"Adapting to the New World of Energy Investing"- Interview with Pine Brook's Claire Harvey

By Andrea Heisinger, Privcap, August 18, 2015

As oil prices stay stubbornly low, private equity GPs have had to adjust their strategy and push back the recovery timeline. Pine Brook's vice president for energy, Claire Harvey, discusses how the market has adapted, why the expected distressed opportunities largely haven't materialized, and how management teams have changed.

Following the collapse of oil prices in late 2014, a lot of distress was expected in companies most immediately impacted by the drop. But that situation hasn't unfolded quite as expected, says an executive from energy-focused private equity firm Pine Brook.

Claire Harvey, vice president, energy, at the PE firm, says that she lumps the world of oil and gas into a "pre- and post-Thanksgiving context," because "a lot changed when prices collapsed." Since then, a lot of capital has been put into the energy space—in general and specifically towards distressed opportunities. The thing is that the amount of distress expected has largely not materialized to date.

"A lot of folks thought assets were going to trade hands cheaply in early 2015, so investors wanted to put money to work," Harvey says. "A lot of money hit the market and hit the sidelines; distress didn't evaporate but has been delayed." She adds that many companies were bailed out by the public markets in early 2015, with billions of dollars in debt and equity issued by public exploration and production (E&P) companies.

Since Thanksgiving of 2014, many private equity GPs have changed their strategies for E&P energy investing, shifting from organic growth by leasing and drilling to more acquisitions and divestitures (A&D) to take advantage of the low commodity price environment, Harvey says. However, so far in 2015, the A&D market has been highly competitive and hasn't yet priced in the distress.

"It hasn't been as frothy as many expected," she adds. "I wouldn't say there are cheap assets out there right now, but the longer that [oil] prices stay below $50 per barrel, the greater the opportunity will be in late 2015 and 2016; companies' hedges are rolling off, cash flows are decreasing based on limited drilling and completion activities, and debt holders are going to force companies to do something. That something will likely cause assets to hit the market"

One thing that has happened in the energy market so far in 2015 is that the rig count has been cut in half, although Harvey says that the rig count has stabilized over the past few weeks. Services and drilling costs are down by about 40 percent, she adds, and with half the rigs coming off the market, the oilfield services space has become distressed, and many companies currently operating are willing to work at the margin and not make a lot of profit. Harvey says she wouldn't be surprised to see some PE firms take advantage of this distress by investing in consolidation plays within the oilfield service sector.

Another distinction of the current market is the difference between management teams out there versus those in action prior to the drop in oil prices. "The first difference is there are more teams targeting A&D and getting assets cheaply, versus leasing and drilling," says Harvey. Management teams need a different skill set to acquire existing producing assets, and the diligence process is different. In this paradigm, successful management teams need to be even more engineering-driven rather than geologically driven—development over exploration.

"Geology will definitely play a role in whether or not a team is able to value an asset at an acceptable level to the seller because they can help identify and value upside potential, beyond the low-hanging fruit," she says. "However, the engineering/operations function is very important for execution."

The oil and gas markets are currently fully loaded with management teams vying with one another, and "there's a lot more capital chasing the good ones," Harvey points out. "At Pine Brook, we seek to partner with those teams who can solve technical and business problems prevalent in the highly cyclical oil and gas industry.

"In a market like this, 50 to 100 companies will show up in a data room to make a bid on a package of high-quality assets, so it's important to find teams that are good stewards of capital and patient enough to avoid overpaying for assets. Those folks are easily identified by the GPs; the cream will always rise to the top."

Harvey says that management teams should be focused on partnering with GPs who are "permanent fixtures in the E&P investing world, not the opportunistic investors du jour." She adds that teams should value experienced investors who have been through commodity price cycles, and who are long-term thinkers. With so much competition in the A&D space, GPs with this experience and perspective can be very valuable to management teams

Despite the delay in the prospect of investing in distressed assets, opportunities are starting to present themselves, Harvey says, and in July, oil prices decreased even more. "It's hard if you own something and want out of it," says Harvey, "but we believe late 2015 and 2016 will present a tremendous opportunity for private equity to invest in quality assets at more distressed prices."