The CAPITAL Carousel

In the past 25 years, more sources and types of financing have become available to the oil and gas industry than ever before.

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Like a merry-go-round in an amusement park, the energy sector in the past quarter-century has watched its fortunes rise and fall in cyclical fashion to the tune of commodity prices bobbing up and down. All the while, investors have been hopping on and off their favorite oil-patch ponies, ever reaching for the brass ring.

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Today, this merry-go-round has come full circle to those heady days of 1981, and investors are again riding high—this time to the tune of $70 oil and $6 gas. Indeed, energy has become one of the most popular rides on the Big Board at the corner of Wall and Broad streets. And pacing the momentum of this ride is a capital carousel filled with more sources and types of financing than the industry has ever seen.

Unlike 1981, there are huge "universal" banks around today, involved simultaneously in lending and investment banking, that are able to take higher risks and provide energy clients—even the smallest ones—greater and faster access to capital.

Private-equity-fund sponsors—backed by growing pools of institutional capital that include mutual funds and hedge funds—are popping up from behind every pumpjack and drilling rig. Also, energy lenders are stretching their credit and derivative-products capabilities to make profitable upstream asset acquisitions occur, even at record purchase prices.

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Filling a vacuum With the enactment of the Tax Reform Act of 1986 and the collapse in crude prices around the same time, institutional investors and tax-driven investments in energy disappeared from the market. But between 1986 and the early 1990s, we saw this capital vacuum begin to be filled by professionally managed, closed-end, energy-focused, private-equity funds—the likes of First Reserve, Yorktown Partners and Natural Gas Partners. Indeed, it's fair to say that during this period, private equity became the only source of outside capital for the oil and gas industry.

Exponential growth In 1987, only two such private-equity funds existed; by 1992, there were four; and by 2002, that number nearly quadrupled to 15. Meanwhile, the capital available to the oil and gas industry from these funds mushroomed from less than $1 billion in 1987 to $11 billion by 2004, with the average fund size about $750 million.

Today, with the migration of open-end hedge funds and mutual funds into the energy space, we're now tracking some 250 private-capital providers to the industry.

Driven by returns During the 1990s, we saw the tech boom and bust in the public markets. For institutional investors seeking strong performance, private-equity funds generally, and those focused on energy specifically, were generating annual returns way above 5% while the returns for every other type of investment were either below 5% or negative. So energy was the bull's eye—and the demand push by institutions into energy caused private-equity funds focused on that space to grow.

If one looks at 2005, funds like Quantum Energy Partners, Lime Rock Partners and Natural Gas Partners were generating internal rates of return greater than 50%—as one would expect when earlier energy investments were made at $25 per barrel, then sold at $65 per barrel through IPOs or asset sales.

Riding the tide COSCO is an investment bank that intermediates energy private-equity transactions, a merchant bank that invests its own capital in every equity financing we manage, and a broker-dealer through our Private Energy Securities Inc. affiliate.

Five years ago, we handled two energy deals totaling $50 million. Last year, we intermediated 10 private-equity transactions worth $430 million. During that time, we've invested in 26 companies and gotten back nine times our invested capital on seven of the investments we've monetized. This year, we're on track to intermediating upwards of 12 private-equity deals worth $400- to $600 million.

Sustainability The resolve of open-end funds that have come into the energy space has yet to be tested by any meaningful downturn in commodity prices. However, closed-end private-equity funds should be around 10 years from now because they raise money on the basis of a 10-plus-year life.