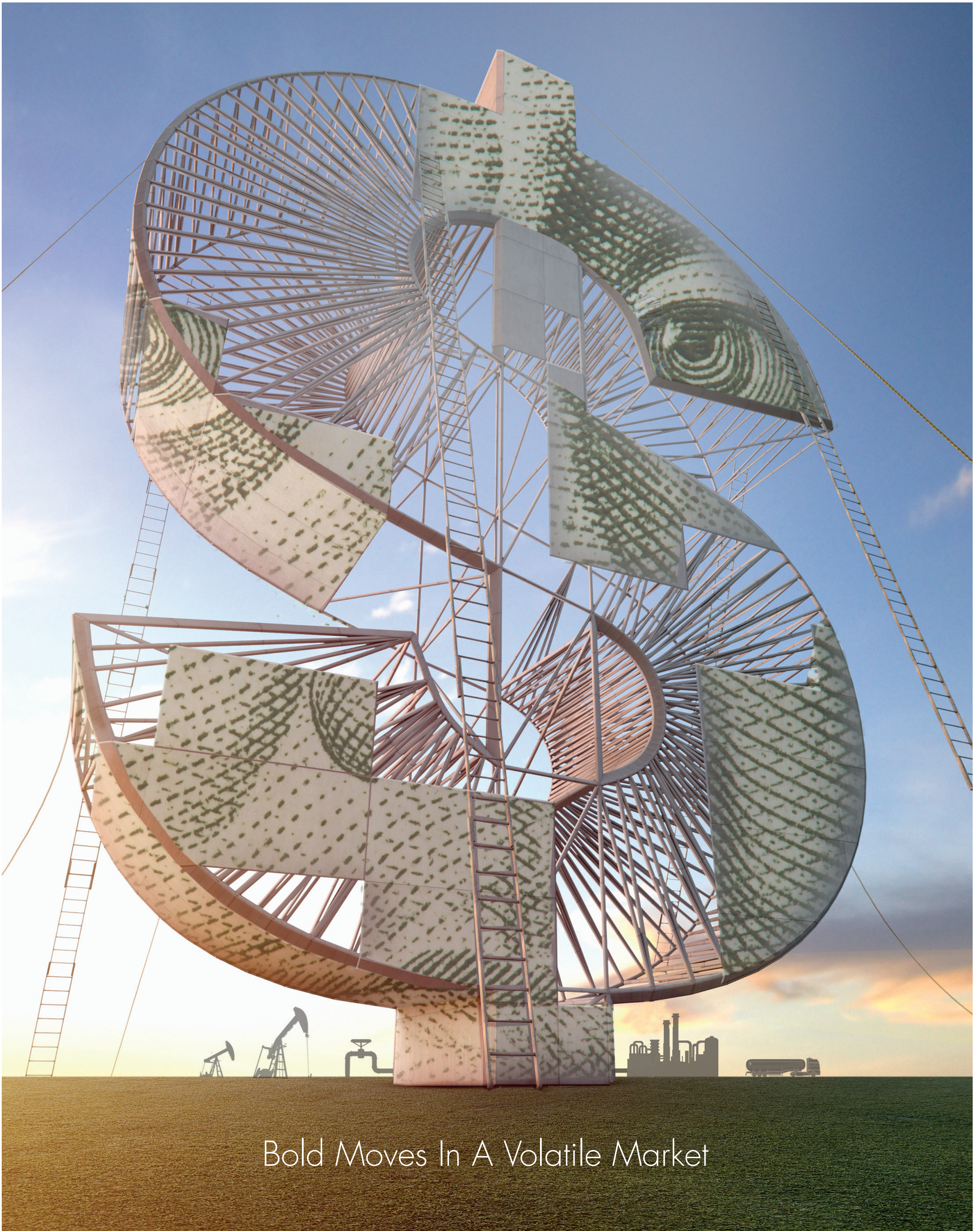
CAPITAL FORMATION 2019



A Supplement To

Oil and Gas Investor

MAY 2019

HARTENERGY

PRIVATE-EQUITY INVESTMENTS STALLING

The caution flag is out in what one provider calls a "super challenging" environment.

