Energy Investors Prospect for the Next Big Thing

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The announcement of Pine Brook closing its second growth equity fund above target at $2.43 billion came just a few days before The Wall Street Journal reported that Energy Future Holdings was flirting with filing for bankruptcy protection.

Pine Brook's success was representative of the capital pouring into private equity firms specialising in energy at a time when many firms out raising capital have come away disappointed from meetings with potential limited partners. Energy has gone through a multi-year boom, private equity has been an important source of capital and the returns have been eye-catching.

But the news about Energy Future Holdings holds a warning about where investors can go wrong in making directional bets on energy prices. The company, formerly known as TXU Corp, was bought by Kohlberg Kravis Roberts, TPG Capital and Goldman Sachs Capital Partners for about $45 billion in equity and debt in 2007 but then foundered as natural gas prices tumbled.

Now, general partners are contemplating the best places to invest amid an uncertain outlook for natural gas and oil prices and a recognition that much of the easy money has been made in popular investment areas such as shale gas.

"We were lucky to be around the shale play in 2008 and 2009. That's when the early or easy money was made," said Michael McMahon, a managing director in Pine Brook's energy investment team. "That is no longer possible."

Many investors think there are lucrative opportunities still to be had because of the yawning need for capital in the energy sector. But more of them are shifting their focus to oil and away from gas, as well as to foreign markets and to more conservative investments containing proven reserves.

Despite the long cold winter in the U.S. pushing gas futures prices above $6 per million British thermal units in February – the highest level in six years – prices in April were back down to about $4.5 per million BTUs, far below the double-digit figures recorded in 2008.

"Gas got better, but relative to the returns you get on oil projects, it's not even close," John England, U.S. oil and gas leader at consulting firm Deloitte, said in a recent report.

The private equity industry has in part become a victim of its own success because the high gas inventory prior to this past harsh U.S. winter was partly the result of greater production from

shale formations, an area in which private equity firms had been a major investor during the past few years.

However, not everybody in private equity is running from natural gas. Washington, D.C., firm EIG Global Energy Partners, for instance, is “mid-term bullish” on gas prices, said co-founder and chief executive Blair Thomas. Believing that gas prices may rise to $5 to $6 per million BTUs in the next few years, Mr. Thomas said he thinks now is a good time to buy dry gas properties.

Rising Oil Demand

By contrast, firms are almost unanimous in their belief there will be rising demand for oil globally for the foreseeable future. “Oil is in vogue; gas is not,” said Jordan Marye, a managing director at Denham Capital.

This shift in interest means firms are taking different investment approaches. For one, back in the late 2000s, private equity shops and the management teams they backed were focused largely on “land acquisition” plays in such major shale basins as Marcellus, Bakken, Permian and Eagle Ford, said Alex Krueger, president and co-head of buyouts at First Reserve. Now, however, “most basins relevant for the next 10 years have played out from a land perspective”, he said.

The land grab at U.S. shale formations over the past few years has largely been completed, with the pace of buying new acreage slowing down last year over 2012 levels, according to Deloitte.

Accordingly, firms are “rebalancing” toward exploitation of existing properties, said Mr. Marye. “That’s a good thing, because energy is a capital-, people- and operation-intensive industry, and firms need to focus on a much smaller number of projects.”

Another change in companies’ approach is that when they do purchase energy assets, they tend to focus on proven producing properties, rather than unproven, undrilled areas. Denham, for instance, is targeting oil and gas producing properties in which finding costs are relatively low, that have proven but untapped reserves – or “lots of running room” in Mr. Marye’s words – and are near pipeline and gathering systems.

A third change is that firms are now not only looking to develop what they call unconventional reserves, such as shale formations in the U.S. and oil sands in Canada, but they are also interested in conventional reserves, or areas where oil and gas have been produced for decades, with what is deemed decreasing production potential.

Over the last few years, many conventional properties have been sold, largely by big energy corporations.

That is an area into which private equity firms and private equity-backed companies come into play, scooping up older wells and applying the same techniques they did with shale wells, such as hydraulic fracturing and horizontal drilling, hoping that they will unlock oil and gas that has historically been off-limits to conventional drilling techniques.

Northern Blizzard Resources, a Riverstone Holdings-backed company, was one example. In 2010, the Calgary-based business paid 975 million Canadian dollars for Nexen's heavy oil properties in Western Canada, assets that are located in an "old and tired" basin, said David Leuschen, a Riverstone co-founder. Northern Blizzard then pumped fresh capital into the field, drilling a new well every one-and-a-half days, improving operations of existing wells and enhancing oil-recovery processes.

In general, Riverstone aims to double or triple production reserves or cash flow of its portfolio companies during its ownership, said Mr. Leuschen, without commenting specifically on Northern Blizzard.

