

Thananchai Sajjaporamest,CFA, Associate Director, The Quant Group – Investment Banking,
thananchai@thequantgroup.com

Thananchai is an Associate Director at The Quant Group – Investment Banking, he has a Bachelor degree in Information Systems with First Class Honors from University of Melbourne, a Master of Science Degree in Finance from Thammasat University and an MBA from the Wharton School, University of Pennsylvania.

Nov 2009

Private Equity in the Energy Industry

Investing in commodities has always been beneath private equity funds. LBO bankers are quick to use words like commoditization and commodities in a depreciative manner citing that commodities are commonplace and do not provide differentiation. Therefore, profiting from commodities is done purely through price because there is no value-additive in pure commodities.

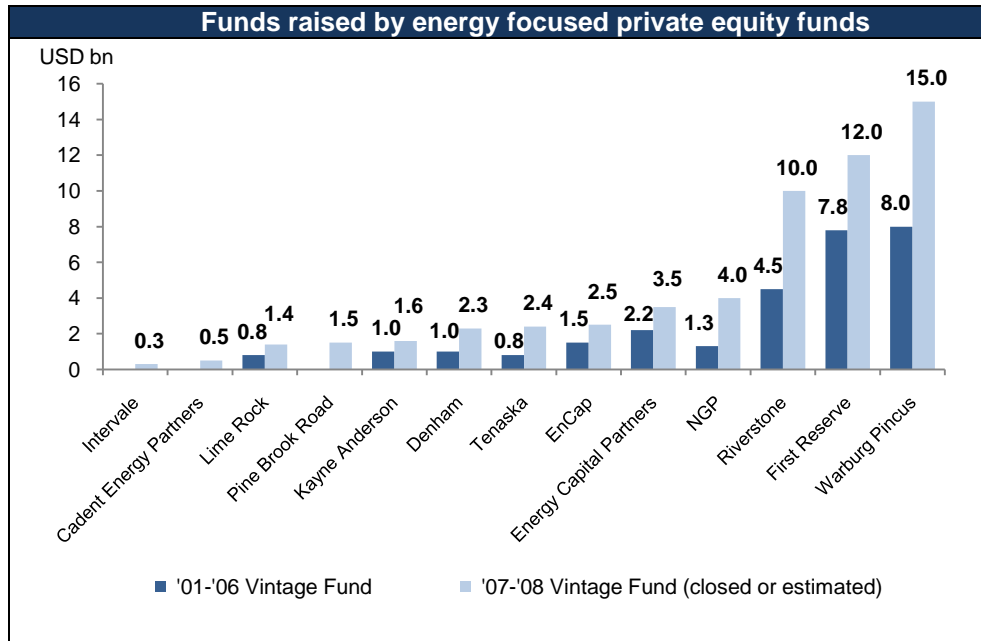
But it just happen that price and the rising kind is the central of the thesis behind owning commodities. As developing economies have continued to enjoy unprecedented economic growth, millions have joined the rapidly growing “consumer class” each year. The appetite for energy has become one of the most critical issues in the development agenda of developing countries. According to the Energy Information Administration (EIA), total world consumption of marketed energy is expected to expand from 472 quadrillion Btu in 2006 to 552 quadrillion Btu in 2015 and 678 quadrillion Btu in 2030 -- representing a 44% increase. Expected growth rates of energy demand in the next 20 years for high-growth economies such as China and India will double given their pace of economic expansion. As such, the global energy infrastructure is expected to require more than \$20 trillion of capital investment over the next 25 years.

With attractive industry dynamics mainly through growing energy demand and limited growth of supply, the global energy and natural resources industry has drawn significant interest from private equity in the past several years.

Changing Paradigm

Conventionally, private equity funds invest in portfolio companies to create value during the period of their ownerships. Typical private equity investments include investments in companies with superior management opportunities particularly in situations where capital availability is limited. However, private equity has been somewhat halfhearted about investment opportunities in commodity plays given that the volatility of commodity prices makes managing portfolio companies more difficult. The commodity play is often seen as fundamentally different from the accepted private equity investment approach – to acquire a company, restructure its businesses, streamline and enhance operations, and exit the investment across a short to medium time frame. Uncertainty resulting from commodity-price cycles also makes the exit strategy of private equity challenging.

Nevertheless, a combination of macro-environment in which emerging economies demand a growing share of the world's energy resources and the emergence of service subsectors of the energy industry which often have low exposure to commodity price volatility has attracted private equity players into the energy space. Furthermore, private equity funds now possess significantly deeper pools of capital to deploy. Below is the chart illustrating many of the major energy focused private equity funds raised new pools of capital prior to the financial crisis and the emergence of multiple new entrants.



Source: *Oil and Gas Investor* estimates, Quantum Energy Partners estimates

Investment Strategy

Investment in the energy sector goes beyond the oil & gas upstream sliver such as E&P (Exploration & Production) but also into midstream like pipelines and downstream such as retail & distribution. Private equity funds have invested across the energy industry from reserves in the ground (i.e. oil, gas and coals) to assets that are close to the end consumer such as gas storage and meters.