By Ellen Chang

Some private-equity investors are sitting on the sidelines when it comes to upstream investments as returns remain lukewarm and uncertainty about commodity prices tempers their enthusiasm.

Investors remained cautious when oil prices were volatile in second-half 2018, after hitting a high of $75 a barrel (bbl), but dipping to a low of $45/bbl on fears of global oversupply. Technology advancements such as enhanced completions, improved operations and better hydraulic fracturing applications have resulted in the resurgence of U.S. oil production.

"Some investors are waiting for prices to stabilize or drop further before making larger or long-term investments," said Evan Turner, managing partner of Drillcore Energy Partners, a New York-based private-equity firm that was launched in 2017. It targets oil and gas investments in unconventional shale plays in North America.

Some investors have opted to provide equity commitments, growth equity or creative drilling capital to upstream companies that are already in their portfolio, or that have an existing business with producing assets, rather than to a start-up E&P seeking assets, he said. Private-equity firms are shying away from bringing on new management teams at the moment.

Some management teams who are starting over after successful exits have chosen to switch from their original private-equity sponsor to a larger, more upstream-focused sponsor. For example, Massif Oil & Gas I LLC was a portfolio company of private-equity firm Castlelake LP, but in November 2018, Massif II was funded by Natural

"An inhospitable climate for exits is a problem."

Jonathan Farber, Co-founder and a managing director, Lime Rock Partners

Gas Partners, Turner said. Massif focuses on the Powder River Basin.

Subpar returns for private-equity firms create an environment which is "super challenging," said Jonathan Farber, co-founder and a managing director of Lime Rock Partners, a Westport, Conn., private-equity firm. It has raised $8.9 billion in private-equity funds and affiliated co-investment vehicles since 1998.

Drilling has shifted geographically in the U.S. In 2011, there were 219 U.S. counties which had drilling rigs running on them, he said. Today just half of the same counties are being actively drilled.

"The shale plays have such an incredible economic advantage relative to conventional drilling and geographically, the business is far more concentrated," Farber said. "That's pretty significant. Unless you're in one of those anointed places, it's really difficult to generate good returns."

Exits which are attractively valued are "hard to come by" and in the vast majority of conventional production, companies cannot find buyers, he said. "If a deal can be done, it's very basement-type pricing," Farber said.

The public markets have lost confidence in the energy sector. The hiatus has stretched to the IPO market; in the past two years, there have not been any exploration and production IPOs.

Public markets have typically led investors out of a slowdown in the past, but public investors are "extra skeptical that these companies can generate value," he said. Public market investors want exposure to better portfolio companies, but under the current market environment, it does not appear to be on the horizon.

Instead, investors remain wary of the claims made by the management teams of many E&P companies and want them to spend within their current cash flow, Farber said. "This has created an inhospitable environment in terms of exits for the companies," he said. "The public market simply isn't there and the private market is very selective."

Outside the fairway

Many private upstream operators are still seeking a combination of acquisition and development capital, but are not reaching their goals, Drillcore's Turner said.

"Often they are just outside of the target fairway of where most investors are willing or advised by outsource technical firms to go into, even though the operators often have producing properties with proven methods of capital realization from their own pockets," he said.

As a result, private-equity firms such as Drillcore Energy Partners have looked to take advantage of pipeline constraints in certain areas, such as West Texas in the Permian Basin, as well as oilfield services and equipment manufacturing companies. This strategy is more typical of generalist investors or industrial-focused private-equity sponsors or investment managers.

"We have even looked at some technology applications for big data in the energy sector as a secondary, opportunistic focus area that can be leveraged to enhance upstream operations," Turner said.

