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Disintermediation of private equity

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OIL AND GAS resource funds are putting pressure on the traditional energy-focused private equity fund model. Promising to cut out the "extra layer" of compensation inherent in a fund-to-portfolio company structure, resource funds offer limited partners more direct exposure to underlying investment assets. This basic pitch explains the growing success of the model, as well as the risks sponsors and LPs face.

As a general rule, resource funds raise capital from limited partners in a manner familiar to the private equity industry. LPs commit capital to a blind pool. The sponsor group earns a management fee and a carried interest, and parties often look to the broader private equity market to negotiate all of the terms.

Many resource funds are focused on lower return, (relatively) less risky producing assets, with lower targeted IRRs, which drive longer investment periods and termination dates. General partners will also successfully negotiate in many funds for participation in carry distributions before a complete return of capital, and other terms that address the unique structure of an asset-focused fund. But in large part, from the investor side, the fund terms are recognizable. And there is a significant overlap in the LP base between these funds and more traditional investment partnerships.

From an oil and gas investment perspective, the resource fund operates much more like a typical portfolio company, with management teams and general and administrative expenses comparable to a stand-alone oil and gas operating company. Though resource funds to an entity argue that they have a competitively lower all-in cost of equity capital than traditional PE portfolio alternatives, providing them a distinct advantage in acquiring assets.

The resource fund promises to reward the LP by eliminating a layer of management and associated compensation expense. Whether conceptually the eliminated layer is the fund carry and fee economics, on the one hand, or the portfolio company equity compensation plan, on the other hand is debatable. But the savings is real and is undoubtedly enjoyed at least in part by the LPs.

Complications arise in articulating what expenses in this model should be "fund expenses" or rather covered by the management fee. There is a compelling argument that expenses otherwise borne by the portfolio company in a typical model should be fund expenses, and expenses normally borne by the fund's investment advisor should be covered by the fee. And market practice is helping to define this tricky area. But carefully disclosing and documenting the expense arrangement, especially in light of recent SEC enforcement decisions regarding expense allocations, is critical.

Resource funds largely come in two flavors: additional private investment fund products offered by established fund sponsors, and funding structures offered by oil and gas operators that adhere to private equity fund norms. And of course, there are hybrid examples.

LPs backing traditional PE-sponsored resource funds rely on the reputation and professional money manager background of the sponsor. However, these funds face challenges in ensuring that the personnel performing the oil and gas investment activity (the internalized portfolio company) are suitable fund employees, from both a cultural and compliance perspective. This fund also can face challenges in recruiting top-level management who have the necessary oil and gas expertise and are willing to perform as essentially a managing director (but not CEO) level.

By contrast, resource funds sponsored by oil and gas operators offer interested LPs a direct relationship with managers experienced with the day-to-day challenges of building and maintaining a portfolio of oil and gas assets. This fund in particular scratches a growing direct investment itch by the LP community.

However, these funds face different challenges, including in many cases complying with investment advisor registration and similar securities requirements for which they have little to no prior experience. They can be long on oil and gas investment track record and short on professional money management experience. They also may require a steep learning curve in understanding what the typical institutional LP will need as part of an ongoing relationship.

While undoubtedly we are seeing a disintermediation of the typical upstream oil and gas private equity structure, the question remains: who is losing out – Fund sponsors? Management teams? The answer appears to be a little of both. But the art of the deal is determining who gains. **OGFJ**

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