Financing the future energy landscape
Private equity trends in oil and gas
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Private equity (PE) is in the midst of a transformational period. Having assisted their portfolio companies to survive the worst of the financial crisis and its aftermath, PE is once again on the offensive. The result is a sector that is evolving its business model to reflect the new realities of the investment landscape. PE is expanding beyond its traditional focus on leveraged buyouts into an array of new asset classes. The largest are transforming themselves into diversified alternative asset managers, offering investors a consolidated platform for PE, venture, debt and credit funds, hedge funds, and fund-of-funds investments.

Investors in the asset class are becoming more sophisticated in their approach to PE, and are demanding more from the firms with which they do business – increased transparency, greater alignment of interests, and access to a wider array of funds that are specialized by sector and geography.

PE firms are evolving their business models to include a wider array of investment types. The largest are transforming themselves into well-diversified alternative asset managers, offering investors a consolidated platform for PE, venture, debt and credit funds, hedge funds, and fund-of-funds investments. Within the PE sector, focus has become a greater differentiator than ever before. Also, funds have become more open minded to deploying capital in emerging markets if that is where the growth opportunities are. While the BRICs remain an area of focus, particularly in the oil and gas industry, firms are increasingly looking to other new markets as a key driver for the next stage of growth – Latin America, Africa and Southeast Asia are all seeing increased interest from global PE funds and Limited Partners (LPs).

This focus is driven by an acceptance that financial engineering by itself can no longer deliver acceptable returns. In order to be successful, PE funds must be able to bring genuine operational and commercial insight to their investee companies in order to develop and execute winning strategies. Where this is combined with the potential to manage the deployment of a large amount of different types of capital, such as the oil and gas industry, then genuinely attractive returns are still available.

They are finding the oil and gas industry fits well with the evolving PE model – a capital-intensive industry, adaptive to varying risk profiles, where PE firms can leverage sector expertise and financial discipline to influence outcomes. It is an industry in a period of significant change, where growing demand for energy must contend with increasing economic uncertainty and continued geopolitical instability.

It is characterized by:

- Unending quest for resources, both to meet the growing demands for energy, thereby fueling economic development, mobility, and industrialization, and to counter the effects of natural decline and the geologic treadmill
- Significant technological advancement; for example, the drilling and well completion technologies that have underpinned the unconventional oil and gas “revolution,” and/or the development of alternative fuels technology
- Structural changes to the industry, including: the rise of national oil companies (NOCs) and increasing resource nationalism; a renewed wave of industry consolidation, a form of “industrial Darwinism” or survival of the fittest; and increasing industry concentration, a refocusing and in some cases, de-integration
- Infrastructure challenges and huge infrastructure investment needs

These trends have combined to create an inviting space for PE. As the broader PE industry continues to mature and evolve, PE firms focused on the oil and gas industry are in the midst of their own transformation and evolution. The field of active players is expanding, with new entrants joining specialist and generalist funds that have been engaged in the space for decades. Firms are getting involved in a broader array of industry subsectors, and they are becoming more active across emerging regions, including Asia-Pacific, Latin America and Africa. Lastly, they are increasingly looking at opportunities in the power and utilities space and in renewable energy.

**PE activity in the oil and gas industry**

<table>
<thead>
<tr>
<th>Year</th>
<th>Value (US$b)</th>
<th>Volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>18.4</td>
<td>65</td>
</tr>
<tr>
<td>2009</td>
<td>3.6</td>
<td>34</td>
</tr>
<tr>
<td>2010</td>
<td>8.3</td>
<td>51</td>
</tr>
<tr>
<td>2011</td>
<td>23.2</td>
<td>45</td>
</tr>
<tr>
<td>2012</td>
<td>27.2</td>
<td>56</td>
</tr>
</tbody>
</table>

*Excludes lapsed/withdrawn deals
Source: Mergermarket.com
The oil and gas industry fits well with the evolving PE model.

Mergermarket data illustrates that 2012 was a record year in terms of PE investment into the industry with more than US$27.2 billion in 56 deals. Perhaps, most importantly, successful exits from a number of high-profile investments and an IPO window that is largely open for profitable and well-governed companies are giving investors confidence to increase their investments across the oil and gas industry.

