Private equity primed for moves in energy

Billions earmarked for energy investments are piling up on the sidelines. Meanwhile, the longer energy prices languish, the more producer and oil-service firms’ coffers dry up. It’s setting up the kind of scenario where PE shines

By Robert Olsen with Andrew Luetchford and John Hague

There has been a lot of talk since the oil crisis began about the interest of private equity investors in the sector, and their ability to fill the capital gap required to restart the energy engine in Western Canada. Private equity typically looks to realize on their investments in three to five years. Is that shorter-term investment horizon a good match for the long-term cyclical nature of the oil patch?

Good bedfellows or not, the amount of private equity capital raised for energy-focused funds in 2015 and early 2016 suggests there will be a lot more partnerships considered between capital hungry sector participants and the private equity industry in the foreseeable future. The challenge—at least in the short term—is the limited number of oil and gas investment opportunities that will meet private equity fund investment fund criteria such that these potential partnerships will actually be consummated.

Let’s first consider capital availability, then general market conditions in the oil and gas sectors and, finally, when and how private equity investors and industry players are likely to work together in the future.

Despite very challenging market conditions, 2015 was actually a record year for natural resources fundraising with $67.8 billion in commitments secured by funds reaching a final close, according to Prequin’s 2016 Global Natural Resources Report. Energy funds accounted for $62.5 billion of this total with North America representing the largest geographic focus. The fundraising pace slowed somewhat in the first quarter of 2016 but a further 12 funds still raised in excess of $11 billion.

Leading the charge in 2015 with its tenth private equity fund was EnCap Investments with a US$6.5-billion close. ArcLight Capital Partners closed its sixth fund at US$5.8 billion with NGP Energy close behind at US$5.3 billion with its 11th fund. Canada’s leading energy-focused private equity manager, ARC Financial Corp. closed ARC Energy Fund 8 with $1.5 billion of institutional capital. ARC indicates that the fund was oversubscribed with the majority of the capital coming from investors in its earlier funds. It is interesting to note that even in the current market, ARC’s investment strategy remains consistent with prior funds, with an exclusive focus on Canadian growth exploration and production and oilfield service companies.

Has fundraising success been matched by investment activity? The answer is an emphatic no. PE capital available for investment in the en-
The energy sector has been increasing because fundraising has outpaced investment activity. Preqin estimates that dry powder for energy funds in mid-2015 with a North American investment focus was well in excess of $100 billion.

When will seasoned fund managers sitting on so much idle capital find themselves closing investments at a reasonable pace? One wouldn’t think long, given the environment. For many oil producers and service companies, liquidity is evaporating and traditional sources of capital—banks and bond or equity markets—are not readily accessible. The significant gap in value between what sellers want, and investors are prepared to pay, is rapidly reaching equilibrium. This is setting the stage for increased investment activity later this year and beyond.

In the short term, we will continue to see a growing number of investments completed for financially troubled companies that have run out of liquidity and must accept aggressive terms and conditions. Distressed debt investors such as Apollo and Blackstone that are highly opportunistic and seeking outsized returns have continued to be active in this space. Companies that took ill-fated advantage of low-priced easy credit to leverage their balance sheets remain prime targets.

Even companies that have remained viable will need capital as low prices and volatility persist. With an eye very much on liquidity, we have been seeing producers across the board reduce expenses and cut capital expenditures, suspend E&P activity and even shutter existing wells. Clearly some proactive, well-adapted companies will continue to attract traditional sources of capital, but others may be forced to close down, sell to a competitor or raise whatever form of capital they can. This is especially true in the oilfield services sector, which relies on producing companies and has been particularly hard hit.

As difficult as energy markets have been, sentiment suggests that the industry has not yet reached a stable state. And so even if oil prices pick up, it will be some time for a full recovery to take place. Wind-ups and bankruptcies will increase. Players that have achieved a measure of stability may need to take even more aggressive steps to stay in the game including further asset sales. Banks that have been patient may not remain so. Credit agreements maturing in the next year or so with favourable pricing and few covenants may not be renewed. Public markets, which had been a ready source of debt and equity capital to the industry in the past, are not expected to be available in the foreseeable future.

The foregoing is exactly the dynamic that energy-focused PE funds have been waiting for with their $100 billion of dry powder. Whether it’s to provide additional capital for existing operators, fund the inevitable business combinations that will arise or to back strong management teams that are needed for troubled businesses, private equity is well placed to act. In fact, while the need for capital has always been an important part of the oil and gas sector, this time around it seems as though PE capital is a more attractive partner than ever. Whether all the new PE entrants will achieve the level of success enjoyed by their longer standing peers such as EnCap, NGP and ARC Financial remains to be seen. But the need for their capital is as real as it gets.

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