The overall outlook for the private-equity market for both private-equity firms and E&Ps seeking investments is "not great unless you are willing to actually fund and build and operate a company longer term," said Mark Tharp, managing director and group head of Dallas-based Orix Energy Capital. "The lack of liquidity will test all PE firms." Orix invests private-equity and debt in upstream and midstream companies in the U.S. and Canada.

Deal size varies

The typical deal size for an upstream company is $50- to $500 million for Orix, which only invests in companies or assets that have existing cash flow, while Lime Rock prefers investing $50- to $150 million per deal, but will fund up to $600 million if it's a co-investment.

"Sometimes we will raise capital for specific deals, and we're not afraid to look at larger deals if the opportunity brings us there," Farber said.

Drillcore Energy Partners is an emerging manager and is in the fundraising process on select deals as an independent sponsor outside of a formal committed fund.

"We have gotten to the deal table on a number of select opportunities, including upstream-focused opportunities with existing production that are seeking acquisition and development capital through a variety of growth equity and creative financing structures, including in the Permian Basin (both Delaware and Midland basins), East Texas, Eagle Ford, Haynes-

ville, Powder River Basin and the D-J Basin," said Turner.

The firm is also in discussions with its LP base and co-sponsors on a few different opportunities where Drillcore has exclusivity to ideas that are "truly off-market."

"We look forward to getting to the finish line with them soon," he said. "We ideally are seeking control-oriented opportunities where we can roll up our sleeves and apply our technical backgrounds in partnership with management teams, but we have been open to co-investments from a non-control perspective where we have some board presence."

Lime Rock invested $100 million in 2007 in CrownRock LP, a Midland, Texas-based oil and gas producer, through Lime Rock Partners IV LP. In June 2018, Lime Rock Partners raised a $1.9 billion fund to purchase CrownRock LP, giving the company a valuation of $5 billion.

"CrownRock has built a nearly 100,000-acre land position that is now producing more than 50,000 barrels of oil equivalent per day," Farber said.

In December 2017, Lime Rock sold GEODynamics Inc., a Millsap, Texas-based provider of oil and gas perforation systems and downhole tools in support of completion, intervention, wireline and well abandonment operations, to publicly held Oil States International Inc.

The deal was profitable and "generated an extremely successful return," he said. "It's harder to make money in oilfield services because much of the business has become highly commoditized and there is very little pricing leverage."

The last three exits for Orix Energy Capital were all "great" since they were vintage deals from the 2015 to 2016 period when "very few people were putting capital to work," Tharp said. "It was the heart of the downturn."

Challenges facing PE

The ideal target threshold for Drillcore Energy Partners has not existed since the market has remained volatile the past few years, Turner said. "While the market has stabilized, you still have a price disconnect with what buyers are willing to pay and what sellers want for their company or a specific asset in their portfolio," he said. "As such, you have a number of PE firms and their portfolio companies in a waiting pattern."

Investors and companies do not want to buy conventional production assets, Lime Rock's Farber said. "The private market is extra weak," he said.

As the difficulties with exits continue in the current environment, PE firms and their portfolio companies are adopting other strategies.

Lime Rock's strategy shifted five years ago to holding businesses longer and investing in various geographic regions instead of focusing on one state or basin, a concept "which has served us very well," he said.

Back in 2010, the firm made a bet that the shale revolution was going to be "really profound in terms of long-term implications and we began focusing on that area," Farber said. The private-equity firm began focusing on buying and developing positions in core shale acreage areas, which remains its focal point today.

While Lime Rock was offered good pricing for its initial E&P investments, it was still not the full price, so the firm came to the conclusion that a hold and drill strategy would be more profitable longer term, he said.

The firm also started adopting a strategy of acquiring mineral rights.

Drillcore Energy Partners remains cautious on two fronts: about both the correct investment to make initially, and how to exit it at the right time and for the right multiple.

