FAMINE OR FEAST?

The plight of private equity in an exit-challenged market pivots on perspective. And focusing on the lack in the short term risks missing the abundance in the longer view.

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Private capital is perplexed. The flight of capital out of public oil and gas markets in recent quarters put a pinch on monetizations for private investments. And that creates a conundrum for private investors: flee the space as have the generalist public investors, or double down?

Several private-equity sponsors have discussed the unusual environment for capital in public forums recently and how they are adapting to trapped investments as exits evaporate.

The investor base

Despite rumors to the contrary, limited partners have not abandoned oil and gas, according to several private-equity sponsors speaking at *Oil and Gas Investor*'s Energy Capital Conference in Dallas in March.

For one, Post Oak Capital maintains a "very stable investor base," said Frost Cochran, managing director and founding partner, although the allocation to the space is not as large as in the past. Nonetheless, "they think in decades, not quarters," he said, "and that exposure is important to them."

Post Oak Capital is settling in for the long haul regarding exits, said Frost Cochran, managing director and founding partner. "We're going to have longer hold periods, and our companies need to be designed and structured for the long haul."

At a minimum, oil and gas is "effectively a hedge" in their portfolios as to their exposure with other sectors. And even though energy is currently in the red, "sometimes your hedges are out of the money," he said. "But you need to be hedged in the event it goes the other way, and sometimes it does."

Some do recognize the true fundamental value that's in the space right now, however: as it transitions from capture mode to free cash flow and true cash on cash generation. "It needs to be proven, but I think there's enough capital out there that believes that's probably going to be the case, so that they continue to allocate to the space," Cochran said.

Geer Blalock, managing director with Denham Capital, emphasized that LPs and investment managers recognize the critical nature of shale production to global supply and want to remain exposed, but "competitive tensions" are apparent in their conversations. Headwinds such as capital allocation, portfolio construction and the weighting of E&P within the S&P 500 have the limited partners adjusting portfolios accordingly.

"On top of that, you have an expanded number of sponsors going out and seeking more and more capital as intensity continues to build," he said, "but we've got a supportive base of investors as well who have taken a view internally on how they want to manage and approach their energy exposure."

Preston Powell, managing director of Carnelian Energy Capital Management LP, said that fair weather investing in the private capital world plays out similarly to retail investors investing in the overall stock market.

"A lot of times some of these investors come in when things are going really well, and they load up on exposure when they did not have it in the space before," he said. "And then they pull back when things get a little bit tough. That's certainly played out in the public markets, and more recently you've seen that play out with certain investors in the private market as well."

The energy private-equity markets experienced a run-up with successes in the early 2010s, and funds got much larger. Yet those returns over the past three years, at least for some, he said, have been compressed, "and you've seen some of those investors pull back."

Nonetheless, "there are a lot of other investors who've stayed in the market who have actually put more money in this time because they see the opportunity."

The exit

The bugaboo in private equity remains the exit—or lack thereof. Money deployed in the past three years and today is largely trapped in portfolio companies unable to find a monetization through sale or IPO. How do you build a concept today that will get sold?

Blalock said private equity and corresponding management teams have to focus on developing assets that mirror the capital markets' requirements on public companies, as they will be the ultimate consumer of the assets. "Our charge as private-equity buyers is to build what the market needs or anticipate what the market will need in the future and build accordingly."

Historically, private equity sold assets into a market window focused on establishing inventory. Now, "you're either going to have to compete with that existing inventory and try to stack up with the best econom-

Geer Blalock, managing director with Denham Capital, said a successful exit comes down to building businesses that have strategic value to the end owner … while maintaining as much exit optionality as possible.

Despite some investors fleeing the market, Preston Powell, managing director of Carnelian Energy Capital Management LP, said, "there are a lot of other investors who've stayed in the market who have actually put more money in this time because they see the opportunity."

ics, or deliver cash flow that can be utilized and accretive to the cause."

