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Roundtable

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The volatility of the energy sector has turned the industry upside down. Top players in the space discuss what this means for investors and how dealmakers can capitalize.

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The volatility of the energy sector has turned the industry upside down. Top players in the space discuss what this means for investors and how dealmakers can capitalize.

Photographs by Alanfil

The energy markets, over the past few months, proved that they are not immune to the travails of the economy. Lower crude prices, the woes of the credit market, and diminishing demand have conspired to sink oil prices, reflecting a pullback that is being experienced throughout the broader energy market. And the slump in one area impacts another, underscored by the questions facing alternatives, which no longer seem as compelling alongside cheaper traditional fuels.

Mergers & Acquisitions brought together top names in the space to discuss the tectonic shifts facing the energy markets. The conversation focused first on the regulatory environment and then moved to what it all means for dealmaking. Taking part in the discussion were Greenhill Capital's Frank Pottow, Pine Brook Road Partners' Craig Jarchow, Douglas Korn of Irving Place Partners (FKA: Bear Stearns Merchant Banking), Debevoise & Plimpton's Maurizio Levi Minzi, and Harris William & Co.'s Andrew Spitzer. The following is an edited version of the discussion.

Mergers & Acquisitions: *Since the volatility seen in the energy market has seemed to take a lot of people by surprise, historically has energy operated in its own cycles, similar to healthcare, or was the precipitous drop in oil and gas prices something that could have been expected in light of the economy's downturn?*

Jarchow: Of course, you are going to have the fundamentals of supply and demand. And we are headed toward a time of economic weakness, so we are seeing a reduction in both oil and gas prices. In a sense, this was predictable because this is a cyclical business.

What you want to do in a downcycle is make sure that you are not long assets or long inventory. You want to be in a position in which you can play the margins in oil and gas, because when you get a reduction in prices, you also see service costs decline. There is a delay in the reduction of service costs, but if you are long assets or long inventory, it's not so easy to play that.

So, as investors, we try to be asset and inventory light. You don't want to pay for reserves. If you avoid large reserve or asset transactions at a peak, you'll be in position to play the margin when the prices go down.

Mergers & Acquisitions: *Given the rapid fall, can we now*

safely say that the record prices in oil were driven by speculation, or was oil, at \$147 per barrel, representative of a fundamental peak, driven by supply and demand?

Pottow: Picking up on Craig's earlier point, oil and gas are cyclical commodities. They are driven in part by supply and demand, but when you talk about supply-and-demand fundamentals, you have to ask about the time-frame. Are you talking about a long-term, secular trend or are you talking about a shorter term, cyclical trend? Or are you talking about an extremely short-term capital flow? I think those questions are all very different.

For example, the longer-term supply trends might focus on deliverability or the relative state of production by the global energy players. For demand, those trends will be driven by the economy, so to assume that the industry is recession proof is ridiculous.

Look at natural gas: You'll have shorter term trends, such as inventories. Natural gas is stored in the summers to be used in the winter, and those inventories are very important, and may play a bigger role in prices than deliverability or overall growth and demand.

Then you have an even shorter term timeframe when look at the growth in what you might call speculative inventories, which is the capital flow within the

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sector. You had a period that started in 2002 until about June 30, 2008 in which there was a phenomenal increase in the amount of capital investing in commodity-related investments; energy-related investments in particular.

I think what we're seeing now is that there are three different trends playing out. Supply and demand will go up and down over the three different timeframes and sometimes they exacerbate the other. What we



have seen during the past three months is an exacerbation of all of those trends. Global demand is going down, and is expected to go down in the face of a very pronounced global recession. You have an increase in deliverability of supply, because over the past five years energy companies have invested substantially more capital, increasing the productive capacity. Oil at \$140 per barrel made those projects look very attractive. Also, a lot of energy companies, particularly mid-sized companies in the US, had capital expenditure budgets well in excess of their annual cash flow, so that only added to the deliverability, which typically has a lag effect.

I also think you have seen a dramatic unwinding of what might be considered speculative investment positions. And if these investments are leveraged, margin calls could further drive liquidity away from the sector. But all of those are important factors.

Korn: There is a distinction between oil and gas, since oil is a part of the worldwide economy and is traded globally. Gas is largely a North American phenomenon. There is some importing of LNG (liquefied natural gas), but it's really a North American play.

