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Private Equity Is Filling Capital Gaps

By Colter Cookson

Developing the unconventional plays that have transformed the United States into a net exporter of natural gas and a driving force of world oil markets requires vast sums of capital. Based on type curves for unconventional plays, Macquarie Infrastructure and Real Assets estimates that the U.S. oil and gas industry may spend as much as $500 billion during the next five years on projects that deliver attractive returns with oil prices between $50 and $60 a barrel.

That capital will need to come from somewhere, notes Paul Beck, one of MIRA's senior managing directors. While producers will continue reinvesting their cash flow, he says much of the money will come from outside sources.

The public equity markets may not be able to provide as much capital they have in the past, Beck warns. "Investors are in the oil and gas game, but they are focusing on larger companies with more liquid stock so they can back out if the industry or the company they have invested in seems unlikely to deliver expected returns."

Smaller companies can access the public equity markets, but Beck says they need exceptional acreage to attract investors' attention. "In the past, investors have encouraged companies to expand their drilling inventories and reserves," he recalls. "Now, they are saying, 'Enough with growth! Any company I invest in needs to make money.' That is encouraging public companies to focus on fiscal discipline and projects expected to generate strong returns."

Like the public equity markets, Beck says banks are investing less in oil and gas projects. "While most of the banks that had clients go through bankruptcy came out in decent shape, they would prefer to avoid going through bankruptcy proceedings again. In the past, a bank lent to an oil company based on the value of the company's proved, developing producing assets without significant consideration of other (subordinated) debt. Today, they are more cautious about lending to companies with other debt, such as public bonds, that could cause the company to go into distress."

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PAUL BECK
Senior Managing Director
Macquarie Infrastructure and Real Assets

Beck points out that regulators are encouraging caution. The restrictions they are putting in place limit banks' ability to advance large sums to upstream companies.

Mezzanine financing is in a temporary decline, Beck adds. "It is harder to raise capital for upstream mezzanine financings than it used to be. Even with $50-$60 a barrel oil prices, investors have other opportunities that can generate comparable returns, but do not have the price risks," he says.

"In the short term, private equity will fill the gaps left as other sources of capital have become more conservative," Beck predicts.

However, he acknowledges that private equity has limitations. Since investors need to achieve high returns, they may not back modest projects, he says. Additionally, someone investing multiple billions of capital may not be able to justify spending time on a $50 million transaction.

Beck continues, "It is harder to raise private equity today than it used to be, but there is plenty of capital to meet the industry's needs."

In April 2017, Macquarie Infrastructure and Real Assets formed a group focused on investing in exploitation, drilling and production companies. Beck says the new business builds on MIRA's experience in infrastructure, real estate, agriculture and energy, where its energy experience previously had focused on midstream and power.

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"This is a great time for a capital provider to enter the upstream sector," he says. "There is a need for capital and a vast set of opportunities. Texas has the Permian Basin and the Eagle Ford. Louisiana has the Haynesville. Oklahoma has the STACK and SCOOP. In the Rockies, the Powder River and Denver-Julesburg basins offer strong economics. So do the Utica's dry gas window in Ohio, and there are various plays in California."

In California, MIRA completed a $160 million partnership with California Resources Corp. to fund four projects in Kern County. Beck notes the firm has the option of increasing its commitment to $300 million. "We are pleased with this transaction," he comments.

When capital seekers approach private equity firms, Beck says they should have as much technical work done as possible. "Be organized," he urges. "Capital providers have more opportunities on their desks than they can fund. They will gravitate toward ones that are easy to understand and evaluate. That means companies with thorough, reasonable and well-organized technical work will have an edge."

Beck recommends capital seekers provide as much detail about the costs of a project as possible, including the cost to get production to market. "Be careful making big assumptions," he adds. "If the business plan assumes cost reductions, the steps to achieving those need to be thoroughly explained and extremely convincing. Similarly, if the type curve ignores nearby wells that performed poorly in favor of ones that performed well, there needs to be a solid justification.

"If operators take the time to tell a compelling technical story, private equity providers will be able to respond to and meet their needs more quickly," he concludes.

A Time for Discipline

With the public markets rewarding fiscal discipline and returns more than reserve growth, the oil and gas industry has had to become more disciplined, says Greg Beard, global head of natural resources at Apollo Global Management LLC. "In the past, oil and gas companies spent 1.3 times more cash than they generated," he relates. "Today, many are living within their cash flow."

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GREG BEARD
Global Head of Natural Resources
Apollo Global Management

With West Texas Intermediate prices in the $50-$60 range, producers with good acreage can make attractive returns, Beard says. "For most oil companies and OPEC members, $60 a barrel is a survivable price," he assesses. "If prices climbed by $10, the combination of increased cash flow and easier access to debt and equity could spur drilling that would dampen prices in six months to a year."

