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Privcap/Report

Private Equity Strategies for a **Low Oil Environment**

Veteran energy investors discuss how to thrive in a prolonged period of price volatility

EY Building a better working world

Andrea Heisinger
Editor,
Privcap

Adapting to a New 'Normal'

If 2015 was a year of muted energy activity by private equity players with uncertain expectations, 2016 is the year the industry came to grips with the idea that lower oil prices are the new 'normal.'

As a result, private equity energy deal flow is starting to pick up again. As Mitch Fane from EY relays in this report, he's seen an "unprecedented" number of bankruptcies from energy companies in this latest down cycle. Those bankruptcies often make an energy operator more attractive to private equity, not less.

This report is designed to help navigate this new landscape. The vice chairman of First Reserve says the key for weathering a down energy cycle is to partner with good managers with access to "good rocks." Gary Womack of Tall City Exploration, which partnered with Denham Capital during the downturn, stresses the need for "extremely good due diligence" during the present cycle.

On a more macro scale, a co-chairman of the Global Forum on Energy Security explains how Saudi Arabia engineered a bout of low oil prices, and why we're entering a new era of shorter, more volatile energy market cycles.

But as oil prices settle into a new normal, energy deals will pick up speed again. We hope that the information in this report helps you in your search for the best opportunities in the sector.

Enjoy the report,

Andrea Heisinger

Privcap/ Game Change

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‘Good Rocks,’ Good Management Will Drive Good Returns

John Hill
Vice Chairman,
First Reserve

Veteran energy investor John Hill describes the difference between the current oil price collapse and previous downturns

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Privcap: First Reserve has been through many cycles. What is different about today’s energy price swoon from previous down cycles?

John Hill, First Reserve: In many ways, it’s similar to other cycles, but they have different reasons for the cycles. I guess this is my third trip through these major upheavals in the cycle since we started First Reserve in the early ’80s.

In the ’80s downturn, it was driven by a collapse in demand. The ’90s were driven by a drop in demand as well, and even more recently, the 2009 collapse in prices was a drop in demand. Today’s cycle is driven by an increase in supply. This is a supply issue created, by and large, by the shale play. In the ’80s, there were probably more bankruptcies—500,000 people lost their jobs. We don’t see that happening this time. Sure, there’s going to be a lot of bankruptcies in the E&P space and in the service and equipment space, but nothing near the number [in the 1980s].

As you look at various players within the energy landscape, where do you see businesses poised to snap back to roughly where they were before the price swoon?

Hill: I don’t think anything’s going to snap back anytime soon. As we approach 2020, we think there’ll be a gradual recovery in the industry as cash flows improve and capital spending improves. But I do think there are some companies poised to benefit from this and others that won’t. Obviously, small, overleveraged companies aren’t going to make it. We think most of the wash-out will occur by the end of this year, but if you look at the majors—they’re fine. The large independents are fine. Sure, they’ve got constrained cash flows as well, but they’ve been able to tap some equity markets to rebalance their balance sheets.

Where do you as a private equity investor make money in a market that you say is gradually recovering?

Hill: The most interesting play for us, first of all, starts with good management teams. I’ve said for years that the biggest, most scarce thing in our industry in energy is good management. You need people who are technically competent, but are also good managers of capital-intensive businesses. First and foremost, teaming up with good management teams, but secondly, doing so in areas with what we call “good rocks.” If you look at some of the shale plays in the western U.S.—the Permian Basin, for example—there are great areas in there that you want to be exposed to as this recovery starts to occur.

What does deal flow look like in todays’ market?

Hill: The deal flow’s been strong...since prices collapsed. On the other hand, it’s only recently that we begin to see deals that look reasonable. Sellers are just now starting to finally get realistic on valuations.

How an E&P Veteran Weathers a Down Market

Tall City Exploration announced a $300M equity infusion from Denham Capital in May. But before that happened, it sold $1.2B of assets.

> "The opportunities are more defined in the Permian because of the volume of drilling in the past five years. The main task this time is to do extremely good due diligence in anything that we buy."
>
> —Gary Womack, Tall City Exploration

Tall City Exploration knows what it's like to sell assets when the oil and gas market is booming—and after the bottom falls out.

The Midland, Texas-based oil and gas exploration and production company shed two assets in the Permian Basin between November 2014 and November 2015. Demand was strong for the November 2014 sale of about 14,000 acres of leasehold in Reagan County, Texas, and 1,400 barrels of oil per day to an affiliate of American Energy Partners for $440M in cash and notes, says Gary Womack, Tall City's vice president of operations.

