Private Equity Participation in the Asian Oil & Gas Industry

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Introduction

Private equity participation in the oil and gas industry is well established in North America with private equity-backed deals accounting for 65% of the aggregate value in oil and gas buyout transactions globally between 2006 and 2014 according to data provided by Preqin. While international exploration and production ("E&P") companies and, more recently, national oil companies ("NOCs") have been the key drivers of deal activity in Asia, private equity involvement has been increasing, particularly since the global financial crisis in 2008.

The recent collapse in oil prices to below $27 a barrel has surprised many in the industry and resulted in dramatic reductions in exploration and capital budgets and redundancies across the entire E&P industry. E&P companies have been forced to reduce capital expenditure as their cashflows have declined and exploration budgets have been revisited given the current outlook for oil prices in the medium term. At the same time, there has been a record influx of funds to private-equity backed energy funds and the industry has over $100 billion of "dry powder" that is yet to be deployed.[1]

M&A in the Asian Oil & Gas Industry

Hess, Newfield Exploration and Murphy Oil are some of the companies that have recently divested assets in Asia, before the precipitous decline of the oil price. Those divestments were intended to redeploy capital to what, at the time, had been more profitable North American operations. Newfield chairman, Lee K. Boothby observed that the sale of his company's assets in Malaysia was in line with its decision to "exit its international businesses and focus on domestic resource plays". In 2013 and 2014 Hess sold over $2 billion of its assets in Indonesia and Thailand. ConocoPhillips and Chevron are currently planning to dispose of their interests in the South Natuna Sea Block B PSC in Indonesia.

2015 witnessed a decline in the volume of mergers and acquisition activity, which was at its lowest level for a decade, according to data compiled by Wood Mackenzie. The disconnect in valuations between sellers and buyers and oil price volatility had a chilling effect on activity and deal-making.

The Emergence of Private Equity in Asian Oil & Gas

Over the last decade, private equity has emerged as a significant source of capital for the oil and gas sector. The return on investments made across the oil and gas value-chain have been high during the last 25 years (at 15 percent net IRR). Between 2009 and 2015, private equity sponsors raised about $251 billion for investment in the energy sector.

The continuing slump in oil prices is likely to strengthen private equity deal making in this sector, as distressed companies need funds to continue operations and are forced to divest assets to service debt and also become acquisition targets in their own right. Private equity might be the only source of such liquidity for many E&P companies, given that equity and debt capital markets are less receptive to funding the sector given the current volatility in the oil price and uncertainty regarding its outlook. However, until bankruptcies occur and debt is written off, it is unlikely that private equity participants will come to the rescue, as the smart play is to wait until these assets emerge from bankruptcy at discounted valuations. Naturally, lenders are reluctant to switch off life support for their borrowers and crystallise losses so we are in a hiatus where hope springs eternal and borrowers seek to restructure their debt and raise further equity, where they are in a position to do so.

While on a far less significant scale than in North America, private equity has emerged as a source of capital in Asia for the oil and gas sector in recent years (as shown in the table) and this trend is likely to continue given the competition for assets in North America.

The Private Equity Advantage

While Asian NOCs are in a unique position to acquire oil and gas assets in Asia, given their access to cheap capital, political ties and 'home field' advantage, private equity has substantial capital reserves and talented management teams who are adept at seeking out and executing deals in the region. Unlike NOCs who are required to remit funding to their governments, private equity capital is immune from such political pressures and is focused on maximising returns for its investors. First Reserve, Blackstone and KKR have all formed private equity ve-

Investor	Target/Company	Investment Commitment (in US$ Million)	Date Announced
Northstar	Samudra Energy	Not disclosed	2005
Actis, Pine Brook, AES and Temasek Holdings	Asia Pacific Exploration Consolidated, L.P.	380	26 October 2007
First Reserve	KrisEnergy	500	14 September 2009
Noble Group, EIG Partners	Harbour Energy, Ltd.	200	14 July 2014
Blackstone	Tamarind Energy	800	30 July 2014
KKR	Mandala Energy	Not disclosed[2]	March 2015
Brookfield Asset Management, Macquarie Capital	Quadrant Energy[3]	Not disclosed	5 June 2015
The Carlyle Group, CVC Capital Partners	Neptune Oil & Gas	5000	9 June 2015
The Carlyle Group	Magna Energy	500	22 June 2015

hicles utilising experienced management teams in Asia, which are actively seeking opportunities.

