Oil and Gas Investor

Uncon Stretches Private Equity

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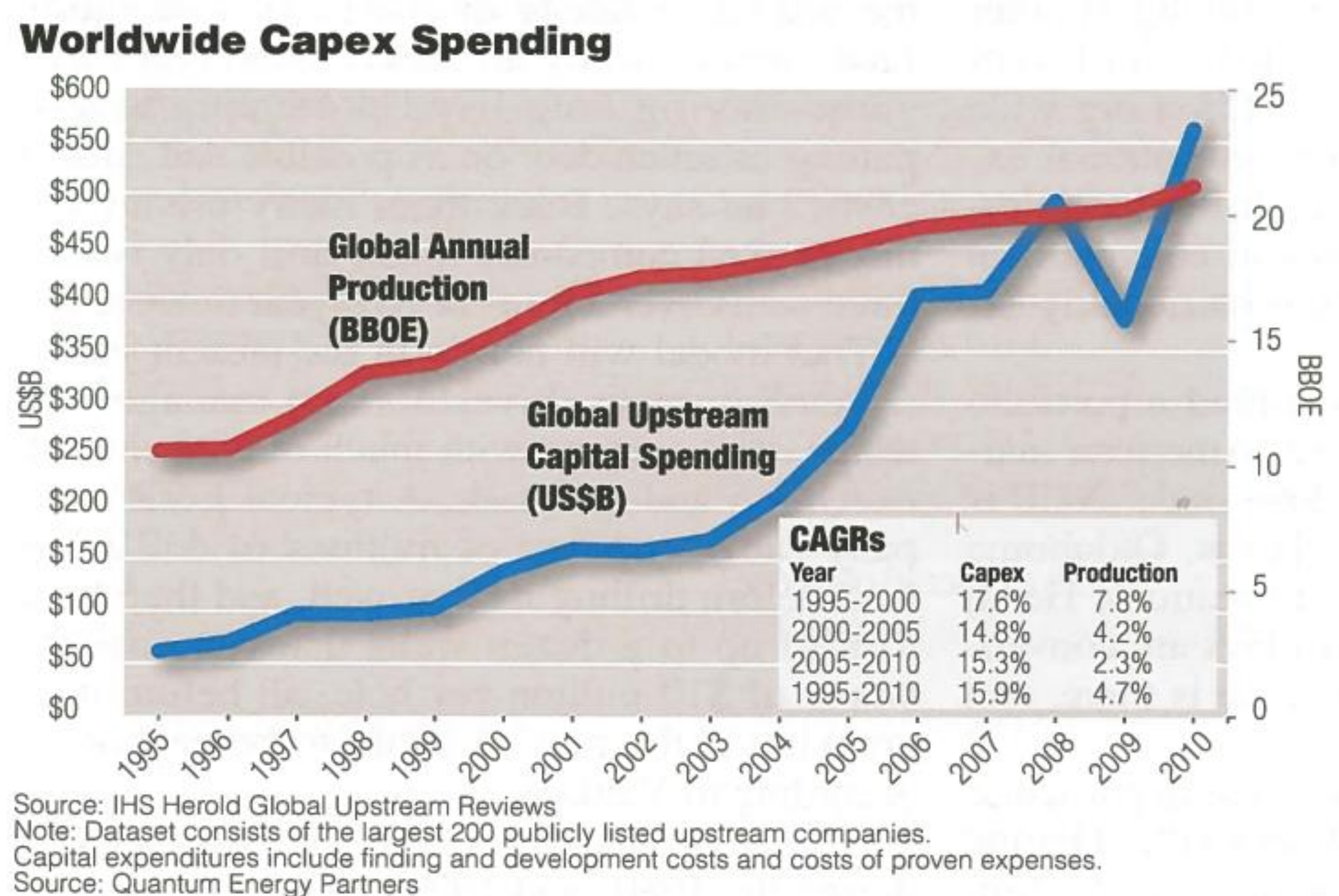
Unconventional resource plays have drawn serious attention and dollars from private equity over the past decade. But not everyone agrees on how PE should participate in the ongoing unconventional spree.