Then came the downturn in oil and gas prices, and Tall City's sale of acreage and interests in wells in the Midland Basin was a much different story. "The Howard County [Texas] asset was a longer process; things semi-stabilized a year ago," says Womack, referring to Tall City's $803M sale to Moss Creek Resources. "We had a buyer approach us who made an acceptable offer. The volatility and pricing made sales more difficult in 2015. Now one of the challenges is there's a lot of discrepancy in buyers' and sellers' price expectations."

Denham Capital, which first met with and invested in the Tall City team back in 2012, had lengthy discussions with the company prior to its divestment of the two assets. According to Denham partner Jordan Marye, those at the firm struck a "philosophical and strategic overlap" with the management team at Tall City, and an agreement emerged. "They were starting a company, and we wanted to be there as a sponsor." The firm committed $300M in equity to Tall City Exploration I, and in May announced a new $300M equity commitment to Tall City Exploration II. The new company will look for investments throughout the entire Permian Basin, located in a swath of Texas and New Mexico, rather than in specific parts like its previous iteration.

Womack says he's been around the oil and gas business for about 25 years and has seen a lot of ups and downs in the oil and gas market. There has been one difference in this down market, he continues: the magnitude. "The buildup as far as activity [in the Permian Basin] is several degrees of magnitude greater than what I've seen in the past." He adds that the downturns he's seen in his career are the same every time. "There's a little bit of infrastructure devastated, but then it's built back up, [and the] service industry takes the hardest hit. We're on the upside of that right now."

One difference between investments made from this second equity commitment from Denham Capital in 2016, versus the first equity commitment in 2012, centers on the exit strategy of assets. "The opportunities are more defined in the Permian because of the volume of drilling in the past five years," says Womack. "The main task this time is to do extremely good due diligence in anything that we buy. We need to manage price volatility.

"We all think that [oil and gas pricing] will work itself out, but the timing is uncertain. Now we're in a buying mode, buying acreage." ■

High Volatility:

How Saudi Arabia Is Driving Oil's New Price Reality

Click to watch this video at privcap.com

While the country strives to keep oil prices low globally, U.S. producers are facing a perpetual price roller coaster

Privcap: So much of the global economy and global energy markets hinge on Saudi Arabia. What do investors need to know about what's going on in Saudi Arabia in order to make informed decisions?

Gal Luft, Global Forum on Energy Security: Saudi Arabia is fighting multiple wars at the moment. It's an embattled state in the sense that they're fighting a proxy war against Iran in two locations: one in Yemen and the other in Syria.

At the same time, they're also fighting an economic war. Who is the enemy? The enemy is Texas. The enemy is Pennsylvania. The enemy is North Dakota. Why? Because in Saudi Arabia, people don't pay taxes, so all the money to keep the country intact has to come from oil. And they need over $90 a barrel to break even. They're not getting it, as is the same situation in the rest of the OPEC countries.

The Saudis made a strategic decision to keep the prices of oil low enough for a long enough time in order to decimate the competitors, to destroy as many American oil companies. Most of them need break-even prices of $50 or $60 a barrel, and if they eliminate enough of the competition while hurting the Iranians, they're getting two benefits. And I think they're willing to pay the price.

In terms of this notion of keeping prices low to shake out the global oil industry, it's a complicated and potentially perilous endeavor. So what are the risks for Saudi Arabia? How long do they need to keep this up?

Luft: Obviously, the downside is that it's costing them money. Every day that the price is low, below what they need, is a net loss for them. But they take the long-term approach here, and they have deep pockets. Unlike most of the other OPEC countries, like Venezuela, Nigeria, or Angola, who have no money, Saudis have cash reserves.

I think their strategy is beginning to work, because we already see an increasing number of American companies moving towards bankruptcies. It's very hard for them to recycle their debts. But you're right. We don't know how long exactly it will take. They still have time, and I think they still can do it for another year or two, easily. After that, it's going to be quite complicated, because that will mean they will not have enough money to keep their population happy.

How much does Iran looking to expand its economy factor into all of this?

Luft: The Iranians have huge potential, but they don't have money. In order for them to materialize their potential, they need investment, and their investment is not there. It's one thing to materialize your pre-existing capacity. It's another thing to increase production capacity, which will take many, many billions of dollars to do.

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"I think that, as long as we live, we will see volatility in the oil market. We are looking at what I call 'perpetual W.' For many years to come, oil prices will go high, will go low, and will fluctuate."