The long-term dynamics of oil — from a demand

point of view — would seem to be strong. A year ago, people were caught up in the euphoria of the emerging markets and the demand coming from areas like China, Russia and India, which seemed to have this relentless thirst for oil. While to some degree it's true, that euphoria was short lived because we seeing demand destruction come from two things: the high prices and the economic downturn. So on the oil side, despite the demand equation, the sentiment is heading in the wrong direction for many of the reasons Frank described.

Gas, though, is largely a North American market. There has been a tremendous amount of capital flowing into North American gas, so I think it's more of a supply issue right now than demand. There may be a bit of slowing in demand around the edges, but long-term the demand equation for gas in North America is still terrific. It's clean burning, domestically produced, and economically attractive given current technologies, many of which weren't available until recently. So there is a distinction between the two.

Pottow: I totally agree. I think what's going on in natural gas is very much supply driven. Deliverability in North America and the lower 48 is up dramatically for the first time in over 20 years.

The other factor that is worth mentioning has been the emergence of alternative sources of supply. Ethanol, for example, has started to crimp the market demand for petrochemical fuels. But alternative sources of energy have a lot of credibility when oil is at \$145 a barrel — I would imagine they'll have less credibility if oil sinks to \$60.

Spitzer: To echo Doug's comments, if you take a step back, a year ago people were talking about the opportunities that existed with \$60 to \$70 oil, even on the alternative side. There was this 12-month spike in pricing, but as it has come back down, what you have now is a psychological issue in which people don't know where things are going or if they're catching a falling knife. Natural gas, though, is more of an insular commodity, so there is not as much of this cloudiness.

Jarchow: The interesting thing too about natural gas is that much of this new supply is coming from these resource plays, typically involving shale, which has a very quick decline rate. Effectively, when you drill a well you get a burst of gas and then most of your reserves can be measured very quickly. Companies are now dialing back their caps to match their cash flow, so I think you'll find the amount of production will be

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scaled back very quickly in response. That means that the North American natural gas market, because of these resource plays, can self correct much more quickly than in the past.

Mergers & Acquisitions: *In light of the sharp falloff, do you think companies will be capitalized to survive this downturn in commodity prices, or will we see a fallout that opens up the same kind of opportunity people might be looking at in the banking sector right now — balance sheet issues that require fresh capital?*

Korn: Some companies are very well situated to survive this downturn, but others are absolutely not. Probably the biggest distinguishing factor is what kind of leverage a company has taken on. A highly leveraged company that is going in a period of down commodity prices in which liquidity dries up, will find themselves under tremendous pressure. You're already seeing this in the public market, with some companies having seen their stocks decline by 80% or more.

Similarly, you may have a company that doesn't carry any debt, but has drilling commitments that they

market dislocation, but one can certainly expect to see tremendous opportunities for those people with capital ready to deploy it.

Mergers & Acquisitions: *What does all of this do to renewable energy? In the early 1980s there had been a push for cleaner energy and alternatives to oil, but that died when commodity prices sank. Conversely, you have global warming and a political climate that wants to reduce exposure to the Middle East. Will that prevent the same kind of defection from the niche?*

Levi Minzi: My sense is that the renewable plays will be around for the long term. They are certainly affected by what is going on in the market, and, if you look at some of the public indices, renewables have declined by 30% in the last few months. That being said, there is substantial political support for renewables, and you saw that with TARP (The Troubled Asset Relief Program).

Within that, the government included the Energy Improvement and Extension Act, which represents perhaps the strongest federal endorsement of renewables. It provided an extension of the production-tax credit for wind, which was extended by just one year; included an eight-year extension of the investment tax credit for solar; and contained to the tune of about \$2.5 billion capital for clean coal projects. Those are powerful incentives. They may be small numbers compared to the overall size of some of these projects, but it shows there is still strong support for that.

To me, the real question is whether or not the financial turmoil will delay the passing of climate change legislation. You also have to ask: Will it even happen? Both of the presidential candidates were in favor of climate change legislation, albeit with very different approaches, whether or not we can afford to implement it right now, because it involves imposing higher prices on everyone — business and retail — remains to be seen.

