

# PRIVATE CAPITAL FLOW

As investors seek safety and diversification, here are four trends affecting E&P investments.

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Last fall, during a pleasant meeting with a young hedge-fund investor, a seasoned oil and gas investment banker made a casual reference that 1986 had been a defining moment in his career. Confused, the young investor asked, "What happened in 1986?"

Of course, 1986 is code for disaster in this industry. And the failure of a present-day oil and gas investor to know the code suggests that lots of new capital has entered the business.

Rising oil prices and the consequential growth of industry cash flows rank as the most obvious source of this. However, much larger trends lie at the heart of the energy industry's spectacular money supply.

From the 30,000-foot view, there are four macro-trends generating powerful capital flows into the industry: increasing diversification of investment styles away from just public stocks and bonds; the shift of retirement savings away from "defined benefit plans" and toward "defined contribution plans;" dollar-pegged global trade; and hydrocarbon depletion.

Oil and gas executives and entrepreneurs must take care to recognize these trends, and not fight them; rather, they should take advantage of them.

## Diversification

Diversification may appear to be a sound investment principal, but in fact, it is a powerful trend that has driven gobs of capital to the oil and gas industry.

In the 1970s, institutional investors generally limited their investments to public stocks, bonds and real estate. But the corrosive effect of inflation on these investments triggered a move toward owning a more diversified asset base uncorrelated with stocks and bonds.

It was hoped that, when one asset class fell in value or earnings potential, another might rise. A carefully constructed portfolio could actually experience reduced investment volatility, enhanced returns and maybe take advantage of mispriced assets or sectors.

Consider that an investor who allocated \$1 million in 1966 to the public stocks of the Dow Jones Industrial Average found—16 years later in 1982—that his investment was still worth the same \$1 million. In the meantime, direct investments in gold or oil and gas properties would have increased several-fold during the same period. The institutional move toward diversifica-

tion was born from this experience.

Some notable efforts to diversify can still be found in the land records of county courthouses today. Life insurance companies responded to the erosion of their large bond portfolios during the inflationary 1970s by investing in working interests and net profits interests in E&P projects, and some are still paying today.

The trend toward diversification accelerated in the 1980s as college and university endowments sought mispriced or undervalued assets in private markets, rather than in public markets, which were viewed as being too efficient. These "alternative asset" allocations were directed to venture-capital, LBO and private-equity funds, and yes, oil and gas funds.

Taking a couple of the top Ivy League endowments as an example, their endowment size may have been \$2- to \$3 billion in 1986 with an alternative asset allocation of 3% or so, or roughly \$60- to \$90 million. Today these same endowments have reached or are approaching \$30 billion in size with 25% or more of that capital allocated to alternative assets, or \$7 billion, representing around a 100-fold increase in capital allocated to alternatives that include private oil and gas investments.

Since other, less progressive investors have slowly jumped onto the diversification bandwagon over time, these new entrants have continued to fuel the supply of capital earmarked for energy. For example, several of the large state-employee pension funds limited their investment to stocks and bonds, up until fairly recently. The arrival of these latecomers has amplified the pre-existing diversification trend.

Finally, diversification in the oil and gas space has evolved over time, from direct property investments initially, to mezzanine lending and then to private-equity investing, as evidenced by the extraordinary size of funds now under management by long-time money managers such as First Reserve Corp., EnCap Investments LP and Natural Gas Partners.

But recent capital flows have begun to appear in search of diversification, specifically from direct property investments, and not from the private-equity style of backing management teams. This is a trend oil and gas entrepreneurs must watch closely.

## Retirement savings

Born in the late 1970s, burgeoning 401k re-

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retirement plans have increasingly steered a huge, yet subtle, supply of capital to the oil and gas industry. The Investment Company Institute reports that as of the end of the 1970s, \$94 billion of capital was allocated to equity mutual funds in the U.S. With the surge in 401k retirement savings, this allocation grew 100-fold to \$10.4 trillion by 2007.