Post Oak is settling in for the long haul regarding exits, Cochran said. While sponsors with sub-$1 billion funds like Post Oak do have the ability to continue to build bolt-on assets for larger buyers, these are workable only in a healthy or marginally healthy market for capital markets-funded companies. That doesn't exist for anyone currently, he said, "so we're going to have longer hold periods, and our companies need to be designed and structured for the long haul."

In the meantime, that return of capital to some extent may come from recapitalizations of portfolio companies to extend ownership for longer periods of time. "You need to have teams that are built for that and have a portfolio that's built for duration. That's the case whether it's an upstream investment, midstream or oilfield service. Duration is important. All of us are learning to live with greater duration with our management teams and our portfolio."

Carnelian, alternately, has found a sweet spot for monetizations in the current climate, said Powell, by being further downmarket in size from the larger private-equity funds.

"We're in the middle market; we'll typically do $50- to $100 million equity checks. For companies of our size, many times the exits are still digestible for some of these public or larger private companies. They can find ways to finance an acquisition if you've turned $50- or $75 million into $150- or $200 million. They're not having to go out and issue equity or do a bond offering to close a deal. We're still finding potential avenues to find liquidity on that route."

Private consolidations

With ongoing chatter regarding how small and midcap E&Ps should consolidate to create scale to appease public investors, the same discussions flow down to the private sector where seemingly myriad portfolio companies dot the landscape. And while these equity sponsors acknowledged that some of the larger energy private-equity funds are rolling up teams with geographical synergies, by and large they are not.

"Consolidation is a continuing theme on both the public and private side, and it makes sense for economies of scale," Blalock said. However, Denham purposefully constructs a portfolio that is differentiated to avoid overlapping on both on a strategic and geographic basis, "so there aren't necessarily those synergies to be realized," he said. "That's intentional."

And bigger doesn't exclusively equal better, he emphasized.

"The real goal we try and strive for is building with intent and purpose, so [creating] thoughtfully designed organizations built for purpose for their associated strategy, and accepting that duration is here to stay for a period of time. You can do that and be small and nimble in a lower part of the marketplace that doesn't see the same level of competition."

Similarly, Post Oak's portfolio of companies doesn't overlap in ways to create synergies, but the company has previously combined management teams with other equity-sponsored companies. Those consolidations were win-win strategies to the private-equity sponsors and to a large extent the management teams as well, he said.

"There is a place where you capture cost synergies, particularly in a long hold period on execution, by doing that."

The risk, perhaps ironically, he noted, is in becoming too large by consolidating.

"We consolidated a company several years ago, and on the exit the capital markets were required to facilitate the exit. Had we not merged that might not have been the case," Cochran said. "We complicated the exit, but the asset became more valuable by doing that."

But merging portfolio companies, as much as it might seem to make sense, is not an easy task, according to Powell.

"One of the things we've seen that's a challenge to that is the relative valuation considerations and the different perceptions of the management teams and the private-equity firms involved. Getting everyone to agree that this company is worth Y and this one is worth X, and those make sense together, has been a challenging exercise," he said.

"We've worked on it in a couple of different instances and will continue to work on it, but as of yet, those have been more difficult conversations than I would expect in this market."

Building durability

Patience and duration are necessary in the current environment, Cochran said. And while some management teams continue to hope for an imminent exit at a perceived relative valuation, they're due for a dose of "market therapy," he noted.

"Sometimes that's helpful to an impatient management team, to keep going out there and pushing to understand where their asset value is and to be shown by the market. But rarely is private equity surprised about where the market views our assets at any given time," he said. "And so we wait patiently for those windows to find our exits or recap opportunities, and to shepherd our management teams that direction also."

What is the sweet spot for an equity-sponsored company to exit? Denham's Blalock said there is no one answer. "It comes down to building businesses that have strategic value to the end owner. You can build small, strategic bolt-ons that go hand and glove with someone's existing position," while maintaining as much exit optionality as possible, he said.

