

CASH FLOWS

Private Funds are Reloading Now to Invest in 2002

Reflecting upon the tumultuous events of the year 2001, one would logically expect to see renewed investor interest in private oil and gas funds.

The list of reasons to invest capital in energy seems to go on and on. We've seen a close brush with tight oil and gas supplies, growing potential for revolution in the Middle East, a punishing bear market in public stocks, a long decline in interest rates that will eat away at bond values when it reverses direction and deflation of high-tech equity values. And finally, we have seen the loss of the 30-year Treasury bond as a reliable source of income for pension fund managers that are scrambling to meet looming retirement liabilities due to a healthy group of aging baby boomers.

Add to these the facts that commodity prices and oilfield service costs are down again and many experts foresee a coming tide of oil and gas property divestitures. The buyers of those assets will require capital, and that is precisely the growth strategy that many private capital sources like to back.

Indeed, the circumstances for energy investing today could hardly be more favorable. Viewed only a few short years ago as having a relatively poor risk/reward ratio, private oil and gas funds are now looking downright safe when compared to more traditional alternatives.

Against this backdrop, it should come as no surprise that several oil and gas fund managers are reporting strong investor interest in their new fund offerings. At least 10 (see table) were attempting to raise more than \$2.5 billion of fresh capital as 2001 drew to a close.

Well over half of this amount reportedly has already been committed—and two firms claim to be oversubscribed.

End of story? Hardly. A closer look at the factors driving these investors paints a much different picture than one might expect. In fact, it looks like oil and gas fund managers really dodged a bullet this year, as private equity commitments in general have fallen across the board.

Evidence of the trouble in general markets abounds. For example, **Hicks Muse**, a well-respected Dallas buy-out firm, reportedly went to market this year looking for \$4 billion and came up with only \$1.5 billion. Pension consultants report that after building up for five straight years, capital flows to private equity have fallen off dramatically.

To what extent was this true or not in the oil and gas arena? In early November, **Cosco Capital Management LLC**, a New York-based investment banking

Tier 1 Investors Now Raising Money

First or second-time funds:

ARC Financial, Calgary
Heller Hickox, Philadelphia
Lime Rock Partners, Westport, CT
Quantum Energy Partners, Houston

Third time or more:

Associated Energy Managers,
Longmeadow, MA
Camcor Capital, Calgary
EnCap Investments, Houston
Energy Spectrum Capital, Dallas
Kayne Anderson Investments,
Los Angeles and Houston
Yorktown Partners, New York

firm specializing in private capital for energy, wanted to find out which funds were willing to get back in the energy game by raising fresh capital.

We surveyed a cross-section of investment professionals to determine why many of the oil and gas funds currently raising capital are achieving success in an otherwise challenging time for private capital markets. We interviewed pension consulting firms and Tier 2 investors, which include various corporate pension funds, insurance companies and endowment funds. We also spoke with a number of Tier 1 investors, including some of the very money management firms that are actively seeking new equity commitments from Tier 2 investors. The results of this survey show how a combination of luck and hard work has paid off "big time" during this difficult year.

Tier 1 investors are general and energy-specific institutional capital aggregators, while Tier 2 investors include pension funds, corporations and endowments.

The denominator effect Most of the investors and pension consultants surveyed cited the need to rebalance portfolios as a daunting impediment to the allocation of capital to private equity investments. Since large institutional investors allocate a relatively small fixed percentage of their portfolios to illiquid private equity, including oil and gas, a decline in the overall size of their portfolios (the denominator) necessarily reduces allocations to all alternatives (the numerator). Therefore, the significant stock market declines this year have automatically reduced the pool of capital available for investment in private equity funds. This is a key reason why some fund managers are failing to reach their targeted fund sizes this year.

Return of capital Despite this downward pressure on private equity allocations, many investors have been will-

ing to recommit and even increase their commitments to existing oil and gas fund managers. Why? Because during 2001, private energy funds have been among the few to *return* capital to investors.

As we noted in a previous survey in the September issue of *Oil and Gas Investor*, oil and gas fund managers spent the first half of 2001 aggressively monetizing portfolio investments and distributing cash back to their investors. During our recent survey, one money manager commented specifically that investors have been so pleased with this return of cash that they have been eager to recommit this—and additional fresh capital—as these very funds come back for more.

Performance Much of the new fundraising success has been attributed to good prior performance. While many venture and buy-out funds during the late 1990s were boasting eye-popping returns, oil and gas fund managers were advertising relatively boring rates of return ranging from the high teens to the mid-upper twenties.

The thing is, throughout the '90s and especially this year, those same oil and gas fund managers have actually delivered on these more modest promises. Moreover, some of the investors surveyed reported that, unlike the sponsors of failed property-level partnership investments in the 1980s, the private corporate equity and debt investment managers during the '90s have proven their ability to profit by investing in oil and gas industry down-cycles and harvesting in industry up-cycles. Hard work by these managers is clearly paying off.

Familiarity Finally, several investors cited simple familiarity with certain oil and gas fund managers as their explanation for the new flow of funds this year. As one investor told us, "If you're already investing in energy, then you keep doing it, and if you aren't, you don't".

The importance of familiarity cannot be overstated. Managers raising capital from their investors for a third, fourth or fifth time are having little trouble, while those attempting for the first or second time must struggle harder against the denominator effect.

As fundraising continues into 2002, the success of first- and second-time fund managers will shed more light on whether or not the events of 2001 have sparked new interest in private energy funds on the part of new investors. By all logic, they should have!

—William E. Weidner,
Cosco Capital Management LLC