Wil VanLoh: 'You can make money at $50 oil'

By Claire Poole
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At 44, Wil VanLoh has seen good times and bad in the oil and gas business, from several different sides of the table: As an investment banker at Kidder, Peabody & Co. and NationsBank (now part of Bank of America), co-founder of investment banking boutique WindRock Capital Ltd. that helped companies raise private equity and make acquisitions and, since 1998, as co-founder, CEO and president of Quantum Energy Partners, which has $10 billion in capital under management. Fortunately for the Houston private equity firm, it managed to sell out of a lot of its positions last year before oil prices tanked and is now investing through the downturn with new and returning management teams. So far, it's committed $500 million to ExL Petroleum Management LLC in November, $300 million to Rio Oil & Gas II LLC in February, $350 million to Rockcliff Energy LLC in April and $300 million to Intensity Midstream LLC this month. It's also formed a novel alliance with publicly traded Linn Energy LLC to target property acquisitions.

He recently spoke with The Deal's senior writer Claire Poole in Houston about how his portfolio companies are coping and what he sees ahead.

The Deal: *You recently raised $3.25 billion for your sixth fund. Was it difficult given the climate?*
Wil VanLoh: It was $3.45 billion, with $200 million from the general partner. Fortunately we raised a

good chunk of it last year, in the third and fourth quarter, before oil prices fell off. A couple of groups did fall away, a few people did get nervous, but we were oversubscribed, so overall, it went well.

Weren't you also raising a co-investment fund? What happened with that?
We're finishing that up with a target of $1 billion. When we have deals that are larger than what we want to allocate, we have certain limits in the main fund, and that's when we would bring in the co-investment fund.

One investor reported that your previous fund had a 19.7% internal rate of return at of the end of 2013. What's your return target?
When we look at returns, we look at the net back to limited partners and we try to get 25% or better back to them once the fund is all said and done, 20% on a fund not substantially realized. It's been a more challenging environment over the past six years, but we still post net returns of 25% or better.

You also invest in power plants and related assets. How has that been going? Will you continue? What trends do you see there?
About 75% or 80% of our capital goes to the upstream, 10% to the midstream, 5% to services, and 5% to 7% to the power space. We saw some dislocation and distressed opportunities in power, so we were able to put some reasonable capital to work over time. Over the last couple of years, it's become more difficult. The power space has not grown in size and there's a finite number of power plants out there that could trade hands. The pie hasn't gotten any bigger, but there's a massive amount of capital in the space, with power funds like Energy Capital Partners, ArcLight and Tenaska, and now yield investors and infrastructure funds. They've driven down the returns you can generate in the power space.

That's why you've seen all the pure-play power guys look at other industry segments. In the E&P space, the capital required also increased by 10 times, which necessitated much bigger pools. We joke, but with Fund III, a $350 million fund we raised 10 years ago, we had as much purchasing power in that fund as we do now. Ironically, everything costs more today because of the horizontal drilling and land costs. We used to pay $200 to $300 to $500 per acre and now it's $2,500 to $5,000 acre.

The fall in oil prices hit a lot of folks by surprise. Did you see it coming?
We have a lot of technical guys here and do a lot of macro research on the industry. We had a feeling last year that with how oil production was growing, a 1 million to 2 million increase over several years, and how tepid global demand was, we felt like prices were too high. Did we say they would fall in October? No. But we thought they were above their intrinsic value.

That said, we don't try to time commodity prices. We're active hedgers, out three or five years, and the other thing we do to protect against commodity prices is we don't take on a lot of debt. Did we see it coming? Not the exact timing. But we were much more careful and we were selling a lot of stuff over the

last couple of years as production grew. Some private equity firms like to find the next play and buy it cheaper. We like to focus our acquisitions on acreage in the core of the plays, which are more resilient than those that are unproven.

What were some of your exits last year?
We sold out of Rio for $580 million.

We heard it was a triple.
It was a good return. In the eastern part of the Permian, we'd accumulated acreage in Midland Basin, with multiple horizons that a buyer could come in and drill on, and acreage in the western side of the Permian, the Delaware. So we sold in a two-part process, with Midland to Diamondback [Energy Inc.] and the Delaware to Concho [Resources Inc.]. We restarted with the team and they're buying stuff out there again. They have some acreage they've leased and they're cobbling together a program again, 500 to 1,000 acres at a time, from ranching families and companies that have strained acreage, all private transactions, under the radar.

