KIRKLAND & ELLIS

Blog Post

Shared Services Platforms — A Potential Cost-Cutting Strategy for a Fragile Energy Market

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The dedicated management team model was never a one-size-fits-all solution. However, with the boom in the oil and gas space over the past decade and potential for "home runs" for management, the dedicated management team became the de facto arrangement. While this arrangement worked out for many, particularly those with high-growth strategies able to reach a successful exit, a number of investors began to see what they believed was a proliferation of independently financed teams with outsized general & administrative expenses ("G&A"). Against this backdrop — and as investors strategize for how to emerge from the current downturn and be best positioned going forward — there has been an increased interest in shared services platforms (or "operations as a service"), in which a manager oversees multiple assets or companies for one or more investors.

Background: Rise of Shared Services Platforms

As the acquisition and divestiture and financing markets languished in 2019, investor returns declined and they began to look for ways to cut G&A and better align incentives with the new economic reality, rising proven developed reserves ("PDP") and long-term strategies. Further, the management team model always proved challenging for smaller asset packages and income-based strategies, as well as for new entrants to energy investing and lenders who were equitizing into an asset, particularly given the competition for good teams.

This situation has worsened as the recent commodity price decline, combined with the ongoing drag from G&A and lack of viable exits, has shortened the liquidity runway and long-term viability of a number of companies, leading to increasing calls for cost-cutting measures and calling into question the traditional dedicated management team approach.

These developments have led to a rise in the use of shared services platforms. While these platforms present an opportunity to lower costs, provide greater G&A stability and maximize efficiencies, as well as increase the viability of acquisitions and equitizations, there are certain considerations to bear in mind as investors evaluate their particular situations and goals.

Is a shared services platform right for this investment?

Just as a dedicated management team is not one-size-fits-all, neither is a shared services platform, so investors need to strongly consider what arrangement works best for their strategy. A key appeal of shared services platforms is the prospect of lower costs and a “plug and play” structure, which is possible because managers can spread their overhead and operations across assets for multiple investors and companies.

In addition to being advantageous to participants without existing operational teams, shared services platforms can be particularly attractive for strategies seeking to acquire smaller asset packages that would otherwise fail to justify a dedicated team, income-based strategies with lower overall return profiles, or those simply in search of a caretaker to maintain asset value prior to a short-term sale or liquidation. They may also be attractive to investors acquiring assets with multiple pools of capital or sponsors looking to replace management teams in one or more portfolio companies or as part of a “smashco” merger with another sponsor.

On the other hand, if the strategy involves assets of significant size and significant long-term growth through acreage aggregation and drilling, an independent management team that is incentivized for the long term may be preferable to a shared services platform.

Is the right team being engaged?

Just like traditional management teams themselves, not all service platforms are created equal. For example, some managers will only offer back-office functions or be expressly limited to non-op strategies, therefore requiring partnerships with an operator for operated assets and creating additional complexity for investors trying to execute quickly. Others may have operational capabilities, but lack the financial and strategic expertise needed to prepare assets for sale or liquidation. Further, some platforms will be ongoing businesses dedicated to asset management, while others could be existing management teams or joint ventures. It will be important for investors to understand their assets and define their needs and strategies to secure the right team for the job.

Does a non-dedicated team work for the strategy and assets?

As investors consider whether their strategies and assets are suited for the shared services platform structure and whether they are engaging the right team, those comfortable with the traditional sponsor-controlled, management team platforms should also assess whether they can adapt to a new approach.

Although the simplified structure of a shared services platform has many benefits, it also represents a stark contrast to the traditional sponsor-controlled platforms many investors are used to. A key distinction for shared services platforms relates to the commitment and nature of the manager's duties. In a traditional sponsor-controlled platform, the management team will devote nearly full time and effort to the business, is incentivized to stick with the company until an exit and is subject to a fulsome non-compete or "areas of mutual interest" restrictions. Conversely, by its very nature, the benefit of sharing G&A in a shared services platform means an investor is sharing the team.

As the manager will continue to manage other assets and investments, it will generally not have a dedicated time commitment (other than an obligation to devote the time and attention necessary to perform the services and potentially minimum time from particular individuals), can typically exit the arrangement after the initial term (subject to a required transition services period), and likely has no or a limited non-compete. Further, the manager will generally have full autonomy with respect to its employees (including salaries and allocation of incentives) and day-to-day decision-making within their delegation.

Additionally, if part of the investor's strategy contemplates an exit or public offering as an integrated company, a shared services platform may be less suitable, as it will be more challenging to build employee loyalty and value around the team.

However, these terms are all subject to negotiation, and the extent to which a manager is willing to be contractually dedicated or cede controls to a company or investor will ultimately depend on the economics, the incentives and the likelihood of future engagements.

How should compensation be arranged and the manager incentivized?

Compensation of shared services platforms has two primary components: the management fee and, potentially, incentive arrangements. From the outset, it will be important for investors and managers to determine the general structure of the compensation arrangement, namely, if it is fee-driven, incentive-driven or a hybrid structure.

The management fee generally takes the form of a fixed fee or fee plus time arrangement, which covers the general G&A and other non-direct asset and company costs. It may be subject to annual adjustments or re-evaluations, as well as minimum terms to compensate the manager for the opportunity cost of taking the engagement.

Unlike a traditional management platform, additional incentives are not universal in a shared services platform. In a truly fee-driven, service-oriented arrangement, the manager may only be taking a fee. However, many investors still desire an incentive component to compensate and encourage performance, especially if the engagement is expected to be longer-term, warrant significant effort from the manager, or is focused on managing and preparing the assets for a liquidity event. These incentives can take many forms including cash sales bonuses, ongoing cash bonuses for achieving performance or cost metrics, discretionary bonuses and traditional equity incentives.

In establishing the incentive, it is important for investors to consider the exit profile of the company and how much complexity to determine the appropriate incentive. For example, if a shorter-term exit is anticipated and a large part of the manager's job is to manage for sale, a simple cash bonus on sale might be warranted. However, if a longer-term strategy is being employed, a more traditional equity incentive program and waterfall may achieve the best results. Similarly, investors will also want to consider the return profile of the underlying assets, as managing a company for ongoing income generation may suggest lower return hurdles and potential interim distributions, while growth and aggregation strategies may suggest deferred waterfalls with bigger upside.

If incentives are being utilized, there is significant interplay between the amount of the management fee and the amount of (and likelihood of earning into) the incentive program. Generally, the lower the management fee, the higher the incentive will likely need to be, and vice versa, so as with the finding the right team and structure, investors will need to seek out the right blend for their needs and goals.

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