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PRIVATE EQUITY PIVOTS TO NEW GAME PLAN

Today private-equity providers focus on returns, cash flow, the right incentives and portfolio discipline.

By Leslie Haines

Even before the shocking oil price plunge threw the industry into a tailspin, private-equity firms and their portfolio teams were displaying more caution and enhanced discipline. That will continue. Rig counts were already coming down, exits were delayed if nonexistent, partner incentives had been adjusted and how companies deploy capital was changing.

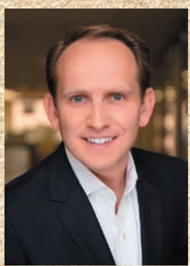
The new reality is that the flow of private equity to new teams has slowed down, and instead providers now favor giving additional capital to the teams that are already up and running—but only if they are "knocking the cover off the ball," in the words of one private-equity provider.

These trends were examined at *Oil and Gas Investor*'s Energy Capital Conference held in March, just a few days before the OPEC+ debacle shook up E&P plans across the U.S.

The M&A scene so critical to private company exits was already scrambled, with hold times being extended beyond the usual three to five years. The need to capture resources and acreage has pivoted such that private equity is more focused on improving its existing teams that are solid and can shift to operations for the full-cycle ownership of oil and gas assets. Portfolio companies that are smaller and earlier in their life cycle are already being consolidated into smashcos to reduce overhead.

Sam Stoutner, principal at NGP Energy Capital Management, said the company has become more inwardly focused in the past two years, working to build good businesses that can generate better incomes. He commented that while the fundraising cycle has also slowed, when portfolios show better returns, more capital will come. "You can't exit right now. Our math is much more focused on how can we get to a good outcome? For some of our companies there was no path forward, and we've consolidated some of them."

In a situation where you can't sell anything, it is also difficult to spend capital. Plenty of private-equity firms still have dry powder, and some were fundraising as 2020 began, but the way their capital is being deployed is changing. "We've spent a lot on nonop assets and royalties, where we feel really good about the economics," said James Crain, partner at EnCap Investments LP. "Before, you could put capital to work on the fringes of a play, and now you can't. Our teams continue to emphasize discipline and patience—they were once running 30 rigs, and now they're running five."



"We've started instituting more annual, more rigorous KPIs for each company on what to achieve, but it's not about production growth."

Sam Stoutner,
NGP Energy Capital Management

In times like these, people go back to the fundamentals, said Scott Browning, principal at Apollo Global Management Inc., and Apollo is no different. "First we look at organic growth; i.e., can you invest capital with returns in excess of your cost of capital?

"Second, we look for multiple expansion. Can you buy something, package it and sell it by starting at $5,000 an acre and selling it later for $10,000? Third, we look for free cash flow. We look at minerals, royalties and nonop interests where some base level of return is based on their free cash flow. Fear in this kind of market causes paralysis in M&A, but we can afford to be patient. We look for a balance between returns and free cash flow."

Incentives if no exit

How can a private-equity player compensate the management teams in its portfolio if there is no exit in sight? Each panelist offered his own take on this critical question.

Management teams are highly critical to success and must be nurtured, said Browning, so Apollo proceeds on a case-by-case basis. "No one can afford to have a team that is improperly incentivized," he said.

"If I hold these companies longer, do my waterfalls have to change?" Crain asked. "With all the talk about E&Ps' lack of access to capital, if you have an opportunity to put some money to use, it's an exciting place to be."

NGP's Stoutner said, "I think private equity got its incentives right a long time ago, and now the publics are migrating to that.

"We've started instituting more annual, more rigorous KPIs [key performance indicators] for each company on what to achieve, but it's not about production growth. It is about single-well economics and measuring progress each year and tying bonuses to that.

"For many management teams, being a survivor is a win in itself, but everybody is getting squeezed a bit," he added.

EnCap's Crain said E&P teams at the end of the day still have to build a set of assets that someone will want to buy, that would be accretive to the buyer, but he conceded that metrics on asset value have been moving around. "The metrics you used a few years ago are likely obsolete now," he said.

