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Prospects for Oil and Gas Investment

Increased competition, falling commodity prices and greater economic uncertainty increase the risk for investment in energy. As with the traditional buyout world, recent investments that were predicated on higher entry valuations and leverage levels will be troubled. In a cyclical industry, there will be substantial pain for those managers who aggressively leveraged their companies. Oilfield services and midstream businesses will be particularly hard hit. But the cyclical nature of the business also makes this an opportune time to invest. Lower-priced acquisitions and a more rational commodity environment signal a better entry point for private equity.

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Lost in today's environment of record low consumer confidence, Americans have received a welcome reprieve at the gas pump, as prices have dropped by more than 50% from last year's peak. This correction is good news for consumers, but poses a problem for investors in the oil and gas industry. In particular, private equity has invested vast amounts of capital in the industry in recent years that suddenly looks to be at risk. Yet despite, or in some cases because of, economic headwinds facing commodity prices, private investment in oil and gas is poised to capitalize on the dislocation. Not unlike the leveraged buyout world, which outperforms in recessionary periods, the oil and gas space can benefit from this rationalization. We believe opportunities in **Exploration & Production** (upstream), **Midstream** and **Oilfield Services** will surface for managers putting capital to work in the next few years, and that private equity, with its long time horizon, is well-suited to take advantage of the unfolding price changes.

We now take a closer look at the opportunities and risks in these sectors.

Exploration & Production

Exploration & Production supplies the lifeblood of the oil and gas industry, attracting significant private equity capital over the last decade. Firms have been

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Exploration & Production (upstream)

- Finding, acquiring and developing oil and natural gas properties
- Within the oil and gas industry, E&P tends to receive the most attention from private equity investors.
- Notable private equity deals are:
 - Warburg Pincus/Spinnaker
 - Quantum/Linn Energy
 - EnCap/Petrohawk

Midstream

- Gathering, processing, transporting, storage and marketing of oil and gas
- This segment is capital-intensive, and the value of existing midstream assets in North America is believed to exceed \$1.0 trillion.
- Notable private equity deals are:
 - Carlyle & Riverston /Kinder Morgan
 - ArLigh /MLP Buckeye Partners
 - Energy Capital Partner/Cardinal Gas Storage

Oilfield Services (ex-midstream)

- All services and equipment are designed to support the exploration and production sector.
- Drill bits, pumps, rigs and seismic imaging technology are all examples of oilfield services.
- Notable Private Equity Deals:
 - First Reserve/Dresser-Rand
 - SCF/Varco International
 - Riverstone & Interval/International Logging, Inc.

drawn to the multitude of ways in which value can be extracted. In addition to financial engineering and improved operations found in traditional leveraged buyouts, managers stand to benefit from the defined market price and potential appreciation of the produced resources. Additionally, a set price for oil and gas enables the use of hedging to model revenue and lock-in margins. Most firms hedge anywhere between 70-100% of their proved developed producing (PDP) volume, often going out 5 years. This is done to ensure one's ability to stay in business and take advantage of any upswings in commodity prices, but also has the added effect of making leverage more attainable since banks are typically willing to lend against fixed future cash flows. Hedging becomes more lucrative at higher prices, and a portion of reserves will inevitably be un-hedged due to the uncertainty inherent in exploration. But rising prices also allow managers to take advantage of the difference between forward prices and lagging service costs. This explains why private equity investment in oil and gas benefited greatly from the positive hydrocarbon environment over the past decade.

Although some firms buy existing companies and assets, a more common E&P approach is to back an expert management team in a particular niche. In recent years, this has often meant unconventional resource plays like tight gas or shale

fracture. Unfortunately, much of what made the E&P segment attractive to private equity has reversed course over the past year. Oil prices have plunged from \$147/bbl to \$40/bbl. Recent investments in E&P will inevitably be troubled as they are selling at the prevailing lower market price. Hedging may mitigate some of that effect, but many portfolio companies engage in the more marginal resource plays which are economic only at higher prices. Companies that bought acreage and assets at exorbitant prices in recent years will be faced with a harsh new reality. Year-end accounting will undoubtedly show significant write-downs on the majority of these investments made in the past 2-3 years.

But growing distress also allows new opportunities to emerge. Assets and acreage purchase prices will continue to decline. Service costs also tend to rise and fall with commodity prices, but with some time lag. Service companies have resisted cost deflation thus far, but a correction is inevitable. The last time commodity prices were at these levels, service costs were roughly 60% of where they are today. A much lower cost basis will make initiatives economic even without a rise in commodity prices. At the same time, it is our opinion that \$30/bbl oil is probably no more sustainable than \$130/bbl. **Over the long term, as economies stabilize and demand picks up, prices should begin to rise. We believe, therefore, that investments made at today's prices will be rewarded.**

Midstream

The evolution of the Master Limited Partnership (MLP)—tax-advantaged vehicles with substantial dividend yields - revolutionized investment in midstream energy. Hedge funds and other yield-hungry investors were buying MLPs, leading to an attractive exit opportunity for private midstream entities with steady cash flows. On the other hand, existing MLPs benefiting from a lower cost of capital were encouraged to expand, able to outbid private equity firms for assets. As a result, MLPs became the primary exit route and a source of competition for private equity.