In this report, we look at the ways that PE firms are developing their strategies for investment across a variety of industry subsectors, along with the key drivers for continued activity. PE firms have the opportunity within this space to pursue a breadth of opportunities that will benefit their investors, the industry and ultimately the global economy as a whole.

This survey was conducted by Mergermarket on behalf of EY. Given the industry’s surge in investment opportunities, the ultimate objective of the survey was to better understand the relationship between PE and the oil and gas industry. To this end, Mergermarket interviewed 100 global PE executives.
Private equity in oil and gas: strategic perspectives

Growing demand, opportunities abound
Energy demand across Asia is rising in line with economic growth. According to the International Energy Agency (IEA), China will account for the largest share of the projected growth in global energy use in the next 20 years, followed by India (where demand is expected to more than double) and the Middle East. The industry certainly is not constrained by a lack of opportunities. Whether it is access to resources or capital, technology or related costs, there are challenges in meeting the world's future energy needs. The easy or cheap barrels have been produced. There are now more players going after the more difficult areas of oil production, creating opportunities for PE firms with different risk appetites.

Private equity’s interest and expertise
The oil and gas industry continues to push the technical boundaries of exploration and development possibilities, effectively deferring the concept of peak oil. The sector is in a period of major capital investment, with US$700 billion forecasted for projects currently under development. Three-quarters of these projects have an estimated cost of greater than US$1 billion, reflecting the fact projects are larger, more complex and technically challenging than ever before. Despite its voracious appetite for capital, the industry remains relatively conservative when it comes to financial structuring. With this backdrop, it stands to reason that a majority of respondents (55%) cite capital requirements as the foremost driver to oil and gas PE involvement.

The main drivers of PE activity in the oil and gas industry

<table>
<thead>
<tr>
<th>Factor</th>
<th>Percentage of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital requirements</td>
<td>55%</td>
</tr>
<tr>
<td>Availability of financing</td>
<td>41%</td>
</tr>
<tr>
<td>Global expansion</td>
<td>36%</td>
</tr>
<tr>
<td>Access to high-growth markets</td>
<td>24%</td>
</tr>
<tr>
<td>Commodity prices</td>
<td>17%</td>
</tr>
<tr>
<td>Market dislocation opportunities</td>
<td>15%</td>
</tr>
<tr>
<td>Access to technological innovation</td>
<td>12%</td>
</tr>
</tbody>
</table>

The primary ways PE can add value to an oil and gas company

- Growth capital: 63%
- Geographic expansion: 17%
- Providing operational expertise: 17%
- Placing effective leadership/executives: 9%
- Providing access to networks: 4%

1 International Energy Agency (IEA), World Energy Outlook 2013
Availability of financing is another significant factor driving PE interest in the oil and gas industry, with 41% of respondents rating it as a prime driver. The last few years can be broadly characterized by a scarcity of public equity financing combined with tight corporate credit conditions that are now loosening. Banks have been through a process of rebuilding their balance sheets and, in many jurisdictions, this process is largely complete. However, caution around risk management and the pressure to deliver an appropriate return have led banks to tighten lending standards, particularly for small to medium-sized borrowers.

The provision of growth capital is the primary way that a PE firm can add value to an oil and gas company, according to 63% of respondents. Contributing to and managing the deployment of growth capital, is a way to help oil and gas firms restructure and grow. Companies in the industry have large capital requirements to expand their operations and start new projects. Fifty-three percent of respondents expect growth capital investment to be the main PE deal type in the Asia-Pacific region in the next couple of years. Respondents also expect this deal type to be most common in North America (51%) and Latin America (34%). Given the slow economic growth in Europe and fallout from the sovereign debt crises, it is not surprising that 42% of respondents cite distressed debt acquisition as being the main deal type in the region.

More generally, an important element of many PE firms’ investment strategy focuses on existing portfolio company growth through organic investment. Forty-one percent of respondents chose making these organic investments as the most important priority in their funds in the next two years. However, almost an equal proportion of respondents believe that making new platform acquisitions will be one of their top two priorities in the next two years.