Gal Luft
Co-chairman, Global Forum on Energy Security

The Saudis don't want to see this happening. They don't want Iran to resume its legendary role as a leader in oil and gas production. And they prefer to keep the price low, for now, in order to stall investments and to make the investor community less excited about long-term, very expensive products.

Then, there is another wild card here. What's going to happen in Libya? Remember, Libya is another producer that has stalled because of civil war. But if we see a movement towards a peace agreement, which I think we'll see in the next several months, we could see potentially another one million barrels of oil coming into the market.

There's the possibility of the Saudis putting together a large—in the trillions of dollars—sovereign wealth fund to diversify [their] investments. What do you think that means for the private equity funds that are always looking to raise capital from sovereign wealth funds?

Luft: The Saudis, in the grand vision of reducing their dependency on petrodollars—it all comes back to two different initiatives. One is the privatization of parts of Saudi Aramco, and that has to do with a lot of things they will have to embark on the terms of providing access to data, which is something that is very difficult to know if they will be able to execute.

The other one is the creation of this fund, but the numbers that they are talking about don't sound realistic to me. In my estimation, the Saudi cash reserves are something in the order of $500B to $600B right now. If low oil prices continue, that money will be eliminated gradually, and I don't know where they can bring up such an amount of money.

So while it may be a good idea for them to create a fund and to begin to invest in things that make sense, that provide revenue for the long term, what they want to do is to make sure that they have other sources of revenue.

Let's take the perspective of a U.S. energy producer. Assuming that the Saudis are successful and the shakeout happens, what would then be the new normal once this current volatility subsides?

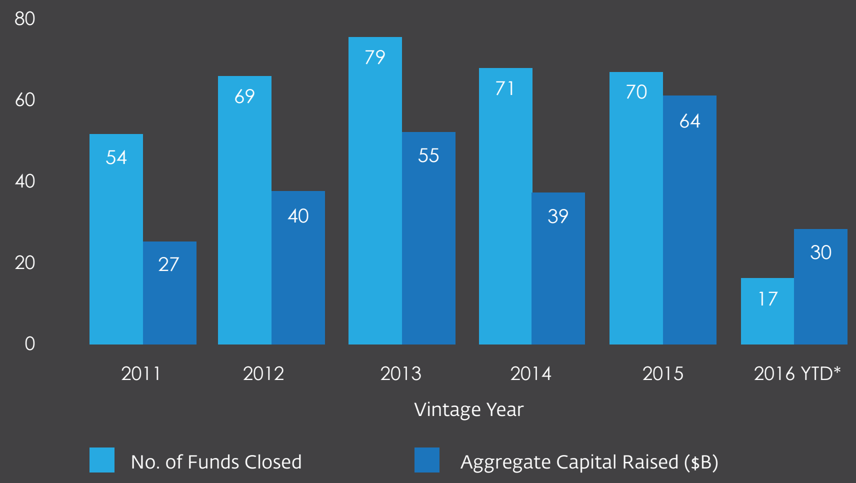
Luft: I think that, as long as we live, we will see volatility in the oil market. We are looking at what I call "perpetual W." For many years to come, oil prices will go high, will go low, and will fluctuate.

Do you think it's going to be shorter cycles, given the various levers that could be pulled and the increasing number of players who can pull them?

Luft: We've seen cycles of about 20 years. Now we're probably going to see five-year cycles, and that's the difference. It means that, for the life of a company, it requires adaptation to the whole new normal.

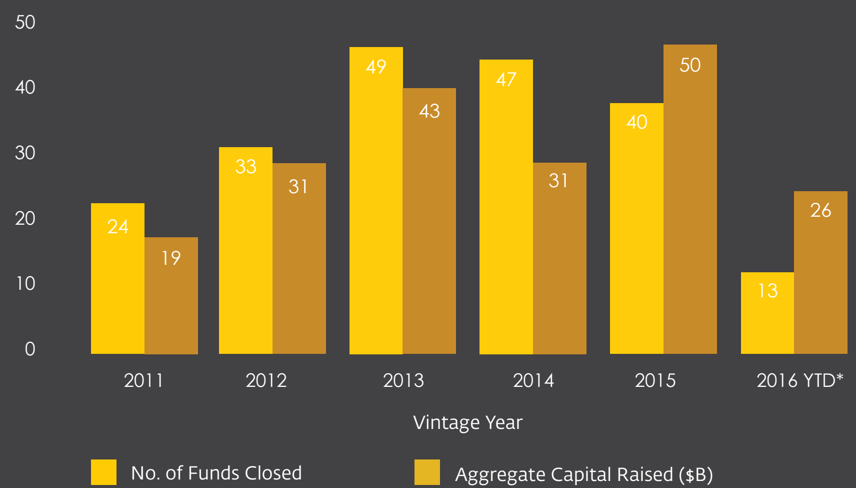
Can Energy Fundraising Recover?

