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PE investments into oil and gas in the low oil price environment

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Over the past 24 months, the low oil price environment has led to increased interest in the hydrocarbon sector from private equity investors. However, this has not translated into the anticipated avalanche of PE investments in comparison to the 24-month period preceding the drop in oil prices, which many analysts had initially predicted. That said, there has been a notable increase in PE deals in the upstream sector, including a number of headline-grabbing deals. This would indicate that private equity firms, known for finding creative solutions for investment challenges, are still finding ways to get the most attractive deals done. This article examines factors which have incentivised PE houses to contemplate entry into the upstream oil and gas market, as well as the challenges to such PE investment.

Introduction

June 2014 saw the commencement of a dramatic fall in oil prices which brought a halt to a prosperous run for the oil and gas industry and significantly slowed M&A activity in the sector. Oil and gas companies, particularly oil majors and independents, have variously responded to the downturn by scaling back expenditure, restructuring their balance sheets, reassessing their financing options and seeking M&A solutions to dispose of non-core assets and streamline businesses.

As institutional lenders have responded to the new low oil price environment with caution (at best) and trepidation (at worst), oil and gas companies, even those with quality assets in their cache, have found that they no longer have easy recourse to traditional avenues of lending.

Fortunately for struggling upstream oil and gas companies, 2014 also signalled the commencement of renewed interest from PE firms seeking to take advantage of the opportunities presented by the low oil price environment. Across the EMEA/Asia and Americas regions, there was a notable 20% increase in deal activity in the upstream sector over the period from June 2014 to June 2016, as compared to the period from June 2012 to June 2014.

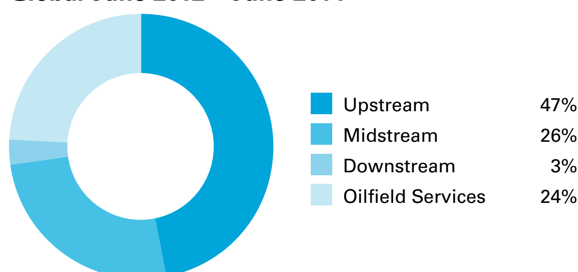
However, although analysts had initially predicted a spate of PE transactions, the hydrocarbon market has seen only a fraction of the projected PE equity investments—in the first half of 2016 Mergermarket reported a relatively small number of deals with an EMEA/Asia focus with a value greater than £20 million, and although there have been a number of deals with an Americas focus, there has not been a material change compared to previous years. To better understand this trend, we will examine the factors which have motivated recent PE interest in the oil and gas sector, as well as the factors which may be holding back actual PE investments in the sector.

PE investment trends[1]

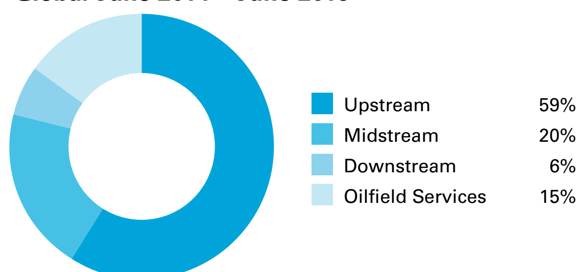
Global June 2012 – June 2016

There were a total of 193 reported PE transactions in the oil and gas sector:

Global June 2012 – June 2014

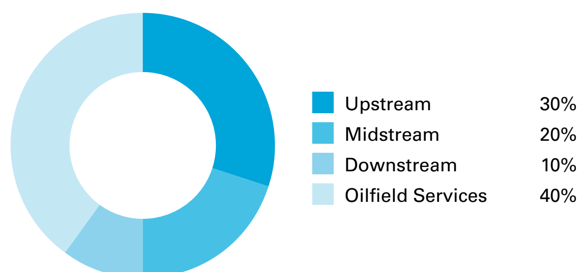


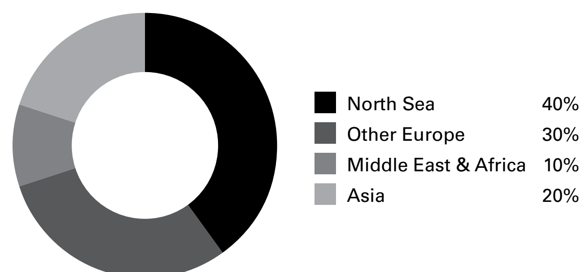
Global June 2014 – June 2016



EMEA/Asia June 2012 – June 2014 (preceding major oil price drop)