Strategies that help to improve the operational performance of the firms’ current portfolio are necessary to enhance the bottom line and also to get a higher valuation at the point of sale. Thirty-five percent of respondents indicate that this is a priority, while almost one-third of respondents consider making acquisitions to existing portfolio companies a priority for their firm. With attractive growth opportunities available in oil and gas, only 16% of respondents consider exiting current investments to be a priority.

**Top two priorities for respondents’ funds in the next 12–24 months**

<table>
<thead>
<tr>
<th>Priority</th>
<th>Percentage of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Making organic investments to existing portfolio companies</td>
<td>41%</td>
</tr>
<tr>
<td>Making new platform acquisitions</td>
<td>40%</td>
</tr>
<tr>
<td>Improving operational performance of portfolio companies</td>
<td>35%</td>
</tr>
<tr>
<td>Making acquisitions to existing portfolio companies</td>
<td>32%</td>
</tr>
<tr>
<td>Restructuring/refinancing debt</td>
<td>19%</td>
</tr>
<tr>
<td>Raising new capital</td>
<td>17%</td>
</tr>
<tr>
<td>Exiting current investments</td>
<td>16%</td>
</tr>
</tbody>
</table>

“There is strong demand for private capital, and PE firms know how to make use of this to generate good returns for themselves.”

_Europe-based PE partner_
Evaluating growth prospects and challenges

Hotspots for private equity
PE firms are currently most active in North America, Europe and the Middle East. In North America, respondents cite their continued faith in its economic recovery, rising equity markets and stronger debt markets as the main attractions for PE investors. PE firms have been particularly active in the unconventional oil and gas growth story in North America. Shale gas and oil are also identified as significant game changers in oil and gas PE over the next five years.

While the weight of PE involvement in the sector is heavily focused on North America and is likely to remain so, the Latin America and Asia-Pacific regions are expected to garner the highest increase in attention from PE firms over the next two years. Eighty-two percent of respondents expect PE activity to increase in Latin America and 79% expect the same in Asia-Pacific. A vice president from a North American PE firm says: “Overall, Latin America and Asia-Pacific will lead in new PE investments in the next two years. North America is recovering fast and is again becoming an attractive area for new PE investments.”

Shale gas and oil are identified as significant game changers.

Expected growth in PE interest by region

Expectations of PE interest in oil and gas in the next 12–24 months

<table>
<thead>
<tr>
<th>Region</th>
<th>Increase</th>
<th>Decrease</th>
<th>Remain the same</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>77%</td>
<td>8%</td>
<td>15%</td>
</tr>
<tr>
<td>Latin America</td>
<td>82%</td>
<td>8%</td>
<td>10%</td>
</tr>
<tr>
<td>Europe</td>
<td>50%</td>
<td>12%</td>
<td>38%</td>
</tr>
<tr>
<td>Middle East</td>
<td>64%</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>Africa</td>
<td>68%</td>
<td>8%</td>
<td>24%</td>
</tr>
<tr>
<td>North America</td>
<td>77%</td>
<td>8%</td>
<td>15%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>79%</td>
<td>2%</td>
<td>19%</td>
</tr>
</tbody>
</table>

Increase Decrease Remain the same
Financing the future energy landscape

Private equity trends in oil and gas

Africa

- 68% Expect the region to see increased PE interest
- 12% Currently active in the region

Middle East

- 64% Expect the region to see increased PE interest
- 32% Currently active in the region

Europe

- 50% Expect the region to see increased PE interest
- 30% Currently active in the region

Asia-Pacific

- 79% Expect the region to see increased PE interest
- 20% Currently active in the region
Key imperatives for PE in the emerging markets

Start with the exit in mind
PE firms that are successful in the emerging markets often start with the exit in mind. Moreover, they don’t limit their thinking to just the exit route – whether they’ll exit via an IPO, trade sale or secondary. In many cases, successful PE firms identify a handful of specific potential acquirers that help drive the investment thesis and the development of value creation throughout the ownership period.

Never underestimate the importance of the network
Finding the right opportunities to back is one of the key issues facing PE in the emerging markets. With the traditional intermediary infrastructure of bankers and consultants largely underdeveloped across most emerging markets, PE firms in emerging regions must build and sustain healthy local networks to ensure successful sourcing and management of deals.