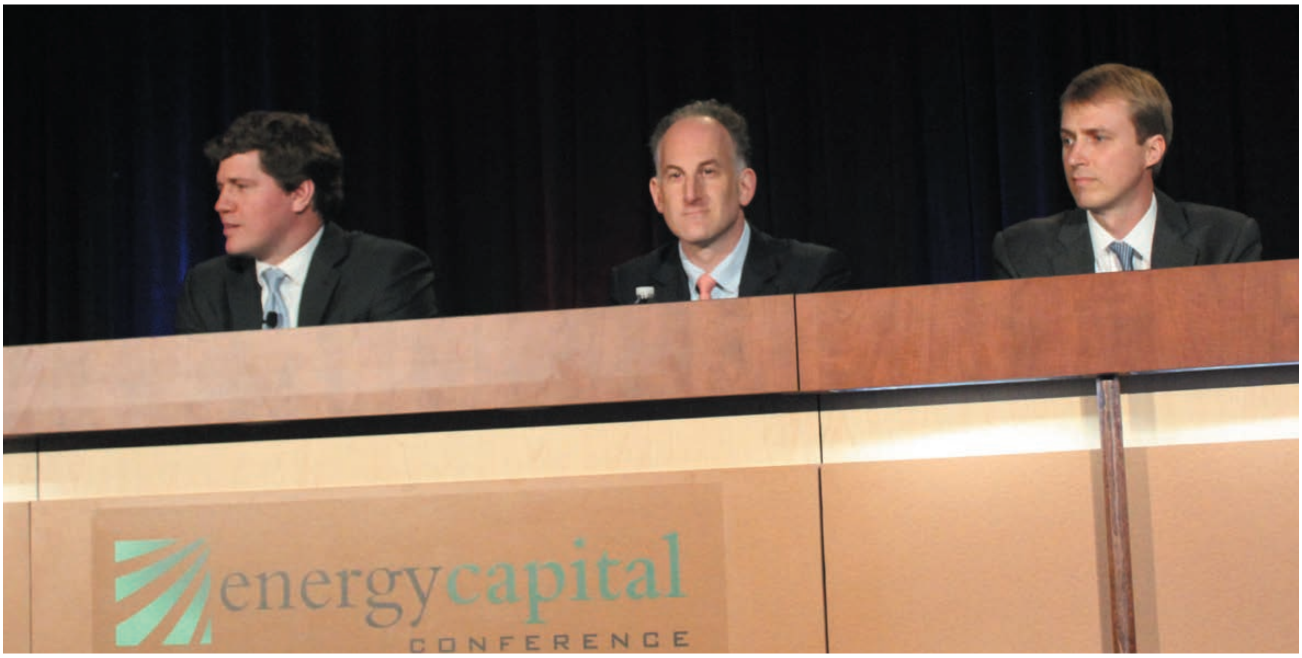
As part of its measurement strategy, EnCap tracks the performance of its companies by comparing them to public ones. "If you compare them on free cash flow or cash flow per number of rigs running, you'd see our companies are performing better. It's not an apples-to-apples comparison, but in general they're performing better," Crain said.

Resetting PDP values

Proved developed producing (PDP) reserves used to be the most attractive, but, like most things in the energy space, their value has declined with the bid-ask spread widening. To cautious buyers, they are probably not worth PV-10 anymore, when you burden them with capital spending, according to NGP's Stoutner. "As more distress creeps into the system, we think there is more coming. But I haven't seen any deal out there that I wish I had done.

"NGP is open for business," he said, but it's not looking to find more oil—it is looking for good teams "with technical chops" that can produce it more efficiently. "We tend to place more capital with our teams that are knocking the cover off the ball," he said.

How much have PDP values changed? "We spend more time underwriting assets that after five



From left, Ryan Turner, Stronghold Resource Partners LLC; David Zusman, Talara Capital Management LLC; and Matthew Jankovsky, Mountain Capital Management LLC, spoke on the middle-market panel at the Energy Capital Conference.

years, you have PV-20 or PV-25," said Apollo's Browning. "We ask ourselves, 'How long will it take to get my money back, assuming conservative prices and conservative terminal value of the assets?' There are a lot of different answers and different assumptions out there now. We live in a world where one guy thinks PV-25 and another thinks PV-8."

