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Private-Equity Firms Adapt to Energy Producer Discipline

As public oil-and-gas producers tighten their belts, private-equity firms are putting more capital and time into developing assets to make them attractive targets. Firms also see fresh opportunities to partner with public energy producers.

By Luis Garcia

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Oil producers' newfound discipline promises to affect private equity on multiple fronts. As producers tighten their belts, private-equity firms need to spend more money on their portfolio companies to boost their attractiveness to public buyers. But producer behavior also creates new investment opportunities for private equity, including in public companies themselves, which find it harder to raise capital on the stock market.

A New Reckoning

Before oil prices began their free fall in mid-2014, public energy companies had no trouble raising capital in the stock market to buy assets from private-equity firms. Even during the downturn, public producers bought tens of billions of dollars in private-equity assets in the prolific Permian Basin of West Texas and southern New Mexico.

But stock investors since have pulled back and now are demanding producers concentrate on developing the assets they accumulated during the previous land grab, industry executives said.

The energy sector's weighting in the S&P 500 index was 6.2% as of April, a nearly 28-year low and down from almost 17% in the years spanning 2008 to 2010, according to energy consultant IHS Markit Ltd. Secondary stock offerings from U.S. oil-and-gas exploration-and-production companies totaled $2.5 billion in the second half of 2017, compared with $13.8 billion in the same period of 2016, at the peak of the Permian deal frenzy, IHS Markit's data showed.

Investor pressure has made public energy companies less willing to acquire undeveloped acreage, forcing private-equity firms to scrap the traditional model of buying land and quickly flipping it to a public buyer, the executives said. Instead, private equity-backed companies now need to drill many more wells on their land to boost their cash flow. Public companies still may back small pure-acreage deals, but any acquisition of size must generate enough revenue to fund further development, according to the executives.

"It's interesting how our businesses' model has changed so much, because we didn't use to have to drill nearly as many wells," said Wil VanLoh, chief executive of Quantum Energy Partners.

"Today, the reason we do is because public companies are not just interested in buying the acreage. They want the cash flow."

Mr. VanLoh added that Quantum's portfolio companies now have to drill five to 10 times the number of wells they used to drill before the oil-price downturn.

To drill more wells, portfolio companies will need to be better capitalized and prepared for a longer hold period.

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The adjustments private-equity firms are making to adapt to public companies' financial discipline aren't without risks. Longer investment holding periods will increase the time firms remain exposed to commodity-price fluctuations and push down internal rates of return, a common metric of private-equity performance that drops with the time it takes a fund to return capital to investors.

"Something we're telling our investors is that holding periods are going to be elongated," Mr. VanLoh said. "It's not going to necessarily [require] fund lives being extended. It's just that we are going to have more portfolio companies go to the latter part of a fund's life."

With public producers becoming less avid buyers of private equity-backed companies,

> firms may have to resort more frequently to other exit options such as initial public offerings and sales to private-equity peers, industry executives said. Firms that sell to their private-equity brethren may not get a price as high as they would if they sold to a public energy company, which typically has a lower cost of capital. More frequent cash-stock deals and IPOs, in turn, also will extend investment periods and exposure to market volatility by forcing firms to hold shares of public companies possibly for years, industry executives said.
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