The number of energy funds closed, both in the U.S. and globally, is on pace to be noticeably less than in 2015. But capital raised is likely to match levels from the previous year.



Global Fundraising Takes a Nosedive

Despite the oil price drop, the number of energy-focused fund closes remained somewhat steady—until 2016



Energy-Focused Capital Raising Perseveres in U.S. Funds

While the number of PE funds closed in the U.S. has continued to drop from 2013 levels, capital raised is on pace to equal that of 2015, which beat that of the previous four years

* As of August 9, 2016

Top 10 U.S. Energy Funds

Fund Name	Final Close Date	Fund Size ($M)
EnCap Energy Capital Fund X	04/07/15	**$6.5 M**
ArcLight Energy Partners Fund VI	07/29/15	**$5.6 M**
NGP Natural Resources XI	01/15/15	**$5.3 M**
Blackstone Energy Partners II	01/26/15	**$4.5 M**
Quantum Energy Partners VI	04/20/15	**$4.5 M**
GSO Energy Select Opportunities Fund	09/01/15	**$2.9 M**
EnerVest Energy Institutional Fund XIV	11/13/15	**$2.3 M**
Ridgewood Energy Oil & Gas Fund III	07/21/15	**$1.9 M**
Carlyle Power Partners II	04/11/16	**$1.5 M**
Old Ironsides Energy Fund II	04/20/15	**$1.3 M**

Source: preqin

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Why Timing is Everything in Today's Energy Market

Why a Rise in Energy Bankruptcies is Good for PE

Why Timing Is Everything in Today's Energy Market

Oil prices have remained far below record levels for nearly two years, and most players in the market have adjusted, whether by business acumen or by financial necessity. But what does that mean for private equity? Mitch Fane, principal, US Energy Transactions Advisory Services Leader at EY, outlines how buyers and sellers are handling the new reality of restrained oil prices.

▶ For more from EY, visit ey.com/oilandgas

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Mitch Fane

Principal, US Energy Transactions
Advisory Services Leader,
Ernst & Young LLP

Privcap: How are buyers and operators in the upstream space handling the continued oil price decline?

Mitch Fane, EY: If you look back at the low commodity price cycle, the first reaction for many producers was to batten down the hatches. They focused on minimizing capex and drilling, conserving cash and living off of their hedges in the hopes that there would be a quick rebound in the commodity price. As the cycle expanded and the industry realized low prices were going to continue, many independent E&P companies entered bankruptcy in order to financially restructure their balance sheets.

What are energy asset prices like, and how are the prices impacting buyer-seller interactions?

Fane: It's a pretty sophisticated market. Buyers realize that because it's a commodity, you have to buy when the cycle is low. At the same time, sellers are looking at long-term price curves and hoping they can survive the downturn (and avoid having to sell) until the commodity recovers.

So for companies that can survive, they are not interested in selling. Instead, they are focused on enduring until the recovery. But the companies that have been forced to go into bankruptcy because they have run out of cash and liquidity will likely have to sell off assets. We have started to see some transaction activity as these companies enter bankruptcy and begin to emerge. As more companies emerge and finalize their financial restructuring, we expect more assets to come into the market.

What would be the impact of buying these energy assets too soon?

Fane: The fear is buying assets or a business that really doesn't have enough liquidity to survive until the economic recovery occurs. For example, a company could buy assets and, unfortunately, end up going back into bankruptcy. Or, more likely, a company could jump in and buy, and then have to hold on to those assets or business for two or three years before a strong recovery results in positive returns.

Conversely, what are the consequences of waiting too long to buy these energy assets?

Fane: The primary concern is missing an opportunity. There are a lot of buyers out there. And we will start to see some price pressure where other bidders come in and bid up the price before a buyer is able to enter the market and acquire those assets. The healthy tension is that if commodity prices remain flat to modest for many years, the gain is pretty thin. Timing is essential.

What happened in upstream in mid-2016 that affected people's strategies?

