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INSIGHT: Price Stabilization, Private Equity Engagement to Bolster Oil & Gas M&A Activity

Uncertainty about crude oil pricing and related bid/ask spreads (the difference between the highest price a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept to sell it) created a thin mergers and acquisitions market during the last 12 months, forcing many companies to adopt a ''wait-and-see'' approach.

According to a recent report from Drillinginfo Inc., M&A activity in the upstream U.S. oil and gas sector totaled $8.7 billion during the second quarter of 2018, down from $19.5 billion in the same period of 2017 and below a quarterly average of $17.8 billion since 2009. The notable exceptions to the slowdown have been companies recently emerged from Chapter 11 restructuring like Linn Energy, Samson Resources, and Vanguard Natural Resources, many of whom have executed on broad-based asset divestiture strategies; private equity-backed management teams; and most recently, strategic companies exiting large-scale domestic shale positions like BHP Billiton Ltd.

We attribute the market slowdown to several key factors.

First, for public companies, shareholders have demanded significantly reduced capital spending and renewed focus on developing and maintaining existing assets. These companies have also been limited in part as lower stock prices created less reliable access to the capital markets either as a method for raising cash or using their stock as currency.

Second, for private companies and private equity-backed management teams, although they participated in a large share of the consummated deals during the last 12 months, transactions were difficult to source as sellers often had pricing expectations that did not match the current crude oil strip pricing. The valuation disconnect can be partially explained by a meaningful rise in crude oil spot pricing (the current price in the marketplace) without a corresponding increase in the price of the crude oil futures contract.

The result is a market condition, sometimes called backwardation, wherein the price of the crude oil forward or futures contract is trading below the price of the expected spot price at contract maturity. And, while sellers' purchase price expectations are often heavily influenced by the current crude pricing environment, prospective buyers appear to be making capital allocation and purchasing decisions on the basis of expected future prices.

Expected Surge in M&A Activity However, more experts are now opining that the forward curve is not representative of future pricing and that long-term crude pricing will stabilize in the near term. That combination of less variable crude oil pricing (with greater confidence in expected future pricing), together with record-level private equity commitments, leads us to believe that the market is ripe for a near-term surge in M&A activity.

After significant volatility in crude oil pricing for four years, crude oil strip pricing appears to be normalizing within a narrower band. A number of industry experts have remarked that oil may have found a pricing floor around $55 to $65 per barrel. Although the recent stabilization in strip pricing has not yet translated to a corresponding increase in the back end of the forward curve, if the backwardation does level out in the manner speculated by many experts, then we expect a narrowing of the bid/ask spreads in the M&A market.

Further, despite the general slowdown in the oil and gas M&A market beginning in late 2017, private equity firms have continued to raise capital for energy and infrastructure investments with private equity currently sitting on over $50 billion of committed capital. In 2017, private equity firms made commitments of $12.4 billion to 73 new upstream U.S. oil and gas companies according to Oil and Gas Investor, and that trend shows no signs of slowing.

Role of Private Equity The Blackstone Group LP is currently raising the Blackstone Infrastructure Partners fund—the largest ever open-ended pool focused on the infrastructure industry—and a $4.5 billion Blackstone Energy Partners III fund; and on Sept. 6, 2018, KKR announced the closing of its $7.4 billion Global Infrastructure Investors III fund. The new KKR fund is the third infrastructure fund of its size to close in 2018, with Stonepeak Infrastructure Partners recently raising $7.2 billion for its latest fund and I Squared Capital closing the IQS Global Infrastructure Fund II at $7 billion.

With private equity firms participating in an increasingly large share of deals (in excess of $15 billion of acquisitions and divestitures in 2017, up from less than $5 billion in upstream transactions from 2008 to 2012), and committed capital hovering near record levels, we expect private equity buyers to be key players in both the upstream space and the midstream space, particularly as public companies continue to direct capital away from all but a handful of geographic areas like the Permian Basin.

