ENERGY

Drilling into new ground

The Asian oil and gas industry has largely been untapped by private equity, but Brad Roach and Karthik Ashwin Thiagarajan say that is beginning to change

Private equity participation in the oil and gas industry is well past its infancy in North America with PE-backed deals accounting for 65 percent of the aggregate value in oil and gas buyouts between 2006 and 2014. In Asia, while international exploration and production groups and, more recently, national oil companies have been the key drivers of deal activity, private equity involvement has been increasing, particularly since the global financial crisis in 2008.

With oil prices falling to a five-and-a-half-year low this year, companies with weak balance sheets or facing significant capital expenditures are expected to divest or farm-out their Asian assets in the light of substantially reduced cashflow from production. These factors may provide a ripe market for opportunistic deal-making by private equity players across the upstream, midstream and downstream sectors.

International oil and gas companies are under pressure from shareholders to rein in capital expenditure on "risky" exploration activities or less productive assets. A number of North American companies were urged to redeploy capital to take advantage of the boom conditions created by unconventional production in North America which, while requiring substantial expenditures and high well counts, promised high short- to medium-term rates of return.

Hess, Newfield Exploration and Murphy Oil are some of those that have recently divested assets in Asia, in part to redeploy capital to their more profitable North American assets and to shore up their balance sheets. Newfield chairman Lee K. Boothby observed that the sale of his company's assets in Malaysia was in line with its decision (in 2013) to "exit its international businesses and focus on domestic resource plays". Hess Corporation sold two oilfields in Thailand in order to fund a $4 billion repurchase of its shares subsequent to a proxy fight with Elliott Management, an activist hedge fund.

PRESSURES ON LIQUIDITY

Roger W. Jenkins, president and chief executive of Murphy Oil, noted that the proceeds from the partial sell down of its Malaysian assets in 2014 were to be used for "strategic and financial initiatives, such as increased drilling capital in the Eagle Ford Shale, acquisition opportunities, debt reduction and share repurchases".

Companies that are highly leveraged, or reliant on cash flow from production in a 'high' oil price environment, are likely to face increased pressures on liquidity as lower prices adversely affect their revenues. Besides making it difficult for these companies to raise additional debt, lower oil prices have also depressed the valuations of these firms.

$157bn

Amount raised by private equity funds between 2009 and 2014 for investment in energy

Over the last decade, private equity has emerged as a significant source of capital for the oil and gas sector. Between 2009 and 2014, private equity funds raised about $157 billion for investment in the energy business.

The continuing slump in oil prices is likely to strengthen private equity deal-making, as distressed oil and gas companies need funds to continue operations and service existing debt. Private equity players might be the only source of such liquidity, given that even equity and debt capital markets have turned their backs on oil and gas issuers.

Traditionally, private equity investment in the industry has been focused on the midstream sector, given that targets here are backed by term contracts and generate stable revenue streams. The downstream sector's vulnerability to economic cycles and the high chance of failure in the upstream sector make these areas harder to value.

Despite these risks, private equity funds are increasingly investing downstream and upstream. Deal activity has also picked up in the oilfield technology sector as companies attempt to acquire 'disruptive' technologies to enable unconventional exploration, boost efficiency and reduce operating costs. The returns on investments made across the oil and gas value-chain have been promising during the last 25 years (at 15 percent net IRR), which is encouraging more private equity fundraising for this sector.

Asia has witnessed the emergence of private equity as a source of capital for the oil and gas sector over the last couple of years.

The slump in oil and gas prices is expected to result in further private equity investment in Asia as banks and financial institutions become hesitant to provide debt funding. Moreover, the focus of private equity investors might be shifting away from developed markets.

Eduard Ruijs, a managing director at First Reserve, noted that, as part of its global approach to energy-focused investment, his firm also seeks oil and gas investment opportunities in Asia. As with its other portfolio investments, First Reserve's focus for Asian opportunities is to partner with companies and management teams to develop projects, monetise assets and support growth strategies.

While national oil companies continue to be 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 is able to attract talented management teams who are adept at seeking out deals.

Private equity is 'patient capital', looking at long-term performance as opposed to publicly-held oil and gas companies consumed by the need to report consistent quarterly numbers and pressure from activist shareholders. Private equity firms also have the ability to tailor investment strategies based on the requirements of investee companies.

Private equity firms act as conduits between institutional investors and oil and gas management teams. While the latter bring industry expertise to the table, private equity firms exert financial discipline and have the ability to manage substantial capital over extended timeframes. Further, with financial institutions unwilling to provide liquidity, private equity firms have a greater risk tolerance and can provide such liquidity in exchange for higher returns.

The investment strategies of private equity firms and energy companies will have to be customised to suit the region. This includes navigating multiple regulatory and fiscal regimes. Besides partnering with companies and individuals with strong technical expertise, a critical requirement in Asia is solid connections with host governments, regulators and local knowledge.

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. These professionals, as observed by Kelvin Tang, president Cambodia and vice-president legal of KrisEnergy, have enduring ties with various stakeholders in Asian jurisdictions as opposed to personnel of international oil majors and national oil companies who are rotated to new areas every few years.

Numerous private equity funds and vehicles are training their sights on Asia, while strategic players are in the midst of a retreat. Recent big ticket moves include the formation of Neptune Oil & Gas (which counts Southeast Asia as one of its three core markets) and Magna Energy (which will focus on the Indian sub-continent). The success of these private equity funds and vehicles, however, will depend on how well they tailor their strategies in the fragmented and challenging Asian environment. ■

RECENT KEY DEALS

INVESTOR/S	TARGET	INVESTMENT COMMITMENT ($M)	DATE ANNOUNCED
Northstar	Samudra Energy	Not disclosed	2005
Actis, Pine Brook, AES, Temasek	Asia Pacific Exploration Consolidated	380	October 2007
First Reserve	KrisEnergy	500	September 2009
KKR	Weststar Aviation Services	200	October 2013
Noble Group, EIG	Harbour Energy	200	July 2014
Blackstone	Tamarind Energy	800	July 2014
KKR	Mandala Energy	Not disclosed	March 2015
The Carlyle Group, CVC Capital Partners	Neptune Oil & Gas	5000	June 2015
The Carlyle Group	Magna Energy	500	June 2015

Source: Gibson, Dunn & Crutcher LLP

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