If there is a potential pitfall in business planning, he said, it's centering a business plan around a specific exit and trying to

AN EXCELLENT TIME

Talara Capital Management's David Zusman views many of the private capital investors of the past decade as venture capitalists. Their model: fund a team with a blank check, buy a lot of land, delineate and extend a field with a few wells, and flip. His point: That model is an anomaly born out of the resource-grab phase of the shale boom, and investing models are now returning to development-oriented strategies based on margins.

"Some of our peers are finding that their venture capital-oriented models aren't working in this market, and they're needing to shift to thinking about holding their assets for longer. In the day and age we live in today, you've got to be the low-cost provider as the industry matures," he said.

"The days of just drilling a well here and there and delineating are over. Now you've got to be running a continuous rig and continuous crew, getting economy of scale like you're a manufacturer."

Houston-based private-equity firm Talara finds no need to change its model; its strategy was always as a developer of properties. A typical Talara investment will target assets with technological upside potential in the $20- to $25 million range, equitize it with about $100 million, then develop half of the potential locations during a five-year period with some $300- to $400 million in capex.

"This is a margin business," said Zusman, co-founder and managing partner. "We're putting dollars into the ground and then we're reinvesting it in drilling more wells. We are turning leases into cash flow and returning that cash flow back to investors. That cycle of cash flow is what's underwriting our investments."

And that model is tailor-made for public shareholders today seeking cash flows. "It's really the maturing of the industry. You're going to get a shift toward more development-oriented capital spending as opposed to land delineation spending."

The buyers of such PDP-oriented assets have changed over time, he noted, but he expects "a more significant push" during the next five years as yield becomes more important. "We expect there to be a fairly liquid market for those exits," he said. "There will be more and more yield buyers in the market. We've seen that already."

Talara Capital Management's David Zusman is the most excited about acquisitions opportunities as he has been in the past 10 years. "The market is ripe today to do some very smart things. It doesn't feel like everybody is jumping in just for the sake of jumping in."

Zusman also sees limited partners adjusting to the changing environment in energy. "The industry always changes and, if you're not on the cutting edge of those changes, you're going to be left behind. LPs view themselves the same way," he said. "We think that the current environment is ideal for our strategy."

Specifically, investors are increasingly wanting to back general partners that are more operationally involved with their properties and are closer to the assets, he said.

"There's been a clear trend to focus on funding the development of specific assets to be able to reach fruition, developmental cash flow, rather than just giving blank checks to a team and hoping to flip."

Zusman is the most excited about acquisitions opportunities as he has been in the past 10 years. "The market is ripe today to do some very smart things. It doesn't feel like everybody is jumping in just for the sake of jumping in."

He conservatively estimates some 8,000 small property owners in the U.S. with assets under a $50 million value that are more undercapitalized now than ever before.

"They can't get the RBL facilities like they used to from the banks, they oftentimes don't have an engineering team to really deploy the latest modern technologies, and they often don't have that level of capital efficiency to get a rig, get a crew and keep that rig and crew running continuously."

The opportunity is to bring in a strong operating team, recapitalization, technological efficiencies and a consistent manufacturing program.

"Our inbound calls from those smaller property owners who need a solution are way up. There are more compelled sellers today at this level who need a development partner. Many of them want to keep a small minority stake in the business—5%, 10%, 15%—so they can ride our coattails of development. That's okay with us."

For those private-capital investors focused on development, it's "an excellent time" to generate solid returns, he said. "It's just back to blocking and tackling, right?"

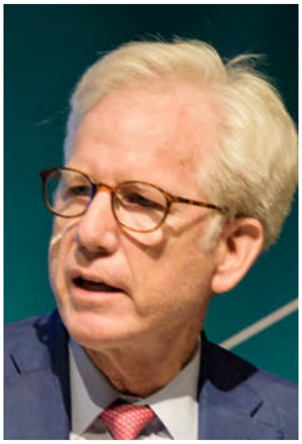
build an asset package for a specific buyer. "You just can't be that predictive on the timing or the profile of who's going to own it. You need to build something that has insulated margins."

