

'The Rocks' Are Key in Bumpy Commodity Markets

A co-founder of Pine Brook discusses how to position portfolio companies for success despite a steep drop in oil prices, what distressed opportunities are like, and how to deal with execution risks.

David Snow, Privcap: Are we in a bull market for energy right now?

Michael McMahon, Pine Brook: It's very difficult to continue to invest, particularly in North America, to generate the type of production—forget about growth. My own view is capital-intensive businesses, they're cyclical and they self-correct and I do believe we're pretty close to the bottom.

What are the distressed opportunities out there like?

McMahon: When you look at the energy sector, somebody said there's a company filing [for bankruptcy] almost every day. When you look, certainly at the companies who have filed early, there are three reasons that contribute to distress. Number one, bad management, number two, bad capital structure, and number three, bad rocks. You can fix the first two, but you can't fix the third.

↓ CONTINUES ON NEXT PAGE



Let's get a bit deeper into what you call a "zombie energy company." What attributes will it have such that even a smart private equity firm can't fix it?

McMahon: It really comes down to the rocks, and if you go back to the '80s, we've seen this movie before. There [is] a whole host of companies, public and private, and they just hung around. Why? Because management teams and directors don't like to put the stake in the heart of these companies. Now, it's going to be a little bit different because private equity controls a number of companies and, candidly, we can't just sit there and let the meter run. You'll see a number of these companies both public and private actually go out of business at a much more rapid rate than people anticipated.

You've also said that when oil was much higher than it is today, you were seeing deals getting done. What was behind the decision-making in that atmosphere?

McMahon: One of the key factors that contributed to that bull market was totally unrestrained capital access. If there's money available, people will find a way to use it. It was driven more by the North American shale play than anything else. Early movers actually figured out that in certain basins, there really were good rocks. The fast followers or the slow followers, when they got into the game, they were confronted with a dilemma—to pay up, to get into the core of the core, you actually degraded your economics.

What is the sweet spot for an opportunity in today's environment?

McMahon: One of the things we've learned through the lens of our management teams is that when people evaluate rocks, we actually now start to classify them in five different categories. Tier one is the core of the core. The economic issue is, can you get control of those? Even in this environment, there are very few really good core rocks that are coming up and when they do come up, they get priced at very attractive returns to the seller.

Michael McMahon
Co-founder and Head of
Energy Investments,
Pine Brook



"When you look at the energy sector, somebody said there's a company filing [for bankruptcy] almost every day."

—Michael McMahon, Pine Brook

With so little room for error when trying to make these projects economical, can you talk about execution risks?

McMahon: Number one, very good G&C (costs for geologists, surveys, and other drilling activities). Even in the sweet spots, one of the things we've learned is that they're not homogeneous. Understanding how the rocks change within a particular play, even one or two sections away is critical. The second thing is well control, well design. If you look at the difference between landing a well in the right zone and steering it to stay in the target zone, that is a huge difference in the results.

The third is, what's the fracking formula, how long are the laterals, how much do you use pressure, how much profit? Also, logistics are important. Then, most important is what Napoleon looked for in his generals: someone who's lucky. ■