"As prices have been volatile due to supply and demand adjustments, we have been looking for the right oil and gas management team to partner with so we can buy producing assets or invest in a producing property alongside that team," Turner said. "This would allow us to achieve a minimum target three times MOIC [multiple on invested capital] for our investments, underwritten at $50 oil and $2.50 gas."

Another strategy the firm is considering is to look at pairing producing assets that may not be the main part of a larger company's overall portfolio, that could be paired with a management team operating a nearby asset, or one that's looking to expand or acquire an asset while also seeking acquisition and development capital.

"Drillcore Energy Partners remains cautious about the correct investment to make initially and how to exit it at the right time for the right multiple."

Evan Turner,
Managing director,
Drillcore Energy Partners

Midstream, mineral deals add spice

While oil prices remain range bound in the $50s, private-equity firms are conducting deals in other parts of the sector. Orix, for one, conducts both midstream and mineral acquisition deals. "Our portfolio is made up of a diverse set of asset investments including midstream and, to a lesser extent, minerals," Tharp said.

Lime Rock does not invest in stand-alone midstream businesses, but will invest in midstream assets as part of building an E&P business in a given area, Farber said. However, Lime Rock has invested more money as a percentage of its funds in mineral rights than many other private-equity firms, he said.

A recent survey by Parkman Whaling of 40 private-equity providers indicated that fundraising remains a challenge because of such negative investor sentiment toward energy. Despite these current market conditions, this is a great environment to deploy non-bank loans on a secured basis with 8% to 13% cash-on-cash returns possible, Tharp said.

"I invest off the Orix balance sheet today, but I am considering third-party institutional capital," he said.

If the LPs are typically becoming more cautious, some firms might adopt more stringent underwriting criteria and a higher cost of capital for upstream start-ups. This sentiment does not apply to Orix though, because "good portfolio managers should never bend the veracity of their underwriting standards," Tharp said. "We certainly do not at Orix Energy Capital."

Drillinginfo Inc. said recently in a report that private-equity providers have throttled back on funding new E&Ps because exit strategies have been so tough recently. Additional private-equity firms are pulling funding to form teams without projects or assets to manage as a result, Tharp said.

The private-equity model appears to be changing—the old build-and-flip model is not a slam dunk anymore.

While it is unknown whether this is a temporary phenomenon or a really long-term sea change, the "ability for a PE firm and their management teams needs to focus on full-cycle returns that ultimately lead to free-cash-flow generation," Tharp said.

In recent years, it appears easier to build and sell a midstream entity than an E&P.

"For the very lucky few that can pull it off, that is true, but I am ultimately more bullish on the high-quality E&P names that have blue chip sponsors and superior operational and execution teams," Tharp said.

Adjustments are needed on the midstream side since the prior strategy of purchasing older pipeline infrastructure and renovating it was profitable, but today most of those opportunities have already been captured, Farber said.

Private-equity firms were able to generate a profit using that strategy in the past because they were operating in a low interest rate environment and capitalized at a low yield. As interest rates are expected to continue rising, the valuation arbitrage is not as obvious, he said.

The outlook

The near-term future depends on the results of the borrowing base redeterminations and oil and gas supply and demand imbalances that may affect the remainder of 2019, Turner said. "I believe you may see an improved outlook in the second half of the year."

What are the best opportunities for 2019 and into 2020 for private-equity providers and E&P companies? The continued divestiture of assets from mid-cap and large-cap companies and majors is a source of opportunity for private equity as the industry focuses on only the core basins with the lowest-cost breakevens, Farber said.

"This would create a lot of opportunity for lean PE-backed operating teams that understand how best to truly optimize costs and operations," he said. "And, midstream is not dead and so, there will be opportunities to invest in networks, pipelines and other assets," he added. "However, it will be harder to make money in that space now than in the past five years."

The global economy relies heavily on the use of crude oil and its products despite advancements in renewables and the electric vehicle industry, and will likely remain that way for the next three decades. "The world is using a lot of oil and will continue to use a lot of oil," Farber said. ■