PRIVATE EQUITY'S RETURN

Improved returns are causing some private equity firms to reconsider the opportunities available to them in the oil and gas industry, but they are weighing these against pressures related to the energy transition.

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Recent months have brought about something of a turnaround in fortunes for the oil and gas industry, and this is causing private equity firms, among others, to reconsider the opportunities the sector offers.

The commodity price downturns of the past decade have been weighing on the industry and have caused capital sources to dry up amid years of poor returns. These sources of capital have included private equity firms, a number of which took advantage of rising oil prices in 2021 to exit the oil and gas space. The trend was compounded by pressures related to the energy transition, which had led to several major players in the private equity space to turn their attention to greener investments.

However, the onset of the war in Ukraine in early 2022 upended energy markets, with commodity prices spiking earlier this year and oil and gas coming back into favor as global energy security became a top priority. While there are some concerns about a global economic slowdown and the impact it could have on energy, the broader expectation is that demand for oil and gas will continue to rise. And a pivot away from Russian oil and gas imports—especially in Europe—makes hydrocarbons produced elsewhere a more attractive resource.

Private equity positions

Against this backdrop, some private equity firms are reconsidering moves to exit oil and gas, though this is not playing out across the board, and others remain keen to leave the space while commodity prices are elevated.

"The trend of PE [private equity] firms monetizing their portfolio companies is still very much ongoing," Stephen Trauber, a vice chairman and co-global head of natural resources and clean energy transition at investment bank Citi, told Hart Energy.

"With commodity prices high, valuations have also risen, and PE is trying to monetize at these elevated valuations," he said.

Trauber warned, however, that bridging the gap between sellers and buyers as far as value expectations go remains a challenge.

"Buyers do not want to overpay in the current high-price commodity environment, so bridging this value gap is the hardest aspect of completing transactions," he continued.

"We have already seen several transactions this year, and I believe we will see several more announced before year-end. Sellers do not want to miss this environment to monetize their assets. Buyers do have much stronger balance sheets and elevated share price valuations, so it is a good environment for buyers to consolidate, capture synergies and create value for their shareholders."

Valuations are far from the only factor affecting private equity behavior, though. As the energy transition accelerated in recent years, pressure has mounted on private equity funds from investors such as public pension funds and endowments to shift their focus to cleaner energy. Certain giant asset managers including Blackstone and Apollo

Global Management recently pulled back from new oil and gas investments. But more recently, other private equity firms that invest in oil and gas have been reported to be talking up the importance of the industry to investors as the spotlight remains on energy security. With the oil and gas industry seeing improved returns, investor interest remains and is indeed rising among some players.

"While there has been some pullback of investments, both in the public markets and from passive limited partners, like insurance, endowments, pensions, foundations and family offices, we continue to see increased investment interest in the right opportunities that minimize risk and provide reasonable returns," Evan Turner, a managing partner at private equity firm Drillcore Energy Partners, told Hart Energy.

Trauber noted that the exit of a number of funds from the hydrocarbon business in recent years has resulted in an environment where there is less competition for assets available. Meanwhile, returns available to private equity firms have been rising, bolstered by higher commodity prices.

"The energy sector has significantly outperformed this year, and investors who have not been invested in energy have largely underperformed," said Trauber. "I do believe some PE firms who have exited the business will return in a balanced manner with the energy transition, and I also believe that new PE firms will be formed to invest in energy as a result of the returns that are able to be generated. We have already started to see some private equity funds who have historically dabbled in energy start to become more aggressive in their investment into the sector."

A degree of caution remains, however, after the hit that many—but not all—investors took on oil and gas over the past decade.

"We believe there will be outliers who are seeking higher-risk, higher-reward investment opportunities that financial sponsors and private equity provide but also realize that many investors did not earn what they expected over the past 12 years or so in oil and gas private equity, while some select ones did very well," said Turner.

Making adjustments

Drillcore's own approach illustrates how private equity firms are adjusting to current market conditions. Founded in 2017, the company targets upstream and midstream acquisition and development opportunities in delineated geologic basins in the Lower 48. Structures that interest the company include traditional buyouts, strategic partnerships—whether joint venture or drillco—and growth equity opportunities across the lower to mid-market, according to Turner.

"We continue to adjust our investment parameters with the economic environment in order to provide the best outcomes for all parties involved in the deals we target," he said. "We believe that increased regulations and higher-for-longer prices lend to a more competitive market for M&A opportunities due to the bid-ask spread with buyers and sellers. We also look for select service opportunities and transition opportunities that make financial sense."