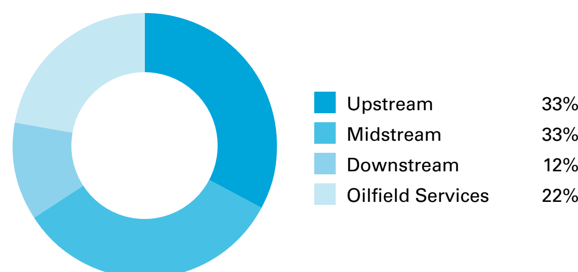
There were a total of 30 reported PE transactions in the oil and gas sector:

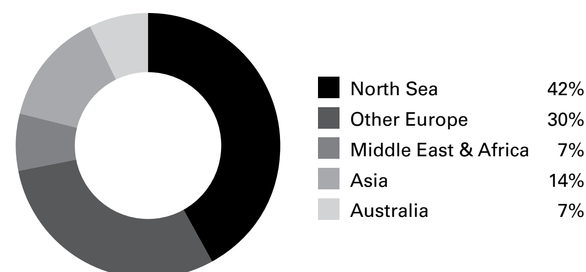




EMEA/Asia June 2014 – June 2016 (post major oil price drop)

There were a total of 27 reported PE transactions in the oil and gas sector:

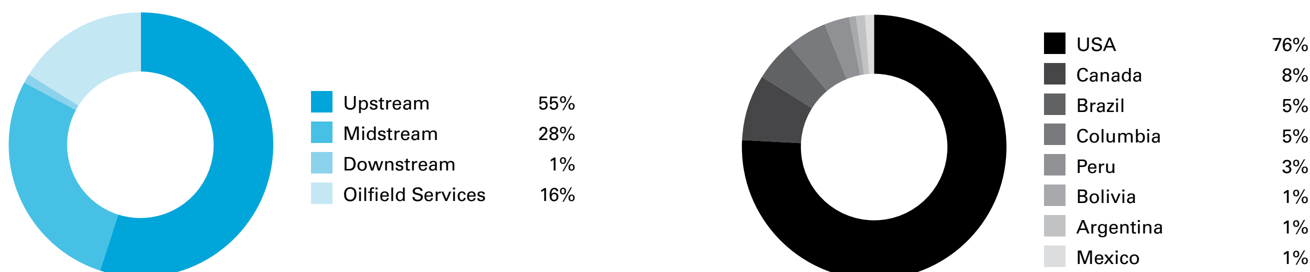




1 Our search results are based on the Mergermarket deals database, which is an M&A focused platform that, *inter alia*, monitors announced and signed deals in the corporate sphere. An important source for the deal database is self-reporting by M&A advisers, such as financial institutions and law firms. We have only selected deals with a value of £20 million or more, which were reported between June 2012 and June 2016. Please note that the figures may reflect investments into entities which cut across oil and gas industry sub-sectors, and include investments into entities which operate in, or with assets in, multiple jurisdictions.

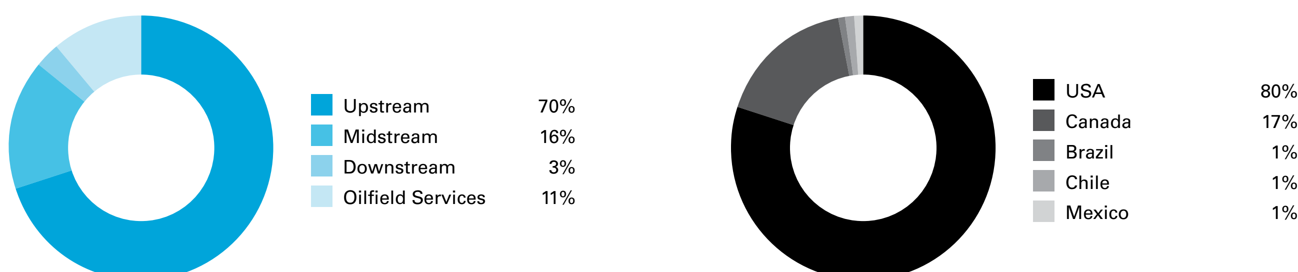
Americas June 2012 – June 2014 (preceding major oil price drop)

There were a total of 67 reported PE transactions in the oil and gas sector:



Americas June 2014 – June 2016 (post major oil price drop)

There were a total of 69 reported PE transactions in the oil and gas sector:



Upstream vs midstream, downstream and oilfield services

The findings indicate that the majority of PE investment in the Americas was in the upstream sector, both before (55%) and after (70%) the material drop in oil prices. In the EMEA/Asia region, prior to the major oil price drop, the oil services sector received the majority of PE investments (40%), followed by the upstream sector (30%). However, following the major oil price drop, upstream and midstream took the lead in the EMEA/Asia region (each taking 33%), whilst the oil services sector slipped to third position (22%).