Other countries may also provide investment opportunities. Mexico, for instance, is opening up its energy industry for the first time since the country nationalised the industry in 1938. Deloitte said in the recent report that the reform could "encourage joint ventures and acquisitions on both sides of the border" as Mexico's national oil company, Petroleos Mexicanos, may look to update its expertise.

Mexico is one market Riverstone is actively reviewing for both onshore and offshore production operations, according to the firm's partners. Mr. Leuschen said the opportunity set in that country is similar to that in the U.S. across various sub sectors, including deep-water exploration and development; exploiting drilling opportunities on the Gulf of Mexico shelf; building and acquiring pipelines, gathering systems and processing plants; exploring shale formations across the border from Texas; and backing and building oil-field services companies.

The Gulf of Mexico, in particular, offers rich deep-water drilling and production potential, said Mr. Leuschen. Riverstone first got into the Gulf area in 2004, backing a company called Mariner Energy, primarily to develop oil and gas in deep water. A second investment, Cobalt International Energy, a deep-water oil and gas producer in the Gulf, went public in late 2009 and was among the better performing investments in Riverstone's earlier funds.

Elsewhere, Riverstone sees opportunity to develop oil and gas in the North Sea, although the opportunities are fewer than those in North America, said co-founder Pierre Lapeyre. In addition, unconventional oil and gas properties in the U.K. and on the European continent represent prospects for private equity firms to apply unconventional drilling and production techniques similar to what they did with shale plays in the U.S., said Mr. Lapeyre.

In theory, though, firms betting on strong oil prices could also go wrong, as they did with natural gas prices. A March article in Barron's, which is also published by Dow Jones, cited analysts predicting oil prices could decline to $75 per barrel over the next five years from the current $100 or so. New discoveries of oil in the U.S. and elsewhere and weaker demand globally because of increased alternative energy consumption place downward pressure on prices, according to Barron's report. If that prediction materialises, many of the firms' oil investments may end up being unprofitable, at least in the short term.

In reality, few firms are willing to predict oil prices. "Our crystal ball is as murky as anybody else's," said Riverstone's Mr. Leuschen. He added that while Riverstone does hedge commodity

price risk, as many other firms do, it focuses more on multiplying its companies' reserves or cash flow. As long as that objective is achieved, the effect of falling oil prices would be limited, he said.

By comparison, the midstream sector, or the gathering, transmission and processing facilities that help bring oil and gas to end markets, is at least one step removed from the direct exposure to commodity prices and tends to generate recurring revenue streams, a key attribute that helps secure debt financing. Pipelines and similar assets typically sign multi-year contracts with energy producers that help lock in cash flow and make it easier for pipeline operators to raise debt.

The need for capital for building new pipelines is increasing as energy developers and producers move to more remote areas in search for oil and gas, farther away from existing pipeline systems. The success of some earlier midstream investments also showed that good returns can be had: Pipeline operator Kinder Morgan, which was acquired for $15 billion in 2006 by a consortium including Riverstone, Carlyle Group, Goldman Sachs Capital Partners and American International Group, for instance, returned about three times the money its sponsors originally invested in the buyout by 2012.

One issue for private equity firms looking to invest in pipelines and other midstream assets, industry participants say, is competition from publicly traded master limited partnerships, many of which are also backed by financial sponsors. "There are a lot more MLPs today than there were two or three years ago, so there is greater competition for assets," said Jim Penilla, director of Robert W. Baird's energy investment banking team, who advised on initial public offerings of several MLPs in the past year.

'Fierce competitors'

That view is shared by Riverstone's Mr. Lapeyre, who said publicly traded MLPs are "very fierce competitors" when it comes to buying and building pipelines. "The flip side is that public MLPs can be very attractive buyers for private equity-backed midstream companies," said Mr. Lapeyre.

Overall, because potential opportunities far exceed the combined capacity of all the private equity funds raised, firms contend they aren't seeing an oversupply of capital. "Capital need in the industry has never been greater," said Denham's Mr. Marye, adding that he thinks the size of funds being raised is "reasonable." Private equity capital already raised and to be raised "pales in comparison" with capital needed, including public equity, private equity, high-yield bonds and bank loans, said Mr. Marye.

Andrea Kramer, a managing director at Hamilton Lane, seconded that view. "The sector is enormous and requires an enormous amount of capital being invested," she said. "I'm not sure if there is an overhang being built."

Accordingly, firms say that valuations in general are reasonable, despite certain subsectors such as upstream oil and gas being relatively pricey. Denham's Mr. Marye, for one, said he thinks valuations are "flat".

“This is a good market for deal-making,” he said. “Things are not too hot and not too cold. Certain segments may be overheated or neglected, but overall the market is a moderate place.”