While profitability of the individual segments of the industry varies substantially and periodically, there exists the vast potential for attractive returns commensurate with risks and resource availability throughout the energy value chain. Key considerations that private equity investors focus on to determine which sectors might offer the best value for new investments are industry fundamentals, new technologies, cost reductions, marketing improvements, changes in regulation or strategic changes by key industry participants.

In one of the largest private equity deals, a consortium of private equity firms led by Kohlberg Kravis Roberts (KKR) banded together to acquire TXU Corp., the Texas utility company, for US\$32 billion in 2007. TXU was a NYSE-listed electric utility with approximately 18,000 MW of generation capacity, 2.1 million retail customers, and the largest transmission and distribution system in Texas. After the completion of the buyout, TXU transformed its operations into three independently managed businesses – generation, transmission and distribution, and retail. The electric distribution side of the company renamed itself as Oncor Electric Delivery, the electric generation business became Luminant, and TXU Energy remained the retail electricity provider. The new corporation was re-named Energy Future Holdings. This strategic move raises a possibility of future divestitures by KKR and its consortium. Separating a company, such as a diversified utility, into distinctly identifiable units and then shedding some of those units in order to monetize value is a strategy that financial players use frequently.

A Simple Value Chain



To illustrate the breadth of investment opportunities in the space, First Reserve Corporation, a leading energy focused private equity player, has investments in the world's largest global commercial helicopter operator, an integrated nuclear fuel supply company, the largest storage terminal facility in the Caribbean and the leading greenhouse gas emissions aggregator in the U.S. Another leading private equity investor, 3i, generated a handsome return of 82% from the sale of its investment in Vetco, one of the world's leading suppliers of drilling, completion and production equipment for onshore and offshore oil and gas fields, to GE. 3i also holds investments in the leading heavy lift transportation for the marine and oil and gas industry, an independent renewable energy company in Belgium, and a provider of produced water treatment systems for the oil and gas industry.

In addition to conventional exit strategies such as IPO and M&A, Master Limited Partnerships (MLPs) provide an exit strategy for private equity investments that is unique to the energy sector. MLP is to the energy sector what REIT (Real Estate Investment Trust) is to the real estate sector. MLPs are basically securitized investment trusts and are publicly traded. The MLP combines the tax benefits of a limited partnership with the liquidity of publicly traded stocks. Due to stringent provisions and the nature of the required distributions, the majority of MLPs operate in the energy infrastructure space such as natural gas extraction and oil pipeline. As an asset class, MLPs offer stable yields which fit well with investment objectives of many institutional investors.

This prompts private equity players to make investments in companies that are prospectively securitizable into MLPs. Two typical strategies include: i) create a new MLP from portfolio company and use the MLP as a vehicle to pursue other growth opportunities, and ii) sell assets to an existing MLP. A well-known example of an MLP is Kinder Morgan Energy Partners LP (KMEP). The main corporation, Kinder Morgan Inc., is the operator of more than 37,000 miles of pipelines and 170 terminals while the pipelines themselves are owned by the MLP KMEP.

Increased Intellectual Capital

One notable attribute of the changing private equity industry is the substantial enhancement of intellectual capital in the energy space. A new breed of private equity funds with deep knowledge and expertise in the energy sector has emerged. Many of these funds are often equipped with energy sector-focused teams and led by experienced managers who have significant exposure to operating and managing assets of energy companies. These firms – to name a few – First Reserve Corporation, Quantum Energy Partners, and 3i have elevated their interests in energy and natural resources investments and even led the trend towards the making investments in greenfield projects. In addition to providing funding, private equity funds are best equipped to add value through offering their corporate finance skills, implementing best-practice governance, and supporting and strengthening management teams and leveraging their networks.

The Rise of Alternative Energy

Alternative energy is the fastest growing segment of the global energy sector following the combination of emerging themes: technological innovations, market forces, and enhanced policies and regulations to promote energy efficiency and curb greenhouse gas emissions. The growth of the alternative energy sector has fueled intense interest of private equity in the space as new industries and new markets have been defined and created. Potential investment opportunities for private equity in the area include buyouts and consolidation of existing assets, development of new technologies and projects, and partnerships with strategic players. The Carlyle Group, a prominent global private equity fund, launched the US\$685 million global power & energy fund in association with Riverstone in 2005 to focus on opportunities in the renewable energy sector. The fund has invested in promising assets across the globe from Brazil to Canada in various facilities including geothermal, ethanol, and biomass. In Thailand, MFC Asset Management launched the THB2.5 billion (US\$75.0 million) MFC Energy Fund to invest in green energy businesses in the country and have already made investments in bio-diesel, ethanol, and energy storage businesses.

The recent transformation of the energy industry will continue to create opportunities that require substantial investments and capable management teams. Private equity players with considerable expertise and network of relationships are well positioned to ride the rising tide.

References:

Private Equity, Energy, and Resources: How the Leopard Has Changed Its Spots, *Journal of Petroleum Technology*, February 2008

Private equity at work in the energy industry, *swissHEDGE*, 2nd Quarter 2007

Private Equity Firms Discover Electricity -- and Lead the Charge for Energy Investment, *Knowledge@Wharton*, April 26, 2007