What were your experiences during past disruptions and what did you learn from them?
It all starts with the fact that the oil and gas and energy in general is a cyclical market. Prices go up and they go down, and as a result, it's the reason why you have to find really good people. It's people that make you money, not assets. If you have the wrong people or those who can't execute well, they can mess up really good assets and you can lose a lot of money really quickly.

Once we find them, we spend a lot of time thinking of where we want to be, the best economic plays with the best returns, and begin with the end in the mind. We take a few companies public, but what we're doing is building companies that strategics want to buy. We want to have assets that are better than what's in their public portfolios or ones that compete with the top quartile of their portfolios. We conservatively capitalize these companies, not overlever, and hedge along the way. Every time we make an investment decision, we put hedges in place.

We've always said this business is about execution, which is never more important than today, with wells that are deeper, longer and more complex than they've ever been. The key to our success is to be disciplined, be patient, back the right people and execute well and you can make money across the cycle. We are generating great returns across our portfolio on drilling because we're in the right plays. Last year, our plays were generating 50% rates of return; with commodity prices cut in half, they're still generating 45% because costs have come down so much.

What do you consider the top quartile?
The Scoop (South-Central Oklahoma Oil Province) is an extraordinary play with great returns if you're in the core. So are the Midland and the Delaware. Those are the three areas where we're most active. Gas

a little tougher, it's been hit harder, and we tend to look at the Marcellus/Utica as the best gas play in North America. It's gone from literally nothing five years ago to 20 billion cubic feet per day [of production]. It's an extraordinary play. If Nymex is $3, you may get $1.60 at the wellhead. Parts of the play have a negative basis differential. But even with the discount from Nymex, it's still the most economic play in North America.

Where would you not go?
We'll look at anything. We have an opinion, but we're open to be proved wrong. There are areas in the core of the Eagle Ford and the Bakken that are very strong, and if you get outside those areas, they're tougher but we can still make money. In the Marble Falls vertical oil play west of Fort Worth, where we have over 100,000 acres, we're still drilling wells that have 50% rates of return. If you would have told me that, I never would have believed you. We're always trying for the proverbial Wayne Gretzky, to skate to where the puck is going to be. The Rockies is unliked by industry today because the rock isn't as good and it's not as prolific and because of the location, it's further to market. But we tend to think there are a lot of areas where we can apply the latest techniques and generate better returns.

How about natural gas?
The Barnett and the Haynesville are the higher cost gas plays and they have huge deposits. But there's a compelling story for gas that will unfold over five or six years. LNG [liquefied natural gas] exports will be the biggest driver and chemical plants are getting built. With gas so cheap in the U.S., a lot of energy intensive manufacturing companies are moving back to the U.S. Then there's the whole trend in the power industry with the environmental push to get cleaner and two to three trillion cubic feet of coal-fired generation being retired. All the plants that will be built will be gas-fired. If you start adding it up, it's a compelling story for building natural gas demand in North America, which is good for gas producers.

How are your portfolio companies dealing with the lower priced environment?
Toward the end of the year, especially after Thanksgiving when OPEC made its famous announcement that it wouldn't cut production, we were going through an active capital budgeting process. Commodity prices had come down but costs hadn't. In the first quarter, budgets were curtailed rather significantly

and if you didn't have a rig contracted, you let it go. In the second quarter, costs have come in line and we're putting rigs back to work again. We were really trying to understand where prices and costs would shake out. As we look throughout the remainder of this year, most of our companies are looking at increasing capital budgets versus what we were planning in the first quarter. We're very optimistic. We'll spend almost as much this year on organic capex versus last year. We'll be a little under, maybe by 15% to 20%.

Are you looking at exits?
It's not a great time, but we actually may take an exit or two this year. In a few basins, commodity prices haven't come way off. There are a few areas where we have assets where the market has been resilient. There have been very few transactions, down 80% or 90% versus last year, which is massive, but we see that turning around a bit. No one knew where prices would settle out. There was also the buyer/seller gap, with too big of a dichotomy to transact. Prices bottomed in the low $40s and are back to $60, which is a closer price to transact now.

What will drive transactions in public markets?
Public companies that were relatively well hedged for 2015 had very little in 2016. If you look at debt levels across small and midcap companies in the first quarter, they had 3.5 times debt to cash flow, and that's hedged. If you look at end of this year, a lot of these are going to be 5.5 times, a meaningful escalation in debt metrics, which we think is going to translate into companies selling assets. The banks were relatively generous in the first quarter and our early read is that there will be a lot more scrutiny in the fall and more pressure for companies to either raise capital or sell assets and pay down debt. In the public debt markets, when you had commodity prices tank in the past, those investors went away.
But a ton of capital was raised in the debt and equity markets this time. If that hadn't happened, you'd have more assets in the marketplace. As hedges roll off, companies will have to do both, issue equity when they can but monetize assets. We're not so interested in investing equity in a public company, but as more assets transact, our companies will be buying.