Emphasize alignment at the outset of the deal
Ensuring that all parties are aligned at the outset is especially critical in the emerging economies; it can often be better to take a smaller stake at the outset and ensure that management has enough of an equity interest to be sufficiently aligned to execute on the strategic vision and seek out additional opportunities for the company.

Plan on bringing something to the table besides capital
Key to PE’s value-add in the emerging markets is the ability to bring something else beyond just capital for growth. Other less-tangible value-adds such as operational expertise, financial discipline, improved governance practices, the ability to leverage the firm’s network of relationships are all drivers of value creation.

Get management right at the outset
The most important determinant for success is having the right management team in place. Successful PE firms often have extensive relationships with management teams well before the initial investment, or spend significant effort on due diligence for teams with whom they have not previously worked. When a change is needed, they make it quickly.

Be clear on risk appetite
The risk profile of emerging markets investments can be very different from those of developed markets. It is important that investors consider not only the risk profile they are buying into, but also how this may change over time and how they can manage this.
The Asia-Pacific region presents tremendous growth prospects for companies involved in the oil and gas industry. The region will benefit from investment in liquefied natural gas (LNG), deepwater exploration and the development of unconventional resources. Additionally, markets that were previously closed to foreign investment, such as Myanmar, are beginning to open up. Natural gas is also likely to become more important over the next 10 years, with Asia, seeing a major increase in demand. According to the IEA, gas demand growth in non-OECD countries will be three times greater than in the OECD. Demand growth in Asia is highlighted by a number of respondents as being a game changer for PE in oil and gas over the next five years.

There are diverse opportunities for PE investors wanting exposure to Latin America’s resources sector. Brazil is expected to become one of the world’s 10 largest oil producers by 2035 on the back of the development of its pre-salt reserves. Argentina is just beginning its journey toward the development of its unconventional resources and is seeking foreign investment to help in that endeavor. There is also potential for increased investment in heavy oil in the sub-Andean basins extending from Venezuela to Colombia, Ecuador and Peru. The South American equatorial margin, offshore Suriname, Guyana and French Guyana, is believed by many to be the mirror image of the geology off West Africa. In addition, Mexico’s proposals to reform its energy sector are opening up more opportunities for oil and gas investments. When asked which four countries they expect will see the highest level of PE activity, respondents most commonly cite the US, China, Russia and Brazil.

In general, respondents are most worried about regulatory issues affecting their oil and gas investments, and 54% cite these risks as the most significant hurdles to overcome in the sector. This shift of geographical emphasis is likely to lead to PE funds having to manage a number of new challenges if they are to be successful. PE firms wanting to invest in the sector will also face the challenge of competition from corporates with strong cash positions. Thirty-nine percent of respondents consider that competition from cash-rich corporates is one of the main challenges to PE involvement in the oil and gas industry. State-owned companies mandated to acquire energy supplies globally are also typically prepared to pay higher prices to secure prospective targets. More intense competition may lead to targets becoming overvalued and 31% of respondents consider this to be the most significant threat to PE investment in oil and gas.
Risk versus reward
When investing in the oil and gas industry, PE executives must weigh the ample business opportunities against the risks. Each region presents different types of risk. With the effects of the Eurozone crisis and political instability in North Africa still being felt, political risk was rated highest in Africa and Europe. For Latin America, and the Middle East, respondents single out operational risk, including health, safety and environmental (HSE), as one of the main detriments to investments in these regions. This is consistent with the results of EY’s Business Pulse: Oil and gas report survey, which ranked the risk of a HSE incident and ensuring regulatory compliance as the number one risk facing the industry. This reflects a climate of zero tolerance for accidents both within the industry and within the stakeholder community.

Regulators are broadening the scope of their focus on the oil and gas industry. In recent years, regulation governing financial reporting and transparency has increased significantly. Additionally, operational and HSE-related regulation has been tightened and expanded. Uncertainty exists as the industry moves into new geographies and operating environments, such as the development of shale gas and Arctic exploration. Ethical regulation has become more of a focus area for regulators with the likes of Dodd-Frank, the UK Bribery Act and Extractive Industries Transparency Initiative (EITI) all directing attention on this area. This changing environment has placed a large burden on compliance teams, who must have an intimate knowledge of regulations in each of the geographies in which they operate.