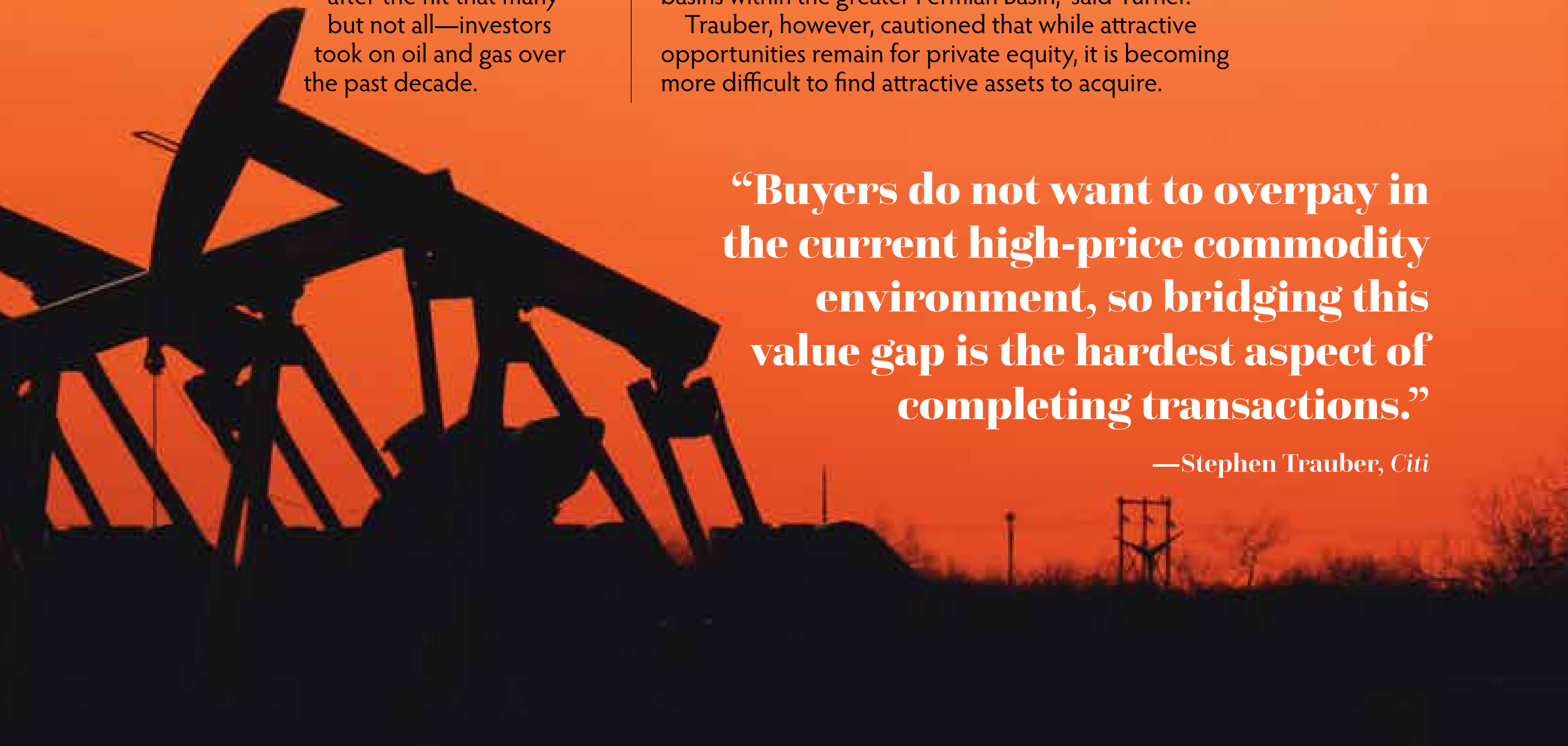
The company is optimistic about the opportunities that remain for private equity firms in the oil and gas space.

"There are many growth and consolidation opportunities," Turner said. "There are a lot of proven management teams with strong track records that have increased the technical expertise across certain basins and can help a financial partner to monetize and extract value from the ground up."

Specifically in the U.S., concerns have also emerged over the attractiveness of shale opportunities waning as Tier 1 acreage is drilled out and operators shift their attention to Tier 2 and 3 zones. However, Drillcore expressed confidence in the potential of some of this acreage.

"We believe that further potential exists in exploration and production of Tier 2 and Tier 3 zones within geologic plays that can be proved up for often more attractive valuations than Tier 1 zones, such as in the Delaware and Midland basins within the greater Permian Basin," said Turner.

Trauber, however, cautioned that while attractive opportunities remain for private equity, it is becoming more difficult to find attractive assets to acquire.



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"First of all, strategic buyers today have synergies, strong balance sheets, strong valuations in their share price and a lower return expectation," Trauber said. "As a result, strategic/corporate buyers are in a stronger competitive position to acquire assets or companies for sale. Despite this, there are still selected assets available such as noncore corporate assets or assets that are small and nonstrategic to corporate buyers. There are also assets in basis."

While Trauber believes private equity firms could still acquire assets at fairly attractive valuations and with the potential for generating favorable returns, he noted that the exit alternatives available to private equity could present a problem with these types of assets.

Transition questions

On top of this, the pace of the energy transition is expected to have a considerable impact on how private equity firms will treat oil and gas over the coming years.

"The movement and focus on energy transition is absolutely playing a large role in PE interest in oil and gas assets," said Trauber.

While for some private equity players this has entailed pivoting away from oil and gas outright, for others it has involved investing in clean energy businesses alongside hydrocarbons or pushing for the oil and gas companies to decarbonize more rapidly.

However, the current focus on energy security alongside the energy transition means that oil and gas is increasingly seen by more players—including national and regional governments—as having a key role to play in the world for longer than previously expected.

"The broader global economies, investors and policymakers are beginning to recognize that the global economy needs more energy from all sources in order to raise the standards of living for impoverished regions and also to make energy affordable to more regions," said Trauber. "Energy security is becoming critically important and recognized. The rapidly increasing and recognized trend is about energy addition not energy transition."

Drillcore too believes that oil and gas has an important role to play globally for decades to come.

"We believe that there will only be a 3% to 5% decline in traditional oil and gas at this point between now and 2050. The reason being is that population growth continues and industry demands accessible and affordable energy and oil and gas provides that, even at some of the recent increased commodity prices caused by supply and demand imbalance and global tension," said Turner.

He added that as ESG policies become more standardized and widespread, this could help bring clarity to investors in energy where there is currently considerable uncertainty.

"We believe that integrated mandated ESG policies will help investors and the world know where their money is specifically going toward," Turner said. "This is one of many catalysts that will likely change the way we work in the future. Time will tell." OGI

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