

# TRENDS & ANALYSIS

## Dear Private Equity, Greetings from Hubbert's Peak

Ever since the 1986 oil-price collapse, OPEC has engineered some measure of price stability by withholding spare production capacity, then an ample 16 million barrels per day. Of course, it has always been so. First, it was John D. Rockefeller who fulfilled this role to subdue manic drilling in the Keystone State. Then it was the Seven Sisters.

Next, the Texas Railroad Commission maintained price stability until 1970, when one day the commission announced, without fanfare, that Texas producers were free to flow oil at will. Then OPEC took charge.

But a strange thing happened in the last week of October 2004: the president of OPEC suggested that if the U.S. wants lower oil prices, then the U.S. should release crude oil from its Strategic Petroleum Reserve. And like the railroad commission's announcement 34 years earlier, this statement received little attention, though perhaps the entire global economy should have taken notice. After all, peaking happens.

### Dominant Upstream Investment-Fund Styles

Period	Fund Type	Fund Term (Years)	Global Cumulative Oil Production (Bbb)
1970s	Drilling Partnerships	10	250-450
1980s	Income Funds	10	450-650
	Mezzanine Funds	10	--
1990s	Private-Equity Funds	10	650-875
2000-	Private-Equity Funds	10	875-1,025
2005-	Mezzanine Funds	Perpetual	--
	Income Funds	10-30	--

Source: COSCO Capital Management LLC

The disciplined approach to private-equity investing emphasizes buying low, selling high and then buying low again. But wait! If oil prices have begun a secular up-trend—or even if they haven't, but accomplished oilmen believe they have—could private-equity investment and capital formation styles be forced to accommodate an oil-shortage thesis? If the smart money is long oil, then could good management teams decide to spurn exit strategies, forcing them to be long dollars?

We are pondering the following four permutations on this theme, none of which is new. What strikes us, however, is that many of these changes are already under way.

**Perpetual investment funds.** Since most private-equity firms organize their funds as 10-year partnerships, they risk becoming less competitive if the best management teams choose not to exit within the required time frame. By forming a perpetual pool of capital, a fund manager may appeal more to the en-

trepreneur with a long-term ownership mindset, brought on by the thesis of perpetual oil shortage.

The business development corporation (BDC) provides just such a vehicle. BDCs became a very hot item last April after private-equity firm Apollo Management raised \$930 million through an IPO of its BDC, Apollo Investment Corp. While numerous private-equity firms lined up to follow Apollo's lead, most withdrew their plans and only a few have followed through, two of which have been energy funds.

Prospect Energy Corp. raised \$105 million from an IPO of its BDC shares last July and NGP Capital Resources Co., sponsored by Natural Gas Partners, raised \$255 million in an IPO in November. As public companies, both may raise additional equity through subsequent issues, thus better accommodating long-term ownership of oil and gas issues, and are more likely to find favor among entrepreneurs seeking longer-term pools of private capital.

**Longer partnership terms.** As an alternative to the BDC concept, private-equity funds could simply lengthen their partnership terms to 15, 20 or even 30 years, thus more closely matching the expected tenures of successful managers and eliminating premature exit worries. Having only stubbornly succumbed to illiquid 10-year lock-ups, institutional investors surely would fight such longer terms. Or so one would think. But one of COSCO Capital Management LLC's low-profile investor contacts in 2004 quietly garnered more than \$500 million of institutional commitments to a 30-year upstream partnership.

Many of the subject limited partners include familiar names from other oil and gas funds formed during the past decade. Clearly, this money manager instills unusual confidence to win such commitments, but its feat will become even more impressive if its fund scoops oil-investment rewards away from its shorter-term brethren.

**Debt with equity kickers.** Longer

terms would almost certainly necessitate other investment-style changes. Chief among these could be the desire for more current income than the traditional capital-gains-only approach. Moreover, persistent high commodity prices would surely heighten the fear of downside commodity-price volatility, especially if current income rises in importance.

Therefore, mezzanine-style investing may grow in popularity to obtain distributable income streams with direct commodity-price exposure and downside protection. As it turns out, both of the BDCs mentioned here are devoted to this investment strategy.

**Royalty trusts and property-oriented investments.** The three traditional secrets to private-equity success have been management, management and management. However, perhaps the greatest public-equity returns during the past five or six years have been delivered by entities virtually devoid of active management—the royalty trusts.

Between 1982 and 1991, property-buying institutional partnerships generally delivered disappointing returns, as they attempted to capture low-risk income and commodity-price exposure during a secular price decline. What management acumen might have contributed to these vehicles was surely lost to poor timing. Indeed, they may again be ill-timed, depending on their term.

But trusts and other property-based cash distribution vehicles may provide several benefits in a declining oil environment. First, they could represent a logical structured exit for capital-gains-only private-equity investors whose portfolio-company managers prefer not to exit.

Second, they may provide an attractive source of liquidity to exiting entrepreneurs who eschew cash or common stock offered by would-be acquirers. And finally, with a sufficiently long-term focus and the right property exposure, such funds could potentially deliver significant income growth in their own right. It should come as no surprise that the 30-year, term fund mentioned above is a property-buying investment vehicle.

Each of these four styles could offer solutions for entrepreneurs seeking to avoid shorting oil in the long term just to issue private equity in the short term. And likewise, each enhances private equity's flexibility either to require or offer exit strategies to successful entrepreneurs who prefer to stay in oil.

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