"A focused and tailored approach to identify and understand potential risks during due diligence is necessary for evaluation purposes."

Canada-based PE partner
Some rapid-growth markets have recently implemented regulatory frameworks similar to those in mature markets as part of their effort to attract investment. Governments in some regions are increasing regulatory oversight and changing the rules for PE investments. Examples of these can be found in countries in the Asia-Pacific region. In China, India and Japan, rules on distressed investments have been changed. PE investors generally have to gain a clear understanding of statutory and regulatory compliance obligations to make their investments successful.

In North America and Asia-Pacific, fiscal and tax risks are the primary concern. As a principal at a North American PE firm explains: “Regulatory and tax policies play a major role in implementing plans for the investment. Gaining the permission to invest is also difficult in certain markets.” One respondent says that they had delayed a new portfolio acquisition because of fiscal policy and tax uncertainty. A stable fiscal regime is a critical factor for companies involved in the oil and gas industry. Long-term investment decisions are made on the expectation of certain rates of taxation and changes to those rates can undermine the economics of projects and limit future investment in affected geographies.

Respondents say that, although these risk factors are creating challenges in valuing their investments and in understanding the complexity of transactions, conducting proper due diligence is the key to overcoming these difficulties. A partner at a Canada-based PE firm says: “A focused and tailored approach to identify and understand potential risks during due diligence is necessary for evaluation purposes. All factors that may affect growth should be analyzed prior to the deal or investment. The strategy should revolve around key objectives and should also include risk-tackling measures to avoid uncontrollable behaviors of the economy.”

### Ranked level of risk associated with each factor in the following regions

<table>
<thead>
<tr>
<th>Asia-Pacific</th>
<th>Africa</th>
<th>Europe</th>
<th>Latin America</th>
<th>Middle East</th>
<th>North America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal and tax risk</td>
<td>Political risk</td>
<td>Political risk</td>
<td>Operational risk/HS&amp;E</td>
<td>Operational risk/HS&amp;E</td>
<td>Fiscal and tax risk</td>
</tr>
<tr>
<td>Operational risk/HS&amp;E</td>
<td>Operational risk/HS&amp;E</td>
<td>Macroeconomic risks including commodity prices</td>
<td>Fiscal and tax risk</td>
<td>Macroeconomic risks including commodity prices</td>
<td>Macroeconomic risks including commodity prices</td>
</tr>
<tr>
<td>Governance risk and shareholder rights</td>
<td>Governance risk and shareholder rights</td>
<td>Fiscal and tax risk</td>
<td>Macroeconomic risks including commodity prices</td>
<td>Political risk</td>
<td>Operational risk/HS&amp;E</td>
</tr>
<tr>
<td>Political risk</td>
<td>Macroeconomic risks including commodity prices</td>
<td>Operational risk/HS&amp;E</td>
<td>Governance risk and shareholder rights</td>
<td>Governance risk and shareholder rights</td>
<td>Governance risk and shareholder rights</td>
</tr>
<tr>
<td>Macroeconomic risks including commodity prices</td>
<td>Fiscal and tax risk</td>
<td>Governance risk and shareholder rights</td>
<td>Political risk</td>
<td>Fiscal and tax risk</td>
<td>Political risk</td>
</tr>
</tbody>
</table>

Highest ranked risk

Lowest ranked risk
Accessing financing for investment

The oil and gas industry’s growing financing needs underpins the expansion of oil and gas investment by PE firms. The IEA estimates that over the 2012 to 2035 period, a cumulative investment of almost US$20 trillion (in year 2011 dollars) is needed in the world’s oil and gas supply system, or almost US$825 billion per year on average. This includes investment to expand supply capacity (including production, storage and transportation, as well as processing and refining) and to replace existing and future supply facilities that will be exhausted or become obsolete; it does not include demand-side spending such as purchases of cars, air conditioners and refrigerators.

Investment will be required around the world, with the largest share expected in the Americas. Of the Americas, the US can be expected to account for the largest percent of the global total, with much of that related to unconventional oil and gas development.