What's attractive now

Many private-equity providers are moving beyond traditional E&P by searching for additional investments in alternate energies, such as solar, or in energy technology companies, such as data analytics firms.

Apollo is looking at distressed debt opportunities today since fronting new teams is more challenging than before and finding an asset at the right price that will generate the right return is also tougher.

"I don't see many teams getting capital in a blind pool now; the bid-ask spread is fairly high," said EnCap's Crain. He said the company still has a lot of unallocated capital on hand, a bit more than $6 billion, so its principals feel well-positioned to bide their time.

Middle-market specialists

Equity and debt providers that specialize in the middle market, i.e., making smaller deals with smaller companies, see opportunities to invest alongside E&Ps that aggregate assets and/or in restructuring financing for them.

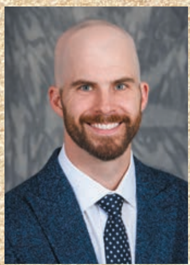
Ryan Turner, managing partner at Stronghold Resource Partners LLC, said Stronghold has done 35 transactions since 2016. The company generally looks for investments in businesses that buy and sell quickly, using capital that can be recycled as quickly as 90 days to two years. "We structure deal terms with the right alignment, sometimes in an equity position and other times in credit," he said.

"In times like these, E&P teams go back to fundamentals: organic growth, multiple expansion and free cash flow."

Scott Browning,
Apollo Global Management Inc.

Mountain Capital Management LLC, formed five years ago, provides private equity. It has invested in five portfolio E&P companies in Texas, Oklahoma and Louisiana, and a second fund is being raised that has had a second close, said principal Matthew Jankovsky. The fund is reaching for $650 million. "We look for $75 million to $100 million in each investment in operators and special situations. We define middle market at sub-$300 million," he said.

"We work with banks, equity owners and others to craft bespoke solutions. We are hyperfocused on complexity."



"The metrics used a few years ago are likely obsolete now. Is ESG part of the conversation? Absolutely."

James S. Crain,
EnCap Investments LP

Talara Capital Management LLC has put about $1 billion of capital to work since being formed 10 years ago. Today it sees opportunities to aggregate assets from E&Ps that need to be restructured are under-scale or are "Mom and Pops looking to exit," according to David Zusman, co-founder and managing partner.

He said he sees a lot of end-of-fund-life issues coming up, such as limited partners wanting to get out of funds. This represents another opportunity for Talara.

The company has a Permian development group since it took the latter's first-liens at a discount. As a result, it ended up being in some of the best rock in the country at a great price per acre, he said.

All oil production is not equal, and there are a lot of traps, Zusman said. Talara tries, for example, to avoid basis risk.

In the middle-market space, assets are owned by varied players, so Zusman has to take a wide view to source deals, he said. There are opportunities to pick up nonop assets and offer preferred equity to E&Ps.

Risk factors

Because there is typically greater risk of bankruptcy among smaller companies that have less capital, Mountain Capital "has its sleeves rolled up" to craft custom transactions that help distressed E&Ps never make the bankruptcy list, Jankovsky said.

Stronghold will do either operated or nonop investments, each having different risks. "We underwrite the risk on every asset that our teams produce or sell," Turner said. "Nonop is about recycle time. How do I get into an asset and turn it into cash as fast as I can? It is much easier to transact at $5- or $10- or $15 million."

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Mountain Capital "is a big believer" in aggregating assets if that means buying bolt-on acreage, Jankovsky said. "We'd much rather place capital into a stable business and then strategically think about bolt-ons."

Zusman said Talara's strategy is a roll-up strategy, which by definition means aggregation of many assets. "There is a lot more transaction volume than is being reported. We spent three years doubling the size of our position in the Permian, but it was done a few acres at a time, and I think that patience pays off. We weren't looking for one big transformative deal."

Turner said Stronghold's team gets asset ideas anywhere, from "discussions at bars" to its own research and full-throated submittals from others. Stronghold will fund E&P projects on a definite timescale but does not hold over the long term, he said. ■