Tell me about your joint venture with Linn Energy, which was pretty novel.
It was a $1 billion equity commitment for an acquisition partnership. The access to capital for some upstream MLPs is more difficult than for c-corps, and how much equity they can access is the biggest driver of a deal. A lot of assets that are more mature than a c-corp would be interested in buying still have a lot of production in them. So we came up with a unique solution: Let's buy those assets together, not what they would normally buy because they have too high of a decline and require too much development capital. And as those assets mature, there will be less capital required, and Linn will have the opportunity to buy them [from us]. We're looking at a lot of stuff already.

Would you consider more alliances like this?
You have to be careful about how many you do. Linn is a pretty big company and they'll know what's out

there. They're a former portfolio company, so we know them well and trust them. It's an evergreen platform. It's $1 billion initially, but hopefully we'll get to $2 billion to $3 billion. We are looking at drilling specific asset joint ventures with public companies.

What would that look like?
Say they own 15,000 to 20,000 acres in the Delaware basin and they won't do a dilutive equity offering. We'd come in and put up capital up to develop the assets. I'm sure others will try to replicate.

We haven't seen a lot of private equity acquisitions because of the still wide bid/ask spread. Do you see that narrowing?
As the year goes on, with commodity prices having bottomed, we'll find a good range.

What type of deal flow do you think we'll see?
It will be out of necessity, companies that are forced to deal with what their issues are.

Are new management teams forming and who have you recently aligned with? Any difference versus previous down cycles?
During downturns like these, executives of public companies have restricted stock and their shares are hit hard. So more good teams become available because their opportunity costs are not as great leaving where they are. We closed a $700 million with Rockcliff [Energy LLC]. It's the fifth company we've built with this team. We just signed up a great midstream team that plans to build a very substantial midstream business [Intensity Midstream LLC]. It's a new team we haven't backed before. Half of our companies are reups and rest are new teams.

How do you find new management teams?
A lot of them we know but haven't done business with. You know who the good players are. We have teams we've courted for years who weren't ready to come out of public companies or were at private companies that hadn't monetized. We just wait for the right time.

One of your portfolio companies, Vantage Energy, delayed its initial public offering in September. Will it be back on anytime soon?
Going public for us takes a huge amount of capital. It's truly an arbitrage. Some management teams want to run a public company, a lot of teams don't, with Sarbanes-Oxley and other liabilities. You talk to public CEOs, especially those who ran private companies, and they went from being a value creator to a manager. They want to build assets, sell them and do it again and again. We did look at taking Vantage public. It didn't need to go public, it's not overlevered and is drilling great returns. If we can't get the value we want in the public market, a lot of that premium would have evaporated. So we're keeping it private and we'll look at an IPO later or we could sell it.

Where do you think commodity prices are headed?
We don't predict commodity prices. But generally speaking, oil, short of a geopolitical event-you could have $80 or $100 oil if Saudi or Yemen blows up or **ISIS** takes over complexes-the fundamentals tell you that oil will be in the $50 to $70 range for the foreseeable future. We see some downside bias to that. There's a lot of stuff people are overlooking.

Like what?
Take storage. We've put an extra 100 million barrels in storage in U.S. That's massive. At some point, they don't keep in storage forever. When the price bumps up, they could pull it out and sell it. People are focusing on rig count being down a lot and production not growing in the Bakken and the Eagle Ford. There some truth to that, but we think the bigger issue is that there are a lot of unproductive wells, a lot of wells people haven't.

Let's not forget that six years ago, there were 1,500 gas rigs running and now there's 300, so the number of gas rigs have fallen 80%. Today, gas production is up 5% to 6%, with one fifth the number of rigs drilling for gas. We're growing gas production at a greater rate than we've ever drilled it before. Rigs become more efficient. Companies are only drilling in the core of these plays. There's no longer drilling of exploratory plays. They're in good rock, we've figured out to drill and complete quicker and are getting much more prolific wells.

The same thing is happening with oil. You're getting these massive efficiency gains. We don't need 1,500 to 1,600 rigs working to keep production growing. We think people are looking at that and extrapolating, "If rig counts are down by half, production will come way down." We're keeping a close eye on it. Uncompleted oil wells are masking the massive efficiency increases. There are a lot of resource plays where costs have come down a lot and you can make money at $50 oil. There's a new paradigm here.

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