Oil and Gas Investor asked several top private-equity executives about their respective position on funding unconventional plays. There are a variety of ways to get into these plays, from backing a private management team to providing project finance for large public companies. Each has a different experience that informs their perspective. Collectively, these perspectives may light the path that led the industry here, and possibly the road ahead.

Worldwide oil and gas capex spending is at all-time highs, despite becoming increasingly inefficient.

Build models, then companies

Not everyone in private equity is unequivocally positive or negative on unconventional resource investments. Offering a balanced view is Wil VanLoh, president and chief executive officer of Quantum Energy Partners LLC. While Quantum has been intentional in making investments in the unconventional space, VanLoh approaches such projects with what he describes as "cautious optimism."

Public company return on unconventional project investment has fallen far short of what has been declared.

"The industry has evolved from one focused on conventional reservoirs to one focused on unconventional reservoirs," he says, acknowledging that in order to be a successful energy investor over the next decade, private equity must have exposure to shale plays as well as to tight oil and gas plays. He says he is now marking oil and gas time as "Before Shale" and "After Shale."

"Many of private equity's early success stories in these unconventional plays were more luck than skill, resulting from owning conventional assets in a particular basin only to wake up one morning and find that there was a new shale play underneath the acreage you already owned," he suggests. The industry has changed, and a successful investment strategy has to change with it.

"These times are very different than what we experienced in the 1990s and early 2000s, when the primary strategy of energy private-equity funds was basically an underground real estate game–buying long-lived producing assets, putting as much debt on as possible and cutting costs," he says. Back then, many private-equity-backed companies might drill only two or three wells over a four- or five-year time span.

Public Company Unconventional Returns

	Investor Presentation Stated		Actual	
	Avg. F&D Cost	Avg. IRRs	Three-year Avg. F&D (Incl. PUDs with conversion costs)	Avg. Five-Year ROIC per 10-Ks
13 Gas-Focused Companies ($/Mcfe)				
	$1.51	53.6%	$2.27	9.8%
9 Oil- and Liquids-Focused Companies ($/BOE)				
	$12.15	96.1%	$19.87	3.2%

Source: Investor presentations, transcripts, company filings and Bloomberg.
Note: In circumstances where there is less than three-year F&D and five-year ROIC data available, historical F&D and ROIC represents the time period of publicly available filings.

That model will not do in the present industry environment. Investors and management teams must contend with much more technical, execution and cost risk. A typical E&P company can spend tens of millions of dollars on land before drilling its first well, and then have to drill up to a dozen wells that can cost upwards of $10 million per hole, all before truly knowing if the play is going to be economic, according to VanLoh.

"Many oil and gas companies disappeared during the 1980s and 1990s, but the companies that survived by the time we started Quantum in 1998 typically possessed some sort of a competitive advantage. They were great operators, they were extremely cost-conscious and they knew how to extend the life of a field," he says. Dealing with a distressed price of $10 per barrel oil has that effect.

But from 1999 to 2008, the industry had the wind at its back as oil prices rose about 1,300% and natural gas prices were likewise up about 700%. At that time, a profitable model was easy to execute: just buy some assets, hold them for a few years, then sell them. But that paradigm had consequences.

"The decade of rising commodity prices dulled the focus on superior execution and cost management."

Getting lucky and flipping land is one thing, but VanLoh says that Quantum seeks to back unconventional players led by a CEO that has been a successful capital allocator in the unconventional space previously, and who has assembled an experienced team. That team needs to be "steeped in geophysics, geology, reservoir engineering, drilling and completion technology and land – all in the unconventional arena," says VanLoh. In an environment of sub-$4 per thousand cubic feet, there is little room for error and only the most experienced and disciplined teams will find success.

Private-equity providers have moved into unconventional resource investments at many different levels.

Changing dynamics

VanLoh suggests that not all shale plays are created equal and, even within a particular shale play, they are much more heterogeneous than most people think. Using publicly available data for various publicly traded shale players, his team calculated the difference between stated internal rates of return in investor presentations and their five-year average return on invested capital (ROIC), found in corporate financial statements.