Fane: A slight uptick in commodity and oil prices during the summer led banks and lenders to reconsider writing off their investments in oil and gas companies. As a result, they began pushing back on some of the plans of reorganization and slowing down the bankruptcy process. However, recent data has shown that the

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summer driving season and other factors did not impact the supply/demand balance of oil as much as hoped, and so prices have moved down. Now operators and lenders are beginning to converge again around the idea that bankruptcy and financial reorganization will better position both parties to emerge and move forward.

Are there are other trends you see now, or that we'll see in the near term?

Fane: The amount and the volume of bankruptcies right now is unprecedented. When commodity prices were high, many banks and private equity funds extended capital with very, very loose lending policies. Oil and gas companies were borrowing at $100 a barrel. When prices collapsed to $30 a barrel, 70 percent of the value went away within a three-to-six-month period. Many companies are still struggling with the impacts of that drop—what does that mean for the company, can it survive, and can it survive past its hedges, which are short-term in nature? Up until this point, companies have survived because they turned capex off. But now and in the next six to 12 months, they're finding themselves in a situation where they will run out of liquidity. We have talked about liquidity cliffs for the past 18 to 24 months, and now is when we will see these cliffs come to fruition.

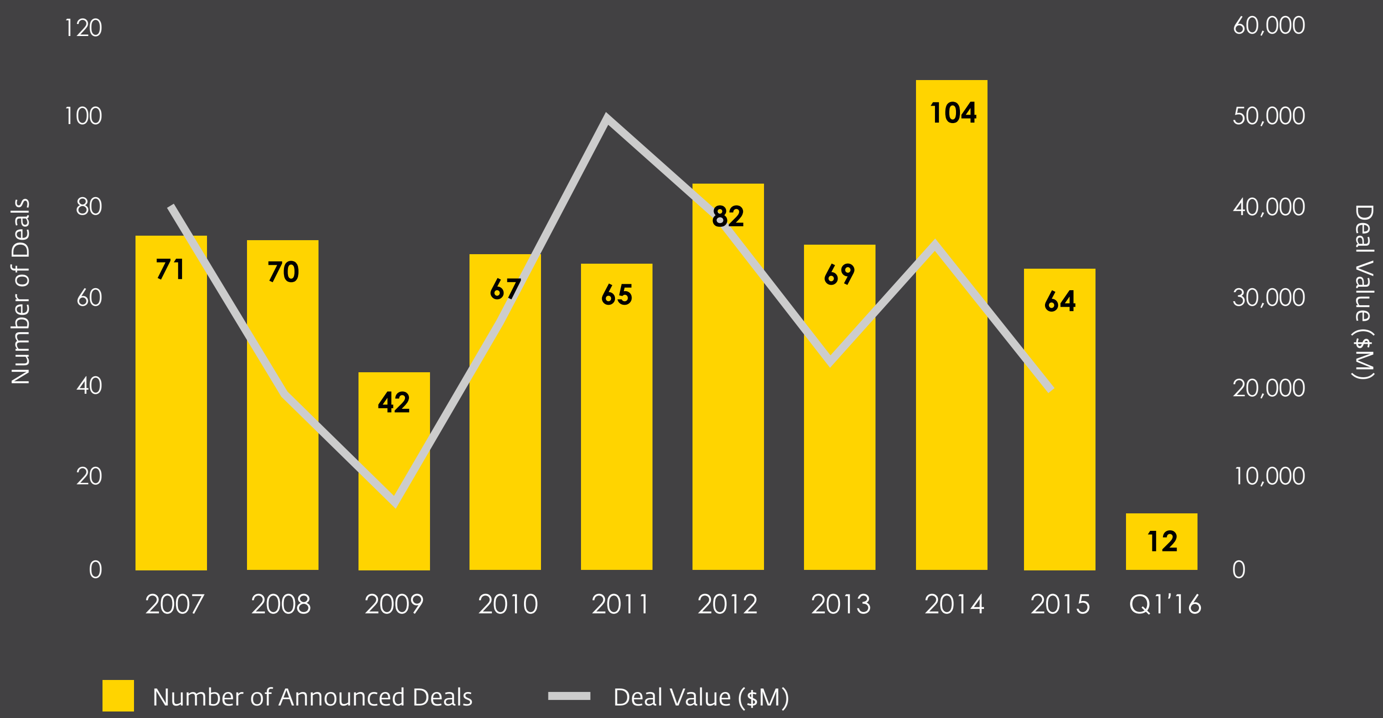
From a private equity standpoint, I'd expect funds seeking to increase their energy assets to be very aggressive in screening all of the oil and gas companies. They need to pinpoint the superior management teams in the industry as well as where the better operators are located.

