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MIDSTREAM Business

Private Money

A trio of private-equity providers finds the midstream sector a hot ticket for investment, despite the competition of cheaper capital.

By Dave Luther

Every business needs energy, making the energy business the largest business in the world. An almost unlimited number of opportunities exist to invest in the upstream, midstream and downstream sectors of energy. But whether value is created or lost is largely dependent on an investment team's strategy and the integrity and skill of the targeted management.

Today, investors find it important to investigate the track record of an investment firm and each of the principals. For example, in the midstream business, the principals must be able to evaluate the probable success of the drilling organization that will furnish the liquids for transporting and processing.

What is the track record of the operating company? How large are the reserves and the wells for the gathering system fill-ins or step-outs? These are just a few of the questions investment organizations, such as private-equity providers, must answer before taking action.

The midstream business requires a high level of skills in the financial and technical areas along with experience and understanding of the entire energy business. Some investment firms like to invest primarily in start-up entities, while others prefer aggregating small properties into a larger, more efficient company. Still others try to find a balance of unique risk-reward characteristics of the two strategies.

Complimentary sectors

In Houston, Quantum Energy Partners LP, an investment firm composed of individuals from varied financial, tech-

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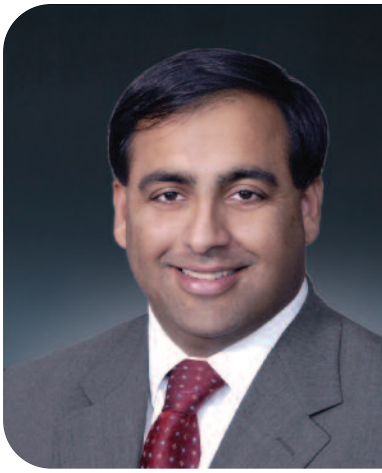
– Dheeraj Verma, a managing director, Quantum Energy Partners LP



nical and professional disciplines, sees midstream investing as an area of profitable and reliable return on investment.

"We currently have about $300- to $500-million allocated to midstream," says Dheeraj Verma, a managing director for Quantum. In addition to being active in Quantum's upstream and power investing, Verma is one of the senior partners of the firm and oversees all midstream investments.

Founded in 1998, the firm manages more than $5.7 billion of equity. The team looks for proven management teams that possess a clear vision and whose companies have sustainable competitive advantages within well-defined segments or strategies in the energy industry.

This year, the firm has been actively looking at new companies and management teams and "will be investing hundreds of millions more during the next twelve to twenty-four months," says Verma. He has a positive outlook for the midstream sector.

"Our advantage is that we have upstream companies we can compliment with midstream, so we invest in areas and businesses where we can add some insight or value, based on our upstream expertise," he says. "We take a five- to ten-year view when we look to invest."

The firm is opportunistic, managing its investments according to strategies, not timelines. "Some years we may spend $500 million to $1 billion, and some years we may not spend anything. It depends on the opportunities available. Our initial investment is usually in the $100- to $400-million range in any one deal. That's our sweet spot," says Verma.

This year, Quantum plans to invest in companies building natural gas storage assets and processing plants in shale plays. Many of its portfolio companies are building greenfield facilities rather than acquiring infrastructure.

Currently, the firm is working the midstream space through two of its portfolio companies—Quantum NGS Holdings LLC (QNGS) and Ceritas Energy II LLC.

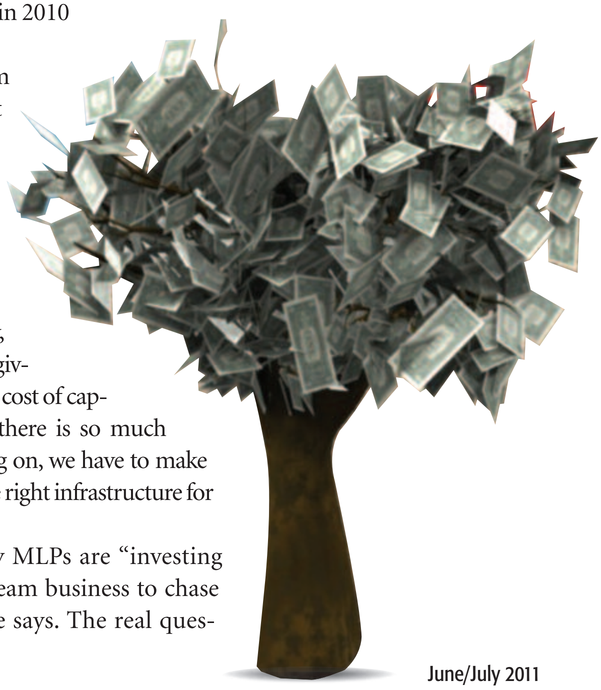
Quantum partnered with Dr. Larry Bickle and Andy Lang, two midstream veterans, to form QNGS. They invest in natural gas storage projects in the U.S. and Europe. Through its subsidiary companies, Merchant Energy Partners and Icon NGS, QNGS pursues projects that are at various stages of completion, including attractive greenfield candidates, prospects in early-stage development and existing facilities that are underutilized. Recently, QNGS entered into the construction phase of its East Cheyenne Gas Storage facility in the Rocky Mountains.

The second is a gas-gathering and processing company named Ceritas Energy II LLC, led by Richard Sherrill. Also based in Houston, Ceritas Energy is focused on developing and operating its midstream assets in the Marcellus shale region.

"Those are folks that we are proud to be in business with," Verma says, referring to the two major players. Yet, more midstream business is ahead. "Right now we are looking at a couple of other companies to back."

At present, Quantum is holding on to its investments and hasn't executed any exits recently. "We are in the midst of building and spending money, and haven't sold anything in 2010 or 2011," he explains.

Although Quantum has a solid portfolio, it didn't come without a fight. "One of the challenges in investing in midstream is competing with lower cost capital. When you think of MLPs today, the capital markets are giving them an even lower cost of capital than usual. Also, there is so much upstream activity going on, we have to make sure we are building the right infrastructure for the right play."



Meanwhile, many MLPs are "investing heavily in the midstream business to chase dividend growth," he says. The real question is: Is there too much money chasing too few assets? For some projects, the answer is yes.

"Some MLPs are trading at yields that are overly optimistic and do not reflect the underlying risks in their businesses," he warns. "Over the past year or two, some of these MLPs have paid a high valuation for buying assets. Are those MLPs going to be able to make those acquisitions work?

"We are a disciplined and patient investor, so it makes it very interesting to watch and try to predict how sustainable these high multiples are that some are paying for these assets," he says.