One example in Denham's portfolio is Covey Park Energy LLC, a large Haynesville Shale-focused business that has been strategic in acquiring and growing its asset base. It's been so successful, in fact, that it is now either a logical consolidator or consolidatee in the region, Blalock said, "but it's taken other exit options off the table.

"They are essentially a public company masquerading as a private company, but the public markets are closed, so we have to pivot another direction to find creative ways to ultimately monetize that business. In the meantime, it's a business built to grow and develop and is accreting equity value as we go."

And if you do try to plan the exit, it's never the way you thought it was going to work out, Cochran said.

"We gave up on that a while back. Some of our teams have been so successful that the exit got complicated because of their



NGP partner Bob Edwards said its portfolio companies are drilling ahead with the exit in mind. "We're profitably growing value with the expectation that the capital markets open up again. It's the private capital that has been investing over the next couple of years that will have inventory to serve up to the more efficient, larger companies."

success. They became so large that it became difficult for who you might have thought would have been the logical buyer to then transact because it was going to take a protracted capital-raising process for them to execute."

Carnelian's Powell adds flexibility to the necessary qualities in a portfolio strategy today. He described one particular company the sponsor took to market last year expecting to sell to one buyer in one package, but eventually sold it to four buyers in four pieces.

"We ultimately got to a good outcome, but it wasn't what we had in mind when we started the business. But the flexibility was important in getting to the exit we all needed. Whether it's selling in pieces, recapitalization or consolidating, often what you had in mind when you started the business will look very different at the end."

Preparing the harvest

NGP partner Bob Edwards acknowledged that, with capital markets closed to large public companies, "it does stall our exits." But Edwards views this period as "an enormous opportunity for acquisitions," he said, at CERAWeek by IHS Markit in March. In the meantime, NGP's portfolio companies are drilling ahead.

"Most of the private equity in this phase of the development cycle, we're drilling. We're profitably growing value with the expectation that the capital markets open up again. It's the private capital that has been investing over the next couple of years that will have inventory to serve up to the more efficient, larger companies."

The disconnect in the markets is centered on the markets' disbelief at returns being flashed by the public E&Ps, he said, and that's where the deep value investors like private equity can come in. "We're not guided by the analysts on Wall Street when we have management teams that can deliver 50% to 70% IRR wells. That's a good return until the publics are consolidated and begin to have disciplined growth."

Edwards said it is a fundamental dichotomy for investors to ask high-growth companies to distribute cash out when capital is still required to maintain production and keep production flat. "The reality is with shale wells declining at 40% to 50% per year, this industry requires a capital machine continuing to pump capital."

Edwards said private-equity portfolio companies—particularly NGP's—are as efficient in their drilling and their capex as they can be considering their relative size to larger companies, "but we know they are not as efficient as Exxon will be with 30 to 40 rigs running in the Permian Basin. What's the role of a $5 billion enterprise value Permian pure play when you need to drill 20-well pads? We're not necessarily the natural owner of those assets," he said.

Still, private capital is investing in value, and value still exists, he assured. "Ultimately, private equity is going to sell to the majors or to the large E&Ps when the markets give them the signal it's OK to openly grow again."

At the moment, although the markets are not rewarding public companies for adding yet another year of inventory to their already swollen inventory of high-return locations, those will soon be depleted. In three or four years, he said, as assets are developed and proven up, the markets will again look to replenish the inventory via the consolidated winners.

Further out, the resource potential for private capital is vast, he said. With shale EURs in the 8% to 10% range of original oil in place, "nobody can tell you what enhanced oil recovery means for shale.

"This idea of working the entire decline curve cycle from initial acreage capture to primary development to whatever secondary development means in shale, to mature production, those are all life-cycle stages that private capital like ours has taken advantage of."

Edwards expects to hold assets "for a little bit longer in this era," but he's fine with that while drilling economic wells in core positions. But his view is that this is an era of plenty rather than lack. "This is an ecosystem where there is a role for private capital to jig when the capital markets are jagging." □