Oil and Gas Investor

Sending Money Home

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As public energy equities have become more demanding—some say "persnickety"—it has fallen to the private sector to provide both growing capital needs and a wider range of options for private capital to gain liquidity. Gone are the days when private equity (PE) could rely on a quick cash sale to a public E&P looking for growth, or a partial sale to public investors via an IPO.

"While it's tough to issue equity in public markets today, there's a lot of debt capital available," observed Wil VanLoh, CEO of Quantum Energy Partners.

Issuance of equity for acquisitions has dropped off dramatically as many public E&Ps adhere to the new-found discipline of spending within cash flow. Exceptions may be made in instances where "bolt-on" acquisitions achieve economies of scale and are clearly accretive. If not, public equity markets have a habit of increasingly penalizing public E&Ps that come to capital markets for funding.

As a result, the once "taboo" move of one PE sponsor selling to a portfolio company backed by another PE firm has become increasingly common. Accepting public equity as currency along with cash in the event of a deal with a public E&P is often a necessity. And some portfolio companies are tapping debt markets so PE sponsors can send home early cash returns to investors awaiting a more receptive equity market environment.

PE filling the void

In large part, these moves have been born out of necessity, as PE has steadily filled a void left by a public E&P sector chastened by investors for its lack of capital discipline in recent years. From 2010 to 2014, PE's share of the A&D market grew from roughly 10% to 50%, noted Wil VanLoh, CEO of Quantum Energy Partners. As of mid-May, its year-to-date share stood at close to 70%.

"Private-equity companies are stepping into the gap because, without them, there would be almost no buyers today," said VanLoh. "The only places where public E&Ps can raise money today are the Midland and Delaware basins. I'm not sure they can do it in

the Stack anymore. Even though the Marcellus is great rock, it's gas; and gas is as out of favor as it's ever been in the 28 years I've been in the industry."

VanLoh attributed capital market weakness—in spite of higher crude prices of late—to the public E&P sector's record of consistently generating a return on capital employed (ROCE) that, on average, has fallen short of its weighted average cost of capital (WACC). The sector has historically "generated horrible ROCE numbers. It's been 6% to 7% and, in some years, as low as 3% to 4%," he said.

While public E&Ps are "starting to perform much better, we're probably a couple of years out before these companies can more easily access the market," he continued. "It's going to take time for E&Ps to generate a ROCE greater than their WACC so that the average investor says, 'Energy's a good place to invest.' And until that happens, it's going to be tough for these companies to issue much equity."

Debt dividend recap

One strategy employed by Quantum to return money to investors pending a final exit is called a "debt dividend recap." This involves having a bond rating agency assess a portfolio company, and then hiring an investment bank to arrange a roadshow with fixed income portfolio managers who can potentially buy the bonds. Some or all of the proceeds are then sent to Quantum's limited partner (LP) investors.

VanLoh cited two such issues by midstream portfolio companies: an $800-million bond offering by Oryx Midstream Services II LLC, based in Midland, Texas; and a $365-million bond offering by Tulsa, Okla.-based Intensity Midstream LLC. In addition, on the E&P side, Sentinel Peak Resources, which acquired onshore California assets from Freeport-McMoRan Inc., completed a $250-million bond issue.

"While it's tough to issue equity in public markets today, there's a lot of debt capital available," observed VanLoh. "When we went on the road with Oryx and Intensity, we went to the bond rating agencies, got rated, and went on a two to four day roadshow. The investment bankers built a book, we priced and issued the bonds, and three days later received proceeds and sent the money to our LPs."

100% of upside retained

Even as all or part of proceeds are returned to investors, equity upside is undiminished, noted VanLoh.

"We were able to send a lot of money home to our investors, and yet, we still maintain 100% control of the asset and 100% of the upside," he said. "For Oryx, we returned multiples of our invested capital to our LPs. For Intensity, we returned almost 100% of our invested capital. And for our E&P portfolio company, Sentinel Peak, we took our entire equity of about $250 million out."

At the same time, Quantum has been careful not to burden portfolio companies with too much debt.

“Oryx, Intensity and Sentinel Peak were all underlevered companies,” according to VanLoh. “They’d grown so much and had so much excess cash flow that we could borrow some money against future cash flows and send it home to our investors. We levered both midstream companies at less than three times debt-to-EBITDA. For Sentinel Peak, leverage was approximately two times debt-to-EBITDA.”

Given that PE firms now make up a bigger portion of the A&D market, transactions are more common involving one PE-backed company being sold to another portfolio company backed by a different PE sponsor—so-called “sponsor to sponsor deals,” said VanLoh. As an example, he pointed to the sale of Stack assets developed by Quantum-backed Vitruvian Exploration III to a Riverstone-backed portfolio company.

In addition, with the IPO window barely open of late, asset sales are increasingly likely to receive bids comprised of both cash and equity when selling to a public E&P. This was the case with the $2.7-billion sale of Vantage Energy LLC, backed by sponsors Quantum, Riverstone and Lime Rock Partners, to Rice Energy Inc. Consideration was split as $1.35 billion in cash and $1.35 billion in stock.

“If you want to sell to a public company, you have to be willing to take some stock back,” observed VanLoh.

Early returns to investors

How important can a “debt dividend recap” be to a final portfolio company exit?

“Basically, there are only three ways to exit a portfolio company: sell it to a public company; sell it to a private company; or take it public,” said VanLoh. “If the market’s not great for selling assets, you’re buying yourself time, you’re getting money back to your investors, and you’re de-risking the investment by taking money off the table. Commodity prices have been going up, but they could go back down.

“The objective is to get an asset to the point where once somebody buys it, all they have to do is finance the acquisition—in other words, so there’s enough cash flow from proved producing assets to fund the drilling program without needing to issue more debt or equity,” he continued. “If an asset is not ready to sell today, maybe we use a combination of the cash flow and some of the debt from the bond issue to just keep developing it. It might be ready in a year or two from now.”

For the LP investors, the early return of funds is key in calculating their internal rates of return (IRRs).

“It gets money back to the investor sooner, which is always important in the IRR calculation and helps increase the IRRs on our funds,” said VanLoh. “If you’re trying to achieve 25%-plus rates of return, sending money home a year or two earlier goes a long way to doing that.”

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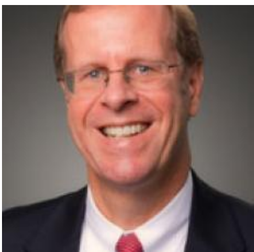

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