A skeptic may claim such growth merely reflects the effect of three bull markets in 27 years, but adjusting for the 13-fold growth in stock-market capitalization during this period reveals there has been a sevenfold increase in capital allocated to public equities.

Previously, people concentrated their retirement savings in employer-provided, defined-benefit pension plans. However, employee-directed plans surpassed defined-benefit plans in total capital in 2002 and have steered huge retirement savings into public stocks.

Oil and gas mezzanine lending came to be dominated by public stock issuers in the late 1990s due, in part, to this trend. More recently, private-equity funds directed to oil and gas have sprung from public companies, including several business-development companies, such as Prospect Energy or American Capital.

More recently, hedge funds and private-equity funds, such as Fortress Investments or Blackstone Partners, have tapped into this growing source of capital, some of which has been directed to oil and gas investments.

The clearest manifestation of this capital flow lies in the extraordinary growth of master limited partnerships (MLPs).

Recent M&A market studies have shown MLPs acquiring oil and gas assets for as much as twice the valuations paid by traditional private corporations, some of which may be funded indirectly by defined-benefit pension plans through a money-management firm.

This capital flow has profound implications for the oil and gas entrepreneur seeking growth capital because, in this example, financing obtained from asset sales could potentially cost half as much as financing obtained by issuing corporate equity.

### **Bretton Woods II**

Growth in global trade pegged to the U.S. dollar represents perhaps the most powerful macro-trend driving capital to oil and gas. Dubbed “Bretton Woods II” by some economists, the floating-rate monetary system that has existed since the 1971 collapse of the gold-based Bretton Woods system has had the pernicious effect of growing the global supply of dollars.

These dollars leave the U.S. in the morning to buy goods overseas, where host governments exchange local currency for dollars, and then the dollars return home the next day to buy U.S. debt and equity securities.

This system has led to massive accumula-

tions of foreign-currency reserves overseas. China, for example, has amassed more than \$2 trillion in foreign currency, with U.S. Treasury and agency securities representing 75% of that holding, up fourfold during the past 10 years.

The result? Capital flows to the U.S. from sovereign-wealth funds have been finding their way into the oil and gas sector (and recently to the financial sector). Last fall, Abu Dhabi’s sovereign-wealth fund bought Calgary’s Penn West Energy Trust for \$5 billion in cash and injected \$7.5 billion into Citigroup.

This trend has a troubling effect on investor expectations. The system strikes many investors as inherently inflationary because growth in the supply of paper currency has been exceeding growth in the supply of hard assets.

Since 1971, the price of gold has risen from \$35 per ounce to solidly above \$800 per ounce and nearing \$900. This dollar depreciation as measured in gold works out to an inflation rate above 9%. And with 10-year, AAA-rated bond yields hovering near 4.5%, these metrics spur many fixed-income investors to hedge against annual losses in their bond portfolio’s value by acquiring oil and gas assets as well as other commodities.

### **Peak oil**

Serious investors in growing numbers consider hydrocarbon depletion to be a worrisome trend and investment theme. As free-market advocates, they naturally reject a scarcity theme. However, those investors paying attention to oil supply and demand data have responded by allocating more capital to oil and gas.

The numbers are compelling. In 1986, when OPEC had approximately 17 million barrels of excess daily capacity, the world had consumed 566 billion barrels of crude oil since Colonel Drake drilled his first well in Pennsylvania in 1859. In the 21 years since 1986, however, the world has consumed almost another 566 billion barrels—and OPEC’s excess productive capacity has dwindled to a number almost too small to measure. This trend has drawn substantial capital into the oil and gas industry.

Hydrocarbon depletion leads to higher commodity prices, and other risks for the investor, such as resource nationalism, fiscal- or royalty-regime changes, contract abrogation, demand destruction and cost inflation. Though this has drawn considerable new capital to oil and gas, some investors are rightly wary and seek new investment themes to address them.

Oil and gas entrepreneurs that can address these risks may be rewarded with more than enough capital to fund their businesses.

Finally, oil and gas companies might want to pay attention to changes in investor preferences that may be emerging as all four of these trends evolve. And they are always evolving. □

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