

CASH FLOWS

The Tables Have Turned: Interest in Private Oil and Gas Investment Climbs

What a difference a decade makes. During the 1990s, many pension fund and institutional investors considered the oil and gas industry a low return, ethically challenged sector with a history of disappointment. Far too often, they viewed oil and gas investments as mere price bets.

But during this time, firms such as **Natural Gas Partners**, **First Reserve Corp.** and **Warburg Pincus** proved to these skeptics that a private equity investment model can be consistently employed to generate attractive returns from the oil and gas industry, however mature. Successes such as **Newfield Exploration** and **National Oilwell** were triumphant demonstrations of this thesis.

During the latter half of that manic decade, however, even these achievements paled in comparison to the eye-popping rates of return boasted by billion-dollar high-tech venture funds. Incredibly, some so-called experts claimed that triple-digit rates of return were required to raise private equity. But alas, the tech wreck that punctuated the end of the 1990s reminded investors that the market really is efficient.

Happily, this has renewed interest in tried and true businesses, such as oil and gas production and oilfield services. Despite Enron-related worries, institutional investors have gained a whole new perspective on the energy industry and its potential for delivering acceptable rates of return.

So far this decade, the oil and gas industry is attracting and receiving an outstanding share of private placement equity. Today's contrast with the 1990s is striking. Last decade, oil and gas fund returns weren't high enough; today they're considered by some to be almost too high. In the 1990s, many institutions felt energy companies lacked control over their destiny due to commodity price volatility, but today, investors favor them for their control. In the 1990s, oil and gas funds were preceded by a legacy of investment failures. Today, they're preceded by a legacy of investment successes. Real assets used to be unattractive, but now they're required. The tables, it seems, are completely turned.

This sea change has created a wave of fresh private equity capital available to proven management teams in the energy sector. **Lime Rock Partners** just closed a \$320-million fund. **Kayne Anderson** recently closed one at \$230

million. **Quantum Energy Partners** has raised \$225 million.

At press time, another fund has reportedly obtained more than \$100 million in new commitments and **Natural Gas Partners** is rumored to be preparing to reload again. All this comes on top of the \$4.2 billion in private equity specifically for energy investment that has been raised just since first-quarter 2001.

Firms with fresh capital were asked in a **Cosco Capital Management LLC** survey to identify the factors driving the unprecedented growth of oil and gas private equity. Several interesting themes emerged.

- **The allure of hard assets** Investors want hard assets with real cash flow, and they see oil and gas production and oilfield services and equipment as a defensive play that meets this need. Investors derive comfort from the steady, though cyclical, demand for these products and services and recognize that past success in this business usually predicts future success. It wasn't always this way. One of the managers reported encountering, while raising capital during the 1990s, a pervasive distrust of the oil and gas business. That distrust seems to have receded.

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- **Industry experience** Investors want their money managed by fund managers whose personnel have real industry experience—who have experienced several industry cycles first-hand. They are leery of those who lack an understanding of technical and industry nuances. In fact, investors feel that specialization is critical because the oil and gas industry contains myriad sub-disciplines. Some even prefer managers who have actually run an energy business, thus providing further downside protection against investment failure.

- **Straightforward strategies** Investors prefer simple, straightforward business plans. The tried-and-true “buy, exploit, then sell high” business plan of small independents provides a plain-vanilla business model from which investors have realized attractive

Energy-Specific Funds Raised, 2001-02 (\$MM)

First Reserve	\$1,375
Yorktown Energy Partners	\$588
ARC Financial	\$200
Lime Rock Partners	\$320
Kayne Anderson	\$230
Riverstone Holdings	\$500
Quantum Energy Partners	\$225
Energy Spectrum	\$112
EnCap Investments	\$625
Total	\$4,175

Source: Cosco Capital Management LLC, New York

returns and can expect to do so again. Even more important, this is an uncomplicated strategy that a shell-shocked institutional investor can understand.

- **Smaller funds** Investors think that the maturity of the oil and gas industry necessarily translates to an abundance of small opportunities, not large ones, and they believe that capital pools must be right-sized to fit such opportunities. Moreover, many investors have witnessed the buildup of great track records in funds ranging from only \$100- to \$500 million in size. Therefore, investors are less resistant to these smaller funds, and with some notable exceptions, they are eschewing those funds attempting to reach toward \$1 billion and beyond.

- **Focus on value creation** Investors have sadly admitted that the outsized rates of return advertised by high-tech venture funds relied too heavily on the supply of capital and not on true value creation. Consequently, they now tend to avoid investments that depend on future demand for new products and services and prefer, instead, investments generating value from the sale of old products and services to a mature market with known demand characteristics. In this environment, a 20% to 30% internal rate of return from an oil and gas corporate-equity deal looks mighty attractive, indeed.

Proven private equity model Finally, investors have noticed the success of certain oil and gas private equity funds during the 1990s, and they want to be part of it. Jon Farber of **Lime Rock** gratefully attributes his successful fund-raising to those who went before him. “**Warburg Pincus**, **First Reserve** and **Natural Gas Partners** made the path a lot easier for us,” he says. This goes to show that capital really does flow to where the returns are.

—William E. Weidner,
Cosco Capital Management LLC