This large sum, in absolute terms, amounts to almost 1% of global GDP on average to 2035 and financing it in a timely manner will depend on attractive investment conditions, notably in terms of the return available on investment.

“In my experience, compared to other sectors, PE firms find it relatively easier to raise funds for oil and gas investments, whether it is debt or other financing, from institutional investors.”

US-based PE partner

Accessibility of private equity debt financing over the next 12 months (compared to previous 12 months)

Do you currently see a significant valuation gap between buyer and seller?

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>49% 51%</td>
</tr>
<tr>
<td>Middle East</td>
<td>56% 44%</td>
</tr>
<tr>
<td>Latin America</td>
<td>40% 60%</td>
</tr>
<tr>
<td>Europe</td>
<td>57% 43%</td>
</tr>
<tr>
<td>Africa</td>
<td>42% 58%</td>
</tr>
<tr>
<td>Asia-Pacific</td>
<td>45% 55%</td>
</tr>
</tbody>
</table>
The industry’s growing financing needs have also given rise to the recent uptick in energy-focused funds. Fund formation targeted at specific subsectors in the industry is a growing trend. In fact, 64% of the survey respondents believe that the fund-raising opportunities in the next year will increase. Illustrating this point further, 65% of the respondents say they will actively be raising funds.

The ease in which PE firms are able to access financing for oil and gas investments is one of the major drivers of activity, says 41% of respondents.

“For PE firms, it is relatively easy to access financing when investing in the oil and gas industry. Thus, there are many funds dedicated solely to investing in oil and gas that have been formed and are gaining popularity. In addition, the capital requirements of the oil and gas industry are always high, which leaves room for PE players to invest,” says a US-based vice president.

The constant need for capital investments and the stabilizing financing environment have a twofold effect on respondents. Respondents are not worried conditions for PE financing will deteriorate in the next year and some expect leverage ratios might rise over the same time period. Forty-seven percent of respondents believe the status quo for PE financing will remain, while 42% believe the conditions are actually going to get easier.

Looking at leverage in recent PE oil and gas transactions, most respondents pegged average leverage or debt-to-capital ratios in each of the four industry subsectors to be roughly between 26% and 50%. Average leverage tended to be generally lower in the downstream subsector and slightly higher in the oilfield services segment. Most of the survey respondents (62%) believe that leverage ratios are broadly going to stay the same.

The respondents are mixed on whether there is a significant valuation gap between buyers and sellers in the oil and gas industry. Notes a partner at a European PE firm: “The changing economic trends are creating valuation differences between the buyer and seller. Buyers sometimes get tired of waiting for the right valuation and end up not doing the transaction.” However, giving way for the completion of more transactions, the gap has not moved by much over the last year, with 34% of respondents seeing no appreciable change and 28% saying that the valuation differences have decreased slightly. Interestingly, the perception of relative valuation correlates closely with where the respondents say they will be focusing on acquisitions.

“The changing economic trends are creating valuation differences between the buyer and seller. Buyers sometimes get tired of waiting for the right valuation and end up not doing the transaction.”

European-based PE partner
Targeting and focusing

PE has been making investments across the entire spectrum of the oil and gas industry, but the survey shows that each of the four subsectors are characterized by different perceptions of potential risk and reward.

In the upstream subsector, the highest-rated driver of PE activity is the sheer abundance of opportunities or the prospect for attractive investment targets. By contrast, in each of the other three subsectors, the primary driver of activity is the potential for consistent and predictable returns. Given the unpredictable nature of the upstream business, unsurprisingly, the certainty in returns is seen as significantly less important than in the other subsectors. The considerable capital needs of the upstream and downstream subsectors are seen as strong drivers of activity in those two subsectors, while reduced exposure to volatile commodity prices is more important for the midstream and oilfield services subsectors.

In addition, the generally attractive valuations in the midstream subsector, with much of that attractiveness in master limited partnerships (MLPs), make them a more relatively important driver in that subsector. Broadly encompassing the gathering, processing, storage and transportation functions of the oil and gas industry, the midstream subsector is an important part of the global oil and natural gas supply chain. In North America, in particular, it is an increasingly distinct and growing component of the energy industry.