Institutional investors continue to subscribe to upstream-focused private equity funds, but Beard says that today, they look closely at managers. "When prices were high, most private equity firms that focused on natural resources were doing well. The downturn has helped the more cautious and prudent managers stand out, so new capital is flowing to them," he reports.

Among fund managers, Beard says there is competition to back the best management teams. He encourages those teams to look for backers that treat their portfolio companies as partners. "Teams need to take the time to ensure the potential backer sees the world the way they do," he adds. "If the management team and its backer view risk the same way, they will enjoy working together and make decisions quickly."

Beard also recommends looking for backers that limit how widely they invest to ensure none of their portfolio companies will be competing for the same assets, a situation he describes as a recipe for ill will.

"At Apollo, we have access to more capital than most firms. For larger transactions, we also can use capital from more diverse funds that are not limited to the natural resources industry," Beard touts.

He adds that Apollo is comfortable with complex capital structures. "For example, when times are tough, the funds we manage are willing to buy distressed debt," he says. "We have the industry knowledge and technical capability to look closely at the issuer's assets and confirm that we will get a decent return even if the company has to declare bankruptcy and convert our fund's debt into equity. This gives us a much larger opportunity set, which we believe has made it easier for us to raise capital."

When approaching private equity providers, Beard says a management team should stress its history. "If a management team wants to deploy capital drilling long horizontals in Appalachia, it should have experience doing that. Ideally, most members of the team have worked with each other in the past. That way, we know they get along."

When it evaluates investment opportunities, Beard says Apollo tries to make sure they will offer a reasonable return even if they never sell or go public. "We do not like to rely on a big exit multiple for an investment to be worthwhile," he says. "Instead, we look to help build businesses that can generate strong cash flows. That makes a sale more likely, but also allows us to preserve our capital if one never occurs."

Abundant Capital

There is more than enough private equity capital available for middle-market exploration, drilling and production companies, says George McCormick, one of the two managing partners at Outfitter Energy Capital. "In addition to those of us who have been around for a while, there are a number of new private equity managers who

have raised funds over the past two or three years," he reports. "In many cases, the managers believe now is a cyclically attractive time to put capital to work in the oil and gas industry."

McCormick concurs. "While I do not see a material increase in oil or natural gas prices in the near or medium term, the overall supply and demand dynamic is promising," he assesses. "Over the past three years, the global upstream industry has underinvested in bringing new production to market, as compared with prior years. As decline curves reduce supply and demand continues to rise, a supply gap likely will emerge.

"The United States is in the best position to fill that gap," McCormick says. "We have the expertise, equipment, infrastructure and good rock to grow production quickly."

Despite the vast sums of money looking for a good home, McCormick predicts capital seekers will face steep competition. "There are more private equity managers than there used to be, but there also are a ton of companies and management teams looking to fund projects," he says.

"The days when four or five smart, seasoned executives could form a team and get backing based solely on their reputations are over," he warns. "The reputations will help, but they need to have access to high-quality resources and show how they can use their expertise to deliver strong returns for the capital provider."

In selecting a private equity partner, McCormick suggests management teams look beyond the amount of capital a backer can provide and the terms it offers. "To be successful in the long run, the capital provider and the management team need to have similar expectations about how their partnership will work and respect the value they each bring to the table," he stresses.

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GEORGE MCCORMICK
Managing Partner
Outfitter Energy Capital

"The best private equity firms want to support their portfolio companies in every way they can," he says. "Sometimes that means providing advice on transactions or helping raise additional capital. In other cases, it means leveraging relationships to bring the company acquisition opportunities. Sometimes it is only acting as another set of eyes that can look at a project and come up with ways to manage risks and increase value for both parties."

According to McCormick, Outfitter generally backs companies that have a knack for finding smaller, off-market assets. "Our teams have the local relationships and expertise to buy high-quality assets at a low cost, which often means outside of auctions and other public processes," he says.

Most of Outfitter's partnerships start with an initial investment between $30 million and $100 million, McCormick reports. "Once we have derisked the asset with that initial capital, subsequent tranches will be less expensive, which is an advantage for us and the management team," he says.

The ultimate goal is to turn the assets into something sufficiently big and valuable to appeal to buyers. "Four or five years ago, those buyers might have been public companies," McCormick recalls. "Today, the public companies in many basins have such large drilling inventories that they are no longer as acquisitive as they used to be. Instead of selling assets to them, we often sell to private companies that are scaling up to go public." ❒