where you're used to support and a vast amount of resources and so on.

Doing your homework on knowing exactly who you are dealing with, from an operator perspective, is critical. And then being ready to build the team, bring people from your own network, being ready to be the safety guy, the sales guy, and the guy that deals with the customer and is not just completely hands-off [in] running the business—that's critical.

You mentioned that it's very helpful for you to be able to interact with the other portfolio companies and learn things from them. Is there anything specific that you've gotten out of doing that?

Moore: If you look at a life cycle of a company, there are obviously going to be points of friction. So it's been good to sit inside the fund and actually watch some of those things evolve to see how departments respond, to know what I would do in the future if a similar situation happened—having that knowledge is going to be a benefit down the road. ■

Bob Edwards of NGP

> "As an entrepreneur or CEO of a portfolio company, you have to be ready to roll up your sleeves."
>
> –Chaden Lassoued, Kinetics Energy Services

Question from Audience

How does being in a volatile price cycle affect the dynamic between the PE firms and the operators?

Matt Morrow, Five Point Capital: In times like this, you do have to reset some of the expectations of what your capital's worth. Really, this downturn in the price environment made our capital more valuable. You're seeing the producers having to sell their assets now because they're trying to find capital to drill or find capital just to survive. You're seeing many of the midstream companies, the MLPs that have normally been doing very, very well, now selling assets.

So our current expectations have gone up somewhat. And we're trying to take that message down to the portfolio companies. We have the opportunity now to actually have higher returns than we did before. The biggest misalignment that we can have with any of the management teams is the understanding of how we value our base case [expectations], our low case, and our high case. [The management teams] have to understand how we look at it, and we should be in agreement on how we look at projects as we move forward.

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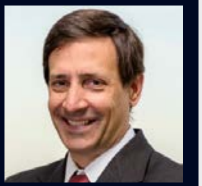
Fishing in Troubled Waters

Experts on distressed opportunities describe a protracted environment where not all underperforming energy assets are created equal

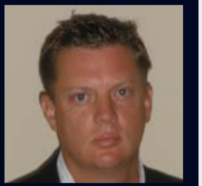
"In terms of what opportunities are going to be interesting moving forward, it obviously has to do with the underlying rock. You can have operators that get the most out of their assets that are actually very competitive against somebody who actually might be sitting on much, much better rock, but not as good amount of credit."

Shaia Hosseinzadeh, WL Ross

Shaia Hosseinzadeh
Managing Director,
WL Ross



Vince Cebula
Managing Partner,
Solace Capital



Matthew Shirk
Senior Manager,
Transaction Advisory Services,
EY

Key Thoughts

Necessity Is The Mother Of Selling

"Frankly, the only time an owner will part with a high-quality asset is when they are out of options or money. And we came into the year with fairly robust capital markets activity in 2014 so RBLs [reserve-based lendings] were not overdrawn. Balance sheets were reasonable from a liquidity point of view. Now when you look at what's happened, hedges are rolling off, RBLs, or debts, are squeezing clients down."

Shaia Hosseinzadeh, WL Ross

Keep The Managers

"The likelihood of managerial change if we are actually owning companies through bankruptcies is pretty small. The teams here are experienced, they have been through multiple cycles, they are doing the right thing. And so what we are trying to do is helping correct their balance sheets into a new price tag."

Vince Cebula, Solace Capital

The First are The Worst

"Unfortunately the first wave [of] M&A that you've seen, and the first wave of distress that you've seen, has largely been bad assets, bad balance sheets, and maybe bad management teams. For those of us in the business of having patient capital, there will be plenty of opportunities in the 2016 time frame."

Shaia Hosseinzadeh

It Starts with "Reordering Deck Chairs"

"You will see lots of bankruptcies in the next six to nine months, but they will just be a right-side in the balance sheet, [a] reordering of the deck chairs. But later in 2016 or in 2017, if the prices stay down, then maybe you'll see actual asset transactions where the whole companies get sold."

Matthew Shirk, EY

Distress Will Stick Around

"Because of the sheer number of debtors out there, and [the] inability to raise a trillion dollars of private equity capital, it is a much longer window. People have plenty of time to pick their spots and invest in what they want to invest in."

Vince Cebula

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