Opportunities in midstream typically come in one of three forms: acquisitions, joint ventures and divestitures, or Greenfield development. Private equity managers buy and/or build assets and expand and improve them before exiting. In recent years, the focus had begun to shift toward development as managers recognized the inadequacy of the current midstream infrastructure and could not compete with the MLP's low cost of capital for acquisitions.

Fundamentals for the midstream sector are primarily dependent on volume and rates (i.e., tolls). As demand falls and commodity prices retreat, the segment faces considerable pressure on both fronts. The new storage and pipelines surrounding some of the more unconventional resource (e.g., shale) plays may come under duress as new fundamentals don't support ambitious production targets. Compounding the issue for existing private equity-backed midstream companies has been the dramatic decline in the MLP universe, where the index fell 38% for the year 2008. Hedge fund redemptions, combined with an overall lack of liquidity in most MLPs, have led to vicious selling in the asset class. This unwinding has taken much of the luster off the most attractive exit route for

midstream. Existing investments are faced both with deteriorating fundamentals and no attractive exit route. Furthermore, midstream companies marking to market at year-end using public comparables will be forced to take dramatic write-downs.

As with services, distress and forced selling in the midstream segment create new opportunities for private equity. While the need for new midstream infrastructure will continue to push development projects, the chance to purchase assets below replacement cost will create new investment targets for private equity. This trend will manifest itself in a number of ways. Corporate divestitures, especially from MLPs, will proliferate as capital ratios come under greater scrutiny. Well-funded energy managers are looking at purchasing some of the smaller MLPs at these depressed prices, either through private investment in public entities (PIPEs), or even “take-privates” for some of the smaller names. Finally, some of the new builds may become targets for opportunistic managers. Demand should pick up again soon, particularly for natural gas, which is more resistant in a recession as it is predominantly used for power rather than as a transport fuel. **Regardless of the price, the need to upgrade existing infrastructure and to develop greater storage and more pipelines to connect new supply to market still exists. Managers able to acquire attractive assets at a low cost-basis can expect to reap substantial profits when the market adjusts.**

Oilfield Services

The oilfield services segment has benefited from an influx of private equity capital in recent years. Unlike E&P, generalist private equity funds were very active in services plays. Closely resembling traditional leveraged buyouts, success in such investments depends on growing earnings through improved operations as well as financial engineering. Leverage tends to be more prevalent (typically 40-50% of capitalization) in services companies than in E&P investments. Oilfield services investments also benefit from rising commodity prices. As the price of the underlying commodity goes up, so does demand for the equipment (e.g., rigs) and the systems needed to extract the resources, leading to higher day rates as well as greater utilization. This phenomenon was exaggerated in recent years as oil and gas prices rose to a level that made equipment scarce and expensive technologies economically viable.

Unfortunately, the dynamic has changed, and recent investments in oilfield services will likely suffer the same fate as many E&P companies. Service costs, especially those tied to unconventional resource plays, are set to plummet. When prices are lower, more expensive projects become uneconomic and they are abandoned. Without the ability to hedge, services companies are vulnerable to commodity prices, making it an especially unstable sector. EBITDA can go negative for extended periods of time. Many recent services deals are over-leveraged and in serious financial difficulty. The coming write-downs in E&P could be followed by significant *write-offs* in services.

At the same time, the dislocation in services will result in new opportunities for

private equity, as an increased number of distressed companies look for capital. Use of certain systems and technologies will be discontinued. Equipment may even be sold at junk value. We believe this presents an outstanding opportunity for managers with capital either to acquire companies at depressed levels or buy control through purchasing their debt. **Although the oilfield services segment remains a highly volatile business, the upside should be significant if one can acquire companies or equipment at deep value. Due to the long time horizon afforded by private equity, conservatively capitalized businesses should be able to wait out the current bear market in energy.** Investments leading to lower extraction costs or greater energy efficiency continue to look compelling. Distressed opportunities and energy efficiency should make up the bulk of the opportunity set for private equity going forward.

The guiding fundamentals for the industry remain, and long-term demand for oil and natural gas is growing. Infrastructure required to store and bring supplies to market is insufficient, and services are needed to support and enhance collection of these resources. The coming industry turmoil is not lost on private equity firms. Upstream-focused managers are increasing their target allocations to midstream and services. With government attention focused elsewhere, private investment in energy will be encouraged. And private equity firms stand ready to capitalize.



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Invesco Private Capital

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