Pottow: That's a real issue. The example of the early '80s is a good one because what happened then is very similar to what's happening now. There was a dramatic increase in the price of crude oil as a result of the first Arab oil embargoes and there was a resulting move toward conservation. You saw efforts then to implement wind and solar and a bunch of other alternative energy initiatives, and for a variety of factors, there was a pretty dramatic drop in the price of oil. It was driven in part by consumption, which fell, I believe, by 15% to 20% over the course of a couple years. But it

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Senior Managing
Director and Partner
Irving Place Capital



are unable to fund. It doesn't have enough cash or equity relative to the commitments. That's on the E&P side (energy and production).

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In the services sector, it might be a similar story. People are predicting that a quarter of the rigs in North America could be idled. That's 500 rigs out of roughly 2,000, so day rates will be affected; utilization will be affected; and you'll likely see cash flow for many of these services companies plunge dramatically.

There will be winners and losers, as in any major

certainly had a big impact in discouraging the adoption of alternative forms of energy.

That example probably hasn't been lost on producers in the Middle East, who see a real threat to their business. But to look at one example, which is ethanol, I think the economics from the outside appear to have been absolutely devastated by what has happened. Longer term, I'm not sure what that means, but I think that people who were quick to back that sector may be a little slower to invest substantial amounts in other newer areas. In fact, I don't think people are going to rush into anything right now in this environment.

Levi Minzi: As an attorney, from my perspective the headline story next year should be climate change legislation. If it happens, you have to dissect the terms of the legislation. A cap-and-trade system would impose costs. There will be players that are providers of allowance submissions and others who will be consumers. So that will change the investment parameters for all businesses, not just energy.

In terms of M&A, people will need to figure out how a particular target may position itself against its peers, and how does that impact the valuation of that particular business. It's a paradigm shift, and we'll see regulation impose new ways of looking at assets that will have to be dealt with.

Spitzer: Over the past three years, you saw three key constituencies come together, which had to happen if alternatives were to gain traction. There was public support, government support, which has been there for a while, and you finally saw the financial support, which hadn't been there for a long time. As Frank pointed out, people don't invest in alternatives out of the goodness of their heart. Regulatory changes can fundamentally shift the financial framework through incentives, but right now there is a lack of credit support. Given the uncertainty of cash flows, a result of the volatility and murkiness in commodity prices, it can be difficult to gauge the opportunities. Until you get some clarity into that, I don't think you'll see significant investment in alternatives like we had just six months ago.

Levi Minzi: That's an excellent point. The fact that they extended the wind production tax credit by one year doesn't really create an environment that allows you to make long-term investments.

Mergers & Acquisitions: As you look at the industry's prospects, whether it's oil and gas, alternatives, or elec-

tricity, how important is the regulatory environment? I'm sure it's something everyone tracks, but how much attention goes into what may or may not happen in Washington as you consider a possible deal?

Jarchow: Our approach is that we'll look at an investment on its own economic merits and not even con-



sider any incentives that may come from the government. And if the investment works on its own merits then we'll go ahead with the deal and view the incentives as possible upside. But it won't make or break a deal.

Pottow: That's the same for us. We don't have any alternative energy investments for specifically that reason. We have looked at wind, and it's potentially very interesting, but without better clarity on the production tax credit it's difficult to get comfortable.

Levi Minzi: I agree, but potentially you may be looking at detriments as well. So investors will track regulation with a view on how it could negatively impact investments.

Pottow: That's a good point.

Mergers & Acquisitions: *This seems like a good segue to discuss the various proposals coming out of Washington. In the recent election, energy was a major theme. From President-elect Barack Obama's pledge to eliminate dependence on foreign oil within 10 years to John McCain's "drill baby, drill" theme, there have been quite a few vari-*

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ations on how to tackle these issues. Do you guys have any thoughts on some of the proposals that were being floated?

Pottow: It's really too bad that we are in the current economic situation that we're facing, because this actually got a lot of attention from both candidates. In World War II, the United States was an exporter of oil



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Frank Pottow
Managing Director
Greenhill Capital Partners



to our allies, which helped win the war. And we have gone from that position to a point now where we're importing about 67% of our oil needs. This has been an irreversible, and increasing trend.

I think the risk, with oil at \$60, is that we're going to turn around 10 years from now, and instead of being totally independent from foreign oil, we will be importing 75% of our needs. There are numbers that get floated around, depending on the price of oil, that there is roughly \$500 billion a year that the US borrows from China to pay to the Middle East. I think that's a legitimate issue.

Jarchow: Also, as it relates to oil specifically, we need to remember that that's primarily a transportation fuel. Certainly things like CAFE standards will help.