Besides raising vast sums of committed capital, private equity firms are also becoming more nimble in their ability to bid on large-scale oil and gas asset packages, as evidenced by the list of reported bidders for the BHP Billiton U.S. shale portfolio. Although the BHP sale included several strategic participants (with several super majors rumored to have bid on at least the Permian Basin portion of the BHP portfolio), a number of private equity firms also bid on the assets through ‘‘consortiums.’’

Consortium Bids Consortium bids are usually structured as either a joint venture or the acquisition of an entire asset package with a subsequent division of assets post-closing; either structure allows the private equity funds to pool capital and disperse transaction risk. A notable example of the joint venture approach is DoublePoint Energy, LLC, a joint venture between Double Eagle Energy Holdings III LLC (backed by affiliates of Apollo Global Management, LLC and Magnetar Capital) and FourPoint Energy (backed by affiliates of Quantum Energy Partners, GSO Capital Partners LP and other investors). The DoublePoint transaction produced a new pure-play Midland Basin company with over 70,000 acres in the core areas of the oil-rich, multipay zones in Midland, Glasscock, Martin, Howard, Upton, and Reagan Counties, Texas. Private equity has also shown a willingness to pursue an ‘‘acquire and divest’’ strategy similar to multiple rumored bids for BHP's assets. With this approach, the private equity firm acquires the entire asset package and subsequently divides the assets among its management teams and portfolio companies or sells a portion of the assets in a contemporaneous divestiture.

In addition to mitigating some transaction risk, the consortium model helps reduce fund limitation concerns. As transaction sizes have increased across middle-market private equity, unsurprisingly, the size of many of the private equity funds has correspondingly increased alongside the use of co-investments and syndicates. However, these funds typically include investment limitations to confine a general partner's investment to the strategy or strategies upon which they marketed the fund. These limitations include targeted sectors, geographies and deal sizes. With respect to deal size limitations, it is common to limit a particular deal to 20 percent to 30 percent of a fund's aggregate commitments without the consent of the limited partner advisory board. Given that the size of many deals has continued to increase, general partners have been forced to think more creatively about deal participation, which (besides the use of syndicates and co-investors) has recently meant structuring the investment as a joint venture or adopting the acquire-and-divest structure outlined above.

Increased Levels of Midstream Investment The private equity energy mandate does not stop at the custody transfer point (the metering location, typically seen as the dividing line between ‘‘upstream’’ and ‘‘midstream’’ activity). Although private equity has previously had an investment role in the midstream space, a number of firms have expressed renewed or increased interest in the midstream market. In 2017, private equity-backed companies spent $9.4 billion on U.S. energy pipelines, storage terminals, and other midstream assets, up from $4.3 billion in 2015, according to data collected by S&P Global Market Intelligence. On Energy Transfer Partners' 3Q 2017 earnings call, senior management remarked that they were routinely losing projects to private equity firms, as opposed to their peers. Given private equity's reputation for being ‘‘smart’’ money, the involvement of private equity lends credibility to the midstream space. Further, the fact that private equity is investing such large amounts shows confidence in the long-term thesis for U.S. energy infrastructure investment and demonstrates that investors increasingly see attractive valuations in the space.

At present, private equity firms active in the midstream space appear to be pursuing a multipronged investment approach, including preferred equity investments (a class of ownership that has a higher claim on a company's assets and earnings than common stock), management team platforms, joint ventures and acquisitions of established companies, and/or gathering and processing systems. Recent examples of these approaches include EIG's preferred equity investment into NuStar Energy and KKR's joint venture with Williams to acquire Discovery Midstream from TPG Growth.

While the overall oil and gas M&A market experienced a notable slowdown due to crude oil price volatility, recent pricing stabilization, together with strategic consolidation in select basins and the expanding role of private equity, has created a market ripe for renewed M&A activity. As private equity continues to raise vast sums of capital and develop innovative deal structures, we expect these firms to be at the forefront of the coming surge.

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