Oil and Gas Investor

Private Equity Prospects

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Energy markets are notoriously cyclical, and capital markets can be fickle. But rarely have there been such complex crosscurrents in energy as there are at this moment. In the public markets, energy equities have suffered dramatic downdrafts, but have recently proven receptive to capital raises by select E&Ps. In crude oil, plummeting prices have now seemingly stabilized, but are forecast to fall once again when—according to many projections, but not all—West Texas Intermediate (WTI) reaches maximum storage capacity levels at Cushing.

For some long-standing private-equity sponsors, these may simply represent additional nuances to factor into the traditional energy cycle. With large portions of the public capital markets still in gridlock, and crude prices at steeply discounted prices versus nine to 12 months ago, conditions for private equity appear attractive. And as sponsors look to deploy capital, there is no shortage: One estimate suggests $60 billion to $100 billion is sitting on the sidelines.

Private equity is also proving to be far from a one-way street. Sponsors are generally advising E&P portfolio companies to slow down capex programs, just as their public E&P counterparts are doing. At the same time, sponsors remain alert to opportunities that may mean moving quickly to put capital to work at elevated levels to take advantage of the distressed industry conditions. And the spectrum of potential investment vehicles may be considerably broader than in the past.

Wil VanLoh, president and CEO, Quantum Energy Partners, said the private-equity firm likes to have lots in the kitty so as to double down when things get "ugly, as they are now; we love these times."

A macro view

Quantum Energy Partners, founded in 1998, has a philosophy that draws upon a broad industry macro viewpoint, while concentrating its portfolio on a focused set of E&P management teams.

“We do a tremendous amount of industry macro work here,” VanLoh said. “We feel that if you have a handle on the long-term trends, it’s easier to understand the direction of the market, even if you’re not precise on timing. We don’t try to predict prices on a given day or month.”

Even as oil prices have dropped dramatically, prompting Quantum to slow down portfolio companies’ capex programs “across the board,” VanLoh is enthused by potential bargains he sees on the horizon.

“Acreage prices have come down all across the country in plays that we know we want to be in over the long term,” he said. “We’re just as active as we’ve ever been. We don’t have a bunch of problems in our portfolio, so we’re able to spend most of our time being very offensive with our existing companies, while also looking at lots of new opportunities.”

Additionally, whereas start-ups by E&Ps may have been the mainstay of new entrants to Quantum’s portfolio prior to the slump in crude prices, “the spectrum of opportunities that we’re looking at today has become much broader,” he said. Moreover, there is no preconceived formula. “We always start with a blank sheet of paper.”

These investments may take a variety of structures to accommodate E&Ps that are “scrambling” to find ways to maintain projects while not outspending cash flow. Among those cited by VanLoh were a variety of joint-venture possibilities, including drilling joint ventures and acquisition joint ventures, as well as PIPEs (private investment in public equity) and structured debt deals with upside from warrants.

Quantum has typically worked with a small, focused selection of E&P management teams. “We’re big believers in having a much smaller number of companies than many of our peers, and have them be exceptional teams, and concentrate our investment dollars in those really good teams,” VanLoh said.

With commodity prices impossible to control, Quantum focuses “on the variables that we can control,” VanLoh said, with management selection at the top of the list. The ability to execute is the No. 1 priority. This means having the requisite reservoir, G&G, and drilling and completion expertise to identify the best rocks and drill and complete wells in line with estimated costs to deliver projected initial production (IP) rates and estimated ultimate recoveries (EURs).

And with commodity uncertainty, “We hedge a lot,” VanLoh said. While many public E&Ps tend to hedge out only 12 months, the average term of hedges held by the Quantum portfolio companies is over three years, with some going out five years. “We look at it almost like life insurance. You don’t try to guess when you are going to need life insurance and buy it. You just make sure you always have it in place. If you’re wrong about commodity prices, it can wipe you out.”

Not surprisingly, Quantum uses “very modest debt,” according to VanLoh, and the firm’s portfolio companies focus “almost exclusively on top quartile plays.” Quantum has mapped some 200 sub-plays throughout North America, and updates the database to review the top 25% in search of 10 to 15 plays with the best risk-adjusted returns.

“Top quartile plays will be the most economic at high prices. But at low prices, they may be the only plays that have any economics, so you can still drill wells even in the downcycle,” he said.

While acquisitions are still relatively hard to close due to the continued wide spread between the bid and ask on properties, Quantum has been able to do a good deal of organic drilling, with good returns, according to VanLoh. Quantum has also been “very successful” in farming into public company acreage, some of it being “core of the core” acreage that wasn’t available 12 months ago.

Lower crude prices are causing the cost structure in the U.S. oil and gas sector to become much more competitive, VanLoh said. “People like to say there is not a lot of elasticity in costs, meaning costs can’t come down that much. But 10 years ago, Quantum was making great returns when oil was $45 to $50 per barrel. The phenomenon of $80 to $100 barrel oil is a relatively short-lived, recent phenomenon.

“I think that, within 12 months, many of the plays that were uneconomic at $50 per barrel are going to be economic again,” he said. “And with service costs coming down to whatever levels are needed to get rigs running again, the U.S. oil and gas industry is going to be able to make good returns in a $50 to $60 per barrel price environment. This is one of our arguments as to why we don’t see oil prices shooting back up to where they were any time soon.”

Quantum’s most recent fund, Quantum Energy Partners VI, which raised about $3.4 billion in equity commitments, has already made three new investments totaling about $1 billion. Typically, the upstream sector accounts for 75% or more of fund investments, with investments to date split roughly evenly between oil and gas. Midstream and oilfield services each generally make up 5% to 15% of investments. “We’re looking at a lot of distressed-type opportunities in oilfield service now,” VanLoh said.

Notably, Quantum has drawn interest from overseas investors, including sovereign wealth funds. “There clearly is a desire, at least at the sovereign wealth fund level, to put capital into U.S. energy hard assets,” VanLoh said. “Relative to other parts of the world, there is actually a rule of law here. In the less developed world there is not the same level of certainty and thus more risk with respect to the rule of law.”

Over the past six months, Quantum has deferred several potential exits of portfolio companies due to the steep selloff in crude. The last exit by a portfolio company was Rio Oil and Gas LLC, which was sold in a series of transactions to Concho Resources and Diamondback Energy for a total of $585 million in September 2014. Quantum has subsequently backed essentially the same management team in their new venture, Rio Oil and Gas II LLC.