(Editor's Note: CAFE standards, corporate average fuel efficiency, refer to efforts from the government to motivate automakers and consumers to shift to more fuel efficient car models.)

But it's also important to remember that oil is a fungible commodity and the price is set on a worldwide basis. Ultimately, we have to focus on domestic production to help with the supply issue, and, internationally, see if we can't encourage the national oil companies to open up more acreage for competition. This is a worldwide problem; not just a US problem.

Mergers & Acquisitions: Is it even possible, though, to completely eliminate demand for foreign oil? Is this something that could happen in our lifetime?

Spitzer: The economics certainly make it extremely challenging, and frankly, without the political willpower to put in a variety of reforms — whether it's CAFE standards or relieving offshore drilling inhibitors — it's not something that would get done without some form of government intervention.

Korn: That being said, the recent turmoil in the market and the government's response have created a very difficult fiscal situation going into 2009. You have the normal cyclical impacts of a downturn in government receipts and that overlays all of the government support to shore up the markets.

You have to go back to the question of whether or not there will be the political will. There are important reasons behind why we have to become less reliant on foreign energy; from a geopolitical point of view, from a carbon emissions point of view. But how now you have to ask, "How do we make that happen in an environment where the government will be under some severe fiscal constraints." That's going to be the real challenge.

Spitzer: And regulation is effectively a silent taxation policy. So instituting that in the face of the pocket-book issues that people are dealing with is going to be tough. Any administration would have to burn a lot of political capital to push through an energy policy that tries to accomplish what either candidate proposed.

Mergers & Acquisitions: Offshore drilling was one area that was hotly debated in the election. Is that a solution or just one piece of the overall puzzle?

Jarchow: Every little bit counts. I do think we have to pay attention and careful attention to the environmental impact of drilling. But if you look at the record of the oil companies drilling offshore — not only in the US but internationally — the record is very good. Safety has improved markedly since 1969, when we had the Santa Barbara oil spill. That sort of thing rarely ever happens offshore anymore.

Pottow: I completely agree and it's not just offshore; there are large tracts of federal land in the Rocky Mountains that are very productive. In fact, that's where a lot of the new increases in natural gas supplies have come from. But a lot of large areas are still off limits, whether

they're completely off limits or require a lot of paper work, it serves to hamper domestic development.

Do I think we can drill our way out of our dependence on foreign oil, though? No. I actually think that's physically impossible unless we dramatically change the use of oil as a transportation fuel and substitute it with something else. But just because something doesn't represent a complete solution doesn't mean we shouldn't try it.

Spitzer: We have seen an intersection develop as it relates to energy and power. To Craig's earlier point about oil being largely a transportation fuel, you're hearing a lot of talk about potential alternatives. T. Boone Pickens, for example, has proposed natural gas as a replacement fuel for automobiles. And then there's the old adage that 75% of France's electrical power comes from nuclear. So if we were to shift to a nuclear driven electrical grid, and build the infrastructure to support that, you could also go the route in which nuclear energy powers the automotive fleet. Ultimately, that would take a lot of dependence away from fossil fuels.

Levi Minzi: There is a lot of excitement in that field. Recently there have been a number of applications filed. There are, I believe, in excess of 17 applications that have been filed with the NRC (Nuclear Regulatory Commission) recently. The interesting development from a regulatory standpoint is that the NRC now allows applicants to obtain a combined license to build and operate a plant. That should address some of the issues that emerged in the 1970s.

On the other hand, there are great challenges facing nuclear. The challenges range from just finding the people to build the plants — we haven't built one since '77 — to finding the materials. For instance, there is only one facility in the world that builds the encasing necessary for modern plants. There is also the cost. These plants are huge consumers of capital and until the banks are ready to commit to the sector, it's unlikely that it will take off.

Mergers & Acquisitions: *What about T. Boone Pickens' Pickens Plan, which Drew referred to? The plan entails using natural gas as a temporary replacement for oil, and then using wind energy to augment electricity.*

Jarchow: I think his plan has some value with regards to transportation, which is the issue that you really need to focus on when it comes to oil prices. Although deploying the infrastructure for compressed natural

gas is quite an undertaking and shouldn't be underestimated. Eventually, his plan entails moving to battery-related technologies for cars, so ultimately there needs to be an improvement in battery technology.