What they found was a huge delta. The average IRRs listed in investor presentations ranged from 50% to 80% on average, while the average ROIC from their publicly filed financial statements ranged from 5% to 10% on average. VanLoh is not surprised.

"This always has been and always will be a 10% to 15% rate of return business. There are projects that do much better and there are projects that do much worse, and you can't forget to include the cost of land, infrastructure, G&A, interest and busted plays," he stresses.

If public companies with access to some of the best acreage, the best people and technology, and economies of scale, can only generate high single-digit corporate ROIC, it bears asking how private equity can make money in this environment. VanLoh has a few ideas.

"First, you partner with the best people that have successfully executed the strategy for which you are giving them money," he says. He is convinced that PE needs to back people who know how to let science guide them to the best areas, secure the right acreage at a good price, design and execute on the right drilling and completion program, and do all this while keeping a lid on costs.

"You can't just say 'Give me the EOG frac,'" jokes VanLoh, emphasizing the importance of correct application of technology.

"Think about it this way— I can give you the numbers to a combination lock, but without the correct order, you still cannot open it."

Second, VanLoh says, PE must capitalize portfolio companies to enable them to play the statistics. Unconventional plays inevitably boil down to the simple math of getting enough acreage in the right plays and in the right parts of the right plays. If you don't have enough capital to spread around your bets, the numbers are against you. Acreage acquisition has a fuse, and that is shorter now than it ever has been.

"It is amazing how over the past couple of years, the cycle time has massively compressed from when you can acquire acreage for just a few hundred dollars an acre, until it costs you thousands of dollars an acre," says VanLoh. Where the tightrope between drilling risk and acreage cost used to be measured in years, it is now measured in months.

This creates a tight window to be what Quantum considers an early adopter of a play, or in the early developing stage. VanLoh is prepared to pay more for acreage he knows has a higher success rate, rather

than buying in at the earliest stages for the lowest acreage cost, when fewer successful wells have been drilled. But being well-funded to manage the probability of success is not sufficient for VanLoh and his team to make returns.

"This is because even with a great team, adequate capital and lots of acreage, the learning curve is still very steep. While the industry continues to apply learnings from one play to the next play with greater speed and accuracy, no two plays are exactly the same," he says. For confirmation, one need only look at Chesapeake Energy Corp.'s activity in the Haynesville shale. After drilling more than 500 wells in the formation, Chesapeake's costs were considerably higher and EURs considerably lower than investor presentations touted, he says.

Wil VanLoh, president and chief executive of Quantum Energy Partners LLC, approaches investments in the unconventional space with "cautious optimism."

That, says VanLoh, is more than a learning-curve problem. The implications about the industry's return on invested capital in unconventional plays to this point concern him. Indeed, VanLoh's analysis suggests that very few of the shale-gas wells drilled to date are economic at $4 per Mcf—and alarming assertion, considering rigs continue to run in many gas plays even as the gas price dawdles below that mark.

There is a final component to VanLoh's point of view that shows his reaction to a change in the industry he believes has already happened. Quantum chooses to be in top-quartile plays, not just for better production on a well-by-well basis, but because he believes portfolio companies must be designed to be going concerns, not just meant for a quick flip.

"There is a lot of unconventional oil and gas in North America and while you could get lucky and get out before having to drill a bunch of wells, you better be prepared to invest your own capital to fully develop your assets. Relying on the 'greater fool theory' is not a strategy in Quantum's investment playbook," he says.

Over the past five to seven years, most of the industry's traditional acquirers have retooled themselves into resource-play companies with multidecade drilling inventories. VanLoh is convinced the old model of "build and flip" cannot be relied upon exclusively as an exit in the future. That's not to say he won't try to sell attractive assets. But when an E&P builds to own, decision criteria change.

While he is convinced that a lot of money is still to be made in unconventional investment, VanLoh is sober and ever-mindful about the failures in unconventional development, failures that have come and gone much more quietly than the winners.

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