In summary, although M&A activity has been light in the industry during the past 18 to 24 months, I do anticipate an increase in the next six to 12 months. ■

The views reflected in this article are the views of the author and do not necessarily reflect the views of the global EY organization or its member firms.

Will Global Oil & Gas Deals Recover?

A stalemate between buyers and sellers of assets could be thawing, but it's unlikely that the number and value of deals will recover enough to match even 2015 levels



Source: Mergermarket

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Why PE's Wait for Distressed Energy Deals Might Be Over

After two years, private equity might finally be able to seize distressed opportunities. Vinson & Elkins' Mark Proctor explains why.

Mark Proctor
Partner,
Vinson & Elkins

Privcap: What are you seeing for energy fundraising so far in 2016?

Mark Proctor, Vinson & Elkins: So 2016 has definitely been a slower year for fundraising in the energy markets. There were about 16 funds that closed on about $16B of capital in the first half of 2016. In 2015, energy funds specifically raised about $64B of capital. In 2014, they raised about $40B of capital. So from just a sheer amount of capital raised, we're on a slower trajectory.

There's a record amount of dry powder in energy funds. Why isn't it being deployed?

Proctor: Energy funds are sitting on about $160B of dry powder right now, according to one estimate that I saw. And they've been slow to deploy it mostly because of the commodity price environment. For a while, buyers have been reluctant to go out and do deals because first they were worried about catching the falling knife, and they all felt like they paid too much for assets. And then the next phase was uncertainty about whether oil prices were going to climb back up to around $100 a barrel—or even $80 a barrel—or whether they were going to hover long-term around this $40-to-$50-a-barrel range. It seems like people are getting comfortable that [oil prices] are not going to climb back up to $100 a barrel and they're going to be somewhere in this middle range of say $40 to $80 a barrel. And so buyers seem like they're more willing to go in and do deals.

What kind of opportunities is the dynamic between buyers and sellers creating for PE?

Proctor: The capital markets have been slower to recover, and if you look at the numbers, we're probably on pace to do half as many deals in 2016 as we did in 2015. And so companies that need to raise capital—either to acquire assets because they think they're getting great prices or to de-lever—have looked to alternative sources of capital, including private equity. So private equity firms have the ability not just to acquire assets directly, but also to jump in and finance other asset buyers that otherwise would have looked to probably the public capital markets in order to raise equity and debt.

Some players are starting to do energy M&A deals again. What in the market has changed?

Proctor: There are certainly more distressed deals out there now than there were six months ago. If you just look at the latest headlines, you've had more than 90 companies in the oil and gas space—specifically, E&P companies—file for bankruptcy in the last two years. You've had about as many oilfield services companies file for bankruptcy.

You've had banks considerably pulling back in the market and re-underwrite reserves and, as a result, reduce borrowing basis. So companies have been in a position where they've needed to raise more capital. A lot of the sellers have been either in distress or near distress where the private equity firms that are on the buy side have been able to get comfortable with the pricing. ■

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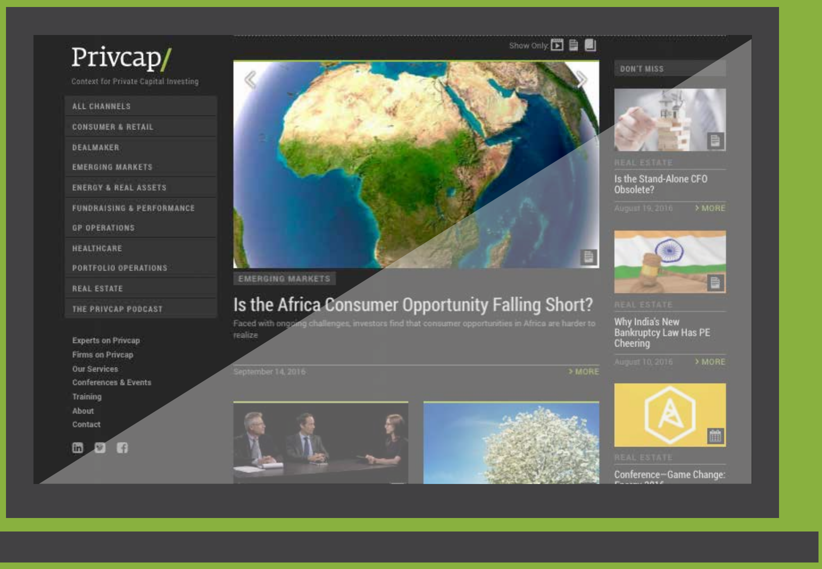

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