Private equity sponsors can tailor their investment strategies and provide flexible off-balance sheet capital to co-invest with E&P companies - as was seen in the recent deal between Linn Energy and GSO Capital Partners, the credit arm of Blackstone. Such deals allow E&P companies the ability to continue acquire and develop assets, while providing private equity sponsors with direct interests in oil and gas assets and a platform for co-investment opportunities and add-on acquisitions. Many believe these types of deals are set to increase since private equity portfolio companies often lack the operations personnel that are required to operate and develop assets.

To succeed in Asia the investment strategies of private equity sponsors will have to be customised to suit the region, and individual countries within the region, which is very different to the operating environment of North America. Besides partnering with E&P companies and management teams with strong operations and technical expertise, a critical requirement in Asia is a strong relationship with host governments, NOCs and regulators. Government ownership of petroleum resources and the prevalence of production sharing contracts in Asia means that there are a wide range of domestic, political and legal considerations that affect the monetization of reserves and access to investment opportunities. One challenge facing private equity portfolio companies in Asia is the perception from host governments and NOCs that they do not have the technical and operational competence of E&P companies. While operations can be out-sourced to specialist personnel and contractors, the experience of host governments in Asia with long-established E&P companies (many of which have been active for 50-100 years) means they are wary of private equity sponsors.

The period of time required to discover and develop resources in Asia is often in excess of 10 years (and often longer in the case of offshore development projects). There is a view that private equity participants do not have the latitude from their investors to stay the course for the development phase of a project and are 'temporary' partners, which makes it difficult for private equity companies to be awarded exploration acreage in bid rounds or through direct appointment. Consequently, it is likely that private equity sponsors will have more success acquiring producing or near-term development assets from E&P companies as they rationalise their portfolios and divest non-core assets. However, competition for such assets is high and NOCs and other industry competitors typically have a lower cost of capital and different commercial and political objectives. Private equity sponsors may need to eschew auction sales and develop close relationships with domestic and international E&P companies, NOCs and host governments in order to access opportunities and modify their time horizon for exit strategies. Accordingly, the role of the management team and their relationships cannot be underestimated. Finding suitable investment opportunities in the Asian oil and gas sector has proven to be a difficult task and a number of private equity-backed portfolio companies have struggled to make acquisitions despite the capital that is available.

Successful private equity participants in the Asian oil and gas industry have brought in industry professionals with extensive experience in Asia to manage their oil and gas portfolios by offering earn-outs and incentive plans. Quadrant Energy, which is backed by Brookfield Asset Management and Macquarie Capital has employed such a strategy for its operations in Australia. The new venture, which was commenced upon the $2.75 billion acquisition of Apache's Australia business in June 2015, has retained a significant number of ex-Apache personnel to manage its operations and provide operational capabilities.

It is clear that there will be a number of opportunities to acquire assets in Asia so it will be interesting to see if private equity sponsors can replicate their successes in North America and treat this as an opportunity to acquire assets at a time in the oil price cycle when valuations are depressed. The number of private equity-backed management teams in Asia is small compared to North America but the competition for quality assets is intense. While the risks are high, the rewards are likely to be commensurate for those who are prepared to take such risk and have a long term view on the demand for energy in Asia's economies.

1 Based on data provided by Preqin.
2 Mandala Energy made its first investment in October 2015 when it acquired an interest in the Lemang PSC in Indonesia from Ramba Energy.
3 Quadrant Energy acquired Apache Energy's Australian business for US$1.9 billion.