Mergers & Acquisitions: *Shifting away from the regulatory issues, Drew, could you give us your overarching view of the market from an M&A perspective? As a banker, what areas within energy are seeing the most M&A interest?*

Spitzer: Our practice is really focused on non-reserve based businesses, whether it's the oil field side or non-asset based products, technologies or services. Over the past month, we have signed two deals. One is on



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Director
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the downstream services side doing work in petroleum refineries and chemical plants — areas that for the most part tend to be resistant to downturns in the market. The other is what could be considered an energy efficiency play, which works even in a falling commodity-price environment.

One of the things that's interesting is that when we had \$30 to \$40 to \$50 oil, people still found opportunities. Now we've had this peak for a 12-month period, but we're back to a level that not too long ago people would have considered a great environment, with oil at around \$70 a barrel. On the oilfield side, there will be some capacity and supply issues that drive things there, but I believe the long-term fundamentals of the energy market are extremely attractive.

The uncertainty of where commodity prices are going will make the deal environment more challenging. We will retrench, but activity will pick up again.

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Mergers & Acquisitions: *Will the falling prices spark consolidation? I read a New York Times story recently that speculated that even Halliburton or Baker Hughes could be a target for one of the oil majors. Do you anticipate seeing strategics start to pair off if prices remain volatile?*

Korn: There are times in the energy cycle with respect to E&P when it's cheaper to buy assets than it is to drill for them. Based on public valuations, there are strong signs that we are in one of those periods and could be for a while. It would not be at all surprising to see some of the majors, which have had trouble replacing their reserves in recent years, make some meaningful acquisitions of large independents. Similarly, the independents could go out and buy smaller companies. Whether this activity is widespread or not, we will see. But when you hit a point in which companies are trading for less than it would cost to drill the reserves, it becomes pretty compelling for the stronger players.

Mergers & Acquisitions: *Would there be any horizontal M&A activity? For instance, if ExxonMobil were to*

Spitzer: Also, historically, they can play multiple parties off of each other in down markets to get cheaper rates.

Pottow: For the very large, international oil companies, the big issue they have faced over the last 20 years has been reduced access to development and growth. Back in the 1970s, a large majority of the remaining oil and gas reserves around the world were available for private ownership and development. The Exxons and Mobils still had a lot of the world available to work with. Since then, there's been an ever increasing trend toward resource nationalism, which means that there's a very small amount of remaining oil and gas reserves currently available for private ownership and development. In recent years, there's been a form of disintermediation in which the state-controlled oil and gas companies would go to an ExxonMobil for help developing a project.

But the majors are very well capitalized and they have great balance sheets. Exxon has a Triple A credit rating and \$30 billion of cash. They can sit back and look at companies that may be trading at less than the cost to recreate them or maybe they can wait it out to see if they can get a better deal from some of these national governments, like Russia, which might be constrained with their own budget concerns.

Jarchow: We are already seeing that. In Australia, for instance, it's effectively a resource play in which the majors make moves for large reserves. BG Group just bought Queensland Gas Company and ConocoPhillips just entered the market.

Pottow: That's a good point. It's a very dynamic marketplace, and typically, transactions among these bigger companies free up ancillary assets to be divested to smaller entities. There is an incredible food chain that goes all the way down to the guy drilling a well in his backyard. We saw this happen a few years ago, when the majors were consolidating. There was an awful lot of this follow-up activity.

Spitzer: One of the interesting dynamics is that the larger players, who had divested assets over the years, are now buying these businesses back up. Chesapeake Energy is reported to be in play and you saw Goodrich buy Haynesville Shale in June. The majors are coming back in to buy these assets because they are so limited in terms of finding other areas of growth.

Another factor is that you have this situation in which there's a dislocation between the public and

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pick off Halliburton, that would be a pretty big bet on the services side?

Korn: A year ago there was some very educated people who were positing that services and technologies were being constrained, and that there might be some activity among the big international players to try to improve their access to those areas. I think with the change in capital flows, this argument goes away.

private valuations in the market. Oilfield stocks are down 65% or more. And the private sellers are largely deciding to wait for the market to firm before they move back in. On the public side, it's interesting because we have seen several oilfield companies whose stock has been depressed still express interest in pursuing an acquisition strategy. They're actually offering stock at depressed levels to try and make those deals happen because they believe it's accretive to their long-term growth plan. Ultimately, what that means is that they're offering a lower price to the seller, but they're offering up their stock at the same time, which might be at a depressed level relative to its long-term value.