On a global basis, the major oil price drop appears to have significantly affected investment patterns in the upstream and oilfield services sectors. The findings reflect a material increase in upstream investments (+12%), however, the tidal wave of PE investment into the upstream sector anticipated by some analysts has not come to pass. The same period saw a significant decrease in investments in oilfield services (-9%), indicating that confidence in the oilfield services sector has fallen, as E&P companies are reducing capital expenditure (including expenditure on oilfield services). Other sectors have not been materially affected; the findings reflect a slight increase in downstream investments (+3%) and a moderate decrease in midstream investments (-6%).

Americas vs EMEA/Asia

PE has traditionally been a more popular form of investment in the oil and gas sector in the US and Canada than in the EMEA/Asia region, which has continued to favour more traditional forms of financing. This is reflected in the origins of PE firms involved in oil and gas deals: in 2014, North American PE firms accounted for 67% in volume and 83% in deal value of all oil and gas deals.

However, our research shows that there has not been a significant increase in the total number of deals in the Americas and EMEA/Asia regions pre and post major oil price drop. That said, within those regions, there appears to be a trend of investing into more mature markets rather than emerging markets. For example, in the Americas, pre major oil price drop, 84% of PE investments went into companies based in the US and Canada, with Central and South America attracting 16% of the PE investments. Post major oil price drop, the US and Canada accounted for 97% of reported PE deals. A similar trend can be observed in the EMEA/Asia regions, where PE investment into Australia, the North Sea and the rest of Europe has grown whilst investment into the Middle East, Africa and Asia has slightly dipped.

What is driving the trends?

Investor confidence: Commitments vs investments

Overall, there has been a slight increase in PE investments in the hydrocarbon sector, but by no means the avalanche that was expected by many analysts. One reason for the gap between expected and actual PE investment may stem from a disconnect between interest in hydrocarbon assets by PE firms and fund managers and confidence in hydrocarbon investment by institutional investors investing in PE funds. Institutional investors significantly reduced their investment in energy funds in 2015, with investment coming to a near halt in the first few months of 2016 as only seven energy funds met their capital targets by the end of the first quarter of 2016, leading to predictions that only 33 energy funds will close by the year end. It seems that at present, institutional investors are currently keen to limit their exposure to hydrocarbons, particularly as they watch to see whether the oil price will rebound.

Brand name funds vs first time funds

Where commitments are being made to energy funds, it is primarily to the energy funds of established PE firms—so called "brand name" PE funds. First time energy funds have not shared in the success of their brand-name counterparts. This has, in large part, been blamed on investor anxiety regarding hydrocarbon investments (as discussed above), coupled with the fact that first-time funds lack both an established track record within the energy sector and specialist technical teams. Such brand name energy funds experiencing success despite investor coyness include:

- EnCap Investments, which raised US$6.5 billion in 2015 for EnCap Energy Capital Fund X;
- Riverstone Holdings, which has currently raised US$3.9 billion as of first close for the Riverstone Global Energy & Power Fund VI;
- Apollo Global Management, which has currently raised US$1.73 billion of its estimated US$2 to 3 billion target for Apollo Natural Resources Partners II;
- Carlyle Group, which in 2015, raised US$2.5 billion for Carlyle International Energy Partners, exceeding its US$1.5 billion target, the largest ever first time fund;
- The Blackstone Group, which raised US$4.5 billion in 2015, exceeding its US$4 billion target, for Blackstone Energy Partners II; and
- NGP Energy Capital Management, which has raised US$5.33 billion for its NGP Natural Resources XI, LP.

Even where funds have been successfully raised, a large portion of such energy focused funds, estimated in a recent study by EY to have grown to US$971.4 billion as of June 2016, have yet to be invested. A key reason for this appears to be that, despite the oil price spread narrowing to the US$40 – 50 range over recent months, the valuation gap for quality assets between buyers and sellers has persisted into 2016, with buyers and sellers disagreeing on appropriate pricing of quality assets. The continued volatility of oil prices, which can make reaching an agreement on pricing challenging as owners of quality assets are reluctant to part with these at prices which they perceive to be undervalued in the event that oil prices make a recovery.

Moreover, the reality is that the hydrocarbon industry can be complex to navigate, particularly with respect to risk, return and regulation in the upstream sector. Thus, whilst we have seen a moderate 12% increase in PE investments into the upstream sector, new entrants face challenges.

