AS THE GOING GETS TOUGH, WHO'S TOUGH ENOUGH?

Private equity firms discuss the current investment environment.

By Nissa Darbonne

In times like these, upstream private equity providers are getting a relatively rare downcycle view of their portfolio-company management teams, according to Ken Friedman, a managing director of SFC Energy Partners.

It's a time when those team members "really want to go through this cycle and do the things that are necessary to live to fight another day," he said in a round-table discussion at *Oil and Gas Investor*'s annual Energy Capital Conference recently. Portfolio companies have to look at every cost that doesn't fit a "conservation mode" and which plays "are really worth hanging onto," he said. "It's a sobering experience," but "a necessary one."

EnCap Investments LP is deploying its upstream $6.5-billion Fund X currently. Doug Swanson, a managing partner, said that among EnCap's roughly 35 upstream investments across North America at present, it too is focusing on balance sheets, risks and other economic measures.

"What we're not doing is picking drilling locations," he added. But, regarding investment decisions, "at the end of the day, it comes down to what are the single-well economics. If we don't have to drill wells, let's not drill wells."

Through its portfolio companies, EnCap's invested in all of the major unconventional resource plays. SFC has less exposure to these as its equity commitments are smaller, Friedman said. A $40-million investment, for example, is better suited to existing field development, such as a waterflood, infill drilling and extensions that may require $2-million wells, rather than $6-million wells, he said.

SOME RECENT UPSTREAM PRIVATE CAPITAL DEALS (FUNDED SINCE JUNE 2015)

Company	Amount ($MM)	Private Equity Source
Luxe Energy	$500	Natural Gas Partners Fund XI
Red Bluff Resources Holdings	$300	Pine Brook
Sentinel Peak Resources	$300	Quantum Energy Partners
Ameredev	$250	EnCap Investments LP
Lola Energy	$250	Denham Capital Management
TRP Energy	$250	Trilantic Capital Management
Element Petroleum III	$200	ArcLight Energy Partners Fund VI
PCORE Exploration & Production II	$200	NGP Fund XI
Amistad Energy Partners	$150	Kayne Anderson Energy Funds
Balidor Oil & Gas	$150	Kayne Anderson Energy Funds
Invictus Energy	$150	Kayne Anderson Energy Funds
Carrier Energy Partners II	$100	Riverstone Global Energy
Lonestar Resources	$100	IOG Capital
Monadnock Resources	$100	Kayne Anderson Energy Funds
Triumph Energy Partners	$100	Kayne Anderson Energy Partners
Resource Energy Partners	Undisclosed	Apollo Global Management

Source: Oil and Gas Investor, *company reports*

Throughout the downturn, private equity players have continued to fund new teams, most with the goal of acquiring and exploiting, rather than leasing, oil and gas assets. Each new company represents a potential business partner; each team contributed some of its own equity.

"What we don't want in this environment is to step into a new play with a gun to our head (in terms of new-play lease deadlines)," he said. "That's absolutely a non-starter for us." But, he added, "We're still leveraging a lot of the technology that has come out of the horizontal shale plays."

In terms of acquisitions, one involved a waterflood project in Canada from ExxonMobil Corp.—but from the time the deal commenced to closing, the price of WTI declined 30%. "Exxon is a company that doesn't really like to change its terms," he said, "so we had little SFC facing Exxon on the other side of the table."

Private equity executives (from left) Doug Swanson, EnCap Investments; Ken Friedman, SFC Energy Partners; and William McMullen, Bayou City Energy, discussed the current investment environment, deal making and management at the recent Energy Capital Conference in Austin, Texas.

The deal almost didn't work, but it didn't blow up. In the end, "the two parties were willing to accept the pain and be equally dissatisfied," he said.

Bayou City Energy Management LLC makes PE investments of between $5- and $35 million, putting it at the smaller end of the market. Bill McMullen, founder and managing partner, said, "We're going into areas of the world, specifically the U.S., where plays and basins are geologically derisked. We're not afraid of unconventional assets," but "where we really butter our bread is going after an asset where we can take LOEs [lease operating expenses] of $20 a barrel down to $10."

Holding for longer

The smaller market, from an equity perspective, "is very undercapitalized," he said. Bayou City has made two investments since its June 2015 formation: TXon-SCZ LLC in and around the KMA Field in Wichita County, Texas, and White Knight Resources LLC in the San Joaquin Basin, California.

It also aims to invest as a drilling partner. Its one deal to date is with Alta Mesa Holdings LP to drill legacy acreage that is in the Stack play in Oklahoma. "We want to put as many dollars as we can into the ground" rather than fund G&A, such as in traditional private equity, he said.

Swanson said it is clear that, although EnCap successfully exited portfolio company Felix Energy Holdings LLC to Devon Energy Corp. earlier this year, "there is no question you're going to have to hold these assets longer."

EnCap might have one exit toward the end of 2016, "if there is a price recovery." Otherwise, "we have to have capital structures in place where you can be patient."

SFC's Friedman expects more transactions eventually. Public E&Ps will need to find drilling inventory that generates positive returns, if a $40 to $50 oil price persists—whether in shale or conventional rock. "It's really about the ability to do something on a low-risk basis and do it repeatably," he said.

McMullen said that, with Bayou City at the smaller end of the market, "We're bumping up against guys who are having issues with their credit facilities." He was waiting in March for capitulations as a result of new borrowing-base determinations.

In addition, the Office of the Comptroller of the Currency issued new, stricter guidelines to banks in late March, regarding lending on proved reserves. "The new OCC standards, I think that is going to force some transactions … to actually break free," McMullen said.

Friedman noted that Harold Hamm, chairman and CEO of Continental Resources Inc., remarked at the conference earlier in the day, while accepting *Oil and Gas Investor*'s Executive of the Year award, that great innovation has come during downcycles. For example, Hamm said, the fracture-stimulated, horizontal discovery of the Middle Bakken shale member in Elm Coulee Field in Montana occurred in 2000.

Friedman said, "As Harold pointed out, often what you find on the other side of these downturns is some of the best opportunity." ■