Mergers & Acquisitions: *What about the electricity side? Maurizio, are there any trends that you've seen develop there?*

Levi Minzi: Just a few days ago, Exelon Corp. made an unsolicited bid to takeover NRG Energy, so that is a clear indication that we could be entering an environment of more consolidation.

It seems to me that there will be transactions in a variety of sectors in energy. There is a clear need, for example, to upgrade the electric grid. The grid, as it stands now, is antiquated; it doesn't work. And if you are really going to develop a wind industry, we need to expand the grid. We need to make it more of a "smart" grid, and if that happens it would generate opportunities for investment that in turn would require the IPPs (independent power producers) and the utilities to pony up a lot of capital.

There will also be opportunities among the renewables, such as wind, in the sense that as we move beyond the startup phase, there may be rollups involving some of the smaller operators.

Mergers & Acquisitions: *The NRG bid outwardly seems like more of a distressed play, and we saw MidAmerican pick up Constellation Energy at a depressed price recently. As it relates to the entire energy space, do you think we'll see more distressed opportunities crop up? And who will be able to take advantage?*

Korn: Distress has clearly come into the picture, although sitting here in late October, it's really a phenomenon of the last 30 days or so driven by a combination of commodity prices and liquidity drying up. But it's starting. I would posit that we are in the early stages of it, and the solutions can come from a variety of sources. There will be great opportunities for private equity; there will be distressed investors who get into

it through buying up the debt; and there will be strategies. This should last a while.

Pottow: Doug is exactly right. There are very good companies out there that have their bonds trading at 80 to 85 cents, some lower. These are quality compa-



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Craig M. Jarchow
Managing Director
Pine Brook Road Partners,
LLC

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nies with strong assets and good operations. But access to capital is going to be an important differentiating force going forward. Up until July, distressed opportunities in energy were like the Holy Grail — you would look for it, but you couldn't actually find it.

Korn: They didn't exist.

Pottow: Now you are seeing things and, as you know, energy is a very capital intensive industry, particularly in exploration and production. And E&P assets are naturally depleting, so if you don't spend any money on them, every day you'll have less than you had the day before. It's the low-cost producers that have survived other cycles and in a depressed-commodity environment, are the ones that end up making it to the other end. Also access to capital is critical.

You've seen a phenomenal amount of money trade hands in the E&P space over the last year, which went to buying up land. Typically, that's the thing that falls the fastest and the furthest until the environment turns around. On a daily basis I think we are seeing a recalibration of land values. It's essentially the spec housing of the energy business.

Mergers & Acquisitions: *Will we start to see some pub-*

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lic-to-private activity?

Jarchow: In theory, that would make sense. In practice, though, it's always difficult to pull them off. We have found that you are better off addressing the issues that the public might have directly. So if it is a capital constraint that the public entity might be dealing with, then you are better off structuring a joint



venture around an asset that might make for an interesting play.

Spitzer: I think public to privates are going to be difficult in the near term. Just given how quickly the falloff has happened, the uncertainty needs to move into the rearview mirror before public to privates start taking place.

As Craig alluded to, companies are being rewarded for finding liquidity, and I know a lot of private equity firms are out there looking for PIPE opportunities. In those situations, dilution will be necessary in order to get that liquidity. In the near term, especially on the E&P side, I'm expecting to see private equity firms moving in to help out the stronger players.

Mergers & Acquisitions: *Speaking of liquidity, what does the credit market look like these days? As it relates to private equity, can firms even find debt to pursue a leveraged buyout?*

Spitzer: Leverage is certainly down if there is even any credit available. It's also different lenders than you might have seen six months ago.

Jarchow: We are actually as busy as we have ever been. We are a growth equity investor, so we build business-

es by putting our money into the ground as opposed to just acquiring assets with large debt packages. If anything, the credit markets have benefited us.

Mergers & Acquisitions: *In this environment what would you consider to be an attractive growth play?*

Jarchow: There are a number of plays that you can look at and a number of geographies if you are looking in oil and gas. I mentioned resource plays earlier. They work differently, both from an operations perspective and an investor's perspective, but there is a chance to put quite a bit of capital to work. Many of these are associated with shale, which is, after all, the most common sedimentary rock. There are a lot of places in the world to pursue these plays, and I think the opportunity in the lower 48 is just starting to open up.