Challenges for PE investments into upstream oil and gas assets

Factors to be taken into account in evaluating PE investments in upstream oil and gas assets are the following:

- Many model production sharing contracts (outside of the Americas region) involve an exploration period of approximately seven years, with discovery and production declarations required to retain the asset and move into production. PE investors will need to consider this in light of the traditional PE investment horizon of five to seven years. This may also steer PE investors towards producing assets with a track record for netting stable revenues;
- The costs of providing decommissioning security during the life of an investment can have a material financial impact. In addition, decommissioning and environmental liabilities associated with upstream assets may extend beyond the period of immediate ownership of such an asset by a company, with some liabilities potentially extending beyond the corporate veil to the ultimate shareholder or controller. This will need to be taken into account by PE investors aiming to achieve a "clean exit" and to protect against cross-contamination of their funds with potential statutory or third party claims for historic decommissioning and environmental liabilities;
- Upstream activities are extremely capital-intensive and risk-prone and cash calls made by the operator to its joint venture partners are often uncapped in amount, unpredictable and can require significant funds to be raised in short order, which can be challenging for PE investors that are reliant on their own limited partners or third-party debt financing;

- PE houses face strong competition from national oil companies and oil majors for quality assets, many of which are marketed as part of controlled auction processes;
- There is a relatively high barrier to entry for new entrants in the upstream sector with little or no track record and established E&P companies (and regulators) will often prefer joint venture partners with proven technical capabilities, and may not be keen to approve transfers of interest to a PE investor with a more limited track record;
- If a PE investor is to acquire an operated asset, it will either need to enter into an operations & maintenance contract with a third-party service provider or acquire its own management team to run the asset; and
- The upstream business tends to be heavily regulated in most jurisdictions, with host governments commonly retaining extensive control over both entry into, and activity within, the upstream sector. To this extent, PE investors may need to invest time and effort in liaising with the relevant governmental bodies and will need to factor governmental consents into their exit strategy. By way of illustration, the UK North Sea has developed a more proactive regulator in the Oil & Gas Authority. By contrast, the US shale gas and oil industry is governed by comparatively "light touch" state regulation and, as a consequence, has attracted major PE investment. A survey of PE investors listed North America as the region which commanded the greatest level of investor interest in its oil and gas sector, followed by the Asia-Pacific region, and then Europe.

CONCLUSION

In summary, the significant drop in oil prices has not been the precursor to the landslide of PE transactions in the oil and gas sector that many industry commentators had first predicted. The primary reasons for this appear to be continued price volatility, execution challenges, and for some of the lesser known funds, funding difficulties. Moreover, wherever possible, oil majors are seeking to hold on to their "crown jewel" assets, leading to valuation gaps.

That said, there appears to have been a moderate overall increase in PE deals in the upstream sector, reflecting the prevalence of attractive upstream assets available on the market. This seems to indicate that private equity firms, known for finding creative solutions for investment challenges, are still finding ways to get the most attractive deals done. For example, headline-grabbing deals include the June 2015 acquisition by Carlyle of a stake in Magna Energy (an India-focused upstream company) for up to US$500 million, with an initial commitment of US$250 million and the April 2015 acquisition by Macquarie and Brookfield of the entire share capital of Apache Energy Limited, an Australia-based upstream subsidiary of Apache Corporation, for US$2.1 billion.

Midstream appears to be the oil and gas sub-sector which is second-most favoured by PE investors at present. This could be because pipelines and processing plants generally come with long-term customer contracts with guaranteed and stable revenue flows that are typically not tied to the oil price, while capex and opex are usually more predictable, making them attractive to infrastructure-type funds. For example, 2015 saw Total dispose of all of its interests in the FUKA and SIRGE gas pipelines and the St. Fergus Gas Terminal to specialised private equity house North Sea Midstream Partners for US$905 million, and BP sold its 36.22% share in the Central Area Transmission System (CATS) business to majority shareholder Antin Infrastructure Partners.

With more quality assets set to come onto the market in 2016 and 2017, it will be interesting to see whether private equity investors continue to capitalise on such opportunities: for example, in June 2016, Shell has commenced its three year US$30 billion assets sale programme to pay for its acquisition of BG Group in February 2016 and has reportedly held initial talks with Neptune Partners, an investment company backed by CVC Partners and the Carlyle Group. It is clear that PE will continue to pursue opportunities notwithstanding the continued oil price volatility and the experienced oil and gas PE investors will continue to lead the way in closing deals in the sector.

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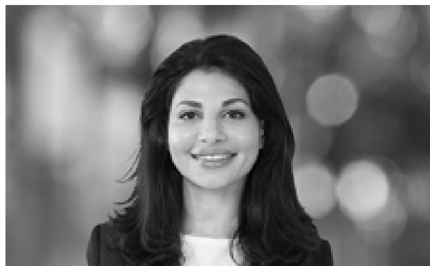

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