Mergers & Acquisitions: *Where else might there be some opportunities for private equity? Is the midstream space looking any more appealing?*

Korn: A year ago there was so much demand coming from MLPs and similar strategic players for these assets. They had a low cost of capital and aggressive growth plans. Now, that has turned around. We have an environment in which those players are becoming capital constrained. And what may have seemed like modest leverage a year ago, today seems pretty high. Some of them will have to shed assets. And some of the E&P companies will also be looking to shed midstream assets to delever. So private equity investors who, by definition, have capital on the sidelines should become competitive.

Pottow: Doug makes a great point. The development of the public MLP (master limited partnership) market for both midstream and E&P assets was an incredible phenomenon over the last couple years. And in this selloff over the last few months, a number of those companies have been particularly hard hit. In part, it's because there was a lot of ownership in the MLPs by industry-specific hedge funds, some of which were able to use leverage against their cash distributions, so the selling is even more pronounced.

In talking about natural gas production, it has to be gathered in pipelines. Oil can be put in trucks, but gas needs pipelines and an important issue is where in North America the production comes from. There has been phenomenal development, for example, around Fort Worth, Texas and considerable development very recently around the Rocky Mountains. There have also

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In E&P land, there is going to be a lot of news when people start to do their year-end valuations.

Frank Pottow
Managing Director
Greenhill Capital Partners

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been some new plays up in Appalachia and in eastern Texas. That is offsetting declines in the shallow-water Gulf of Mexico. But the fact of the matter is that you can't just move pipelines. So the need for new pipelines to gather that new production creates opportunities in the midstream sector.

Mergers & Acquisitions: *What about services? How might that area be impacted?*

Spitzer: Traditional industrial services and the downstream services businesses, working in refineries, have historically shown a resilience to downturns in commodity pricing. I think they will continue to be interesting assets from an investment perspective and we are working on a couple deals in the space right now.

To Frank's point, pipeline construction is historically an industry that has its ups and its downs, but the backlog remains extremely strong and committed for the next two-plus years.

Mergers & Acquisitions: *What about on the electricity side? We obviously saw KKR and TPG play in this space, but is that opportunity dead at this point or could there be more activity?*

Levi Minzi: There could be opportunities. I think we will be in a quiet period until the beginning of the year at a minimum. That being said there are great challenges ahead for the industry overall, so I see great opportunities for private equity, assuming that there will be passage of climate change legislation.

I suspect there will be a need to consolidate some of the renewable businesses that have been launched, and I think private equity can lead that activity, preparing these businesses for a future sale to the utilities, which will have to meet renewable standards.

Mergers & Acquisitions: *Where else might deal flow come from? I know a lot of people here have experience in the E&P space.*

Pottow: As we've mentioned, access to liquidity is going to be of paramount importance because we don't know how long this downturn is going to last, and we still don't know how bad it's going to get. A lot of companies have attractive assets but you need capital to develop those. Typically, at least for an exploration and production company, they have a borrowing base with their lenders that represents some fraction of what the asset is worth, even in a depressed price environment.

So to the extent they can sell an asset and use the

process to pay off debt, that very act should generate some additional liquidity. We expect to see companies that want to preserve strong liquidity monetizing very attractive assets at potentially attractive prices.

Mergers & Acquisitions: *I know it's difficult to generalize, but can you provide some sense of where valuations will be?*

Pottow: In E&P land, there is going to be a lot of news when people start to do their year-end valuations. Those are currently generated based on the year-end price. There has been quite a bit of development activity, but there has been some pretty dramatic price changes. Trying to determine how something trades as a multiple of some outdated number is very difficult to do. In a few more months, I think we will see more clarity as to where things actually are.



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Larger players, who had divested assets over the years, are now buying these businesses back up.”

Andrew G. Spitzer
Director
Harris Williams & Co.

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Mergers & Acquisitions: *When we do emerge out of this, what are some changes that we might expect to see in the energy markets?*

Jarchow: I see a couple fundamental changes. On the private equity side, the arbitrage will no longer be financial engineering. We will go back to building businesses. And we will emphasize the quality of management teams, and both the macroeconomic and microeconomic opportunities being pursued. Also, we will see hold times become extended, but returns will be perfectly adequate. Fundamentally, though, the private equity business is going to get back to basics. **MA**