The US midstream subsector has been populated by financial “players” – non-traditional, non-industry owners, which have emerged as buyers of major midstream assets. PE firms have also become increasingly involved in the subsector. Another growing trend in the US is MLPs increasingly moving to consolidate midstream assets, aiming to take advantage of their greater tax efficiency and generally lower cost-of-capital.

MLPs play directly into a global energy model that is “infrastructure short.” They are slated to be a critical factor in the development of future North American energy supply, all of which will be infrastructure intensive, e.g., deepwater Gulf of Mexico, Alaskan/Arctic gas, Canadian oil sands and LNG.

The primary drivers by industry subsectors

- Greatest supply of targets
- Significant capital requirements
- Attractive valuations
- Consistent/predictable returns
- Reduced exposure to movement of commodity prices
- Ease of exit
In general, MLPs avoid trading and commodity risk exposure and thrive on relatively stable cash flows. They typically feature high-quality management rather than a focus on project development and asset-less trading. Management teams typically have large insider stakes and lots of “skin in the game.” The MLP structure offers minimal corporate-level taxation without the risky tax strategies, shelters and/or offshore havens. The structure offers a lower cost-of-capital, and generally, greater returns as compared to conventional structures. MLPs have two further notable features. Given that the structure mandates high returns to shareholders, cash for expansion has to come from the market, thereby imposing capital discipline. Most critically, MLPs need regular acquisitions to feed the Depreciation, Depletion and Amortization (DD&A) flow, which, in turn, lowers reported income and raises the tax attractiveness of the investment.

The midstream subsector, which predominantly features a fee-based structure, is generally less tied to the direction of oil or natural gas prices, than the other subsectors. This is in direct contrast to upstream investments, which are subject to commodity price fluctuations, although this risk can generally be at least partially mitigated through hedging strategies. Considering its low-risk profile and the wealth of investment opportunities in the midstream subsector, a plurality of respondents rate this subsector as the one that provides the most optimal investment opportunities.

Reduced exposure to commodity volatility in the midstream subsector is its biggest selling point. Notes a vice president in a North American PE firm: “The midstream subsector is somewhat insulated from the effects of commodity price changes and thus provides a relatively safe investment. For another decade, the returns will be considerably high and can be predicted when investing in the midstream subsector as the demand movement is more predictable.”

Outside of these four core oil and gas subsectors, 86% of the survey respondents say they are currently pursuing other energy options. Of these alternatives, renewable energy is the number one choice, followed closely by power and utilities, with petrochemicals/chemicals and mining registering as distant choices for the survey participants.
Conclusion: what’s next?

Our survey respondents expect interest in the oil and gas industry from PE firms to increase globally over the next few years, with the boost driven by these companies’ significant cash pile and the recovering financial markets. Latin America, Asia-Pacific and North America are expected to gather the most attention from PE firms for different reasons.

With strong investment drivers existing in each of these hotspots, respondents say PE firms are ready to make considerable investments in these regions. In North America, respondents cite their continued faith in its economic recovery, rising equity markets and stronger debt markets. The Asia-Pacific region presents growth prospects given increasing oil and gas spending, as energy projects in this region become more complex. In Latin America, tax incentives such as those given in Brazil for oil and gas investments and Mexico’s proposal to reform its energy sector are opening up more opportunities for oil and gas investments.

A European-based PE partner says: “PE activity in the oil and gas industry is increasing in every region, including Europe. These firms have a lot of dry powder and the growth prospects look much better with the improving markets.”

Lastly, from a regional perspective, our respondents cite Africa as the next big market for oil and gas PE concentration. Several note that Africa is emerging as a big resource for oil and gas companies, but because of the political issues, PE investments in Africa have lagged behind those in other regions. However, as political tensions are alleviated, PE firms will also have to change their strategy and respond accordingly.

Our survey also looks longer-term – over the next five years or so – asking what some of the “game changers” might be for PE in oil and gas. As would be expected with an open-ended question, the responses range far and wide. Many respondents reiterate two of the overarching risks for the PE industry as a whole, as well as for PE in oil and gas: the broader global economy and the availability of finance. They also note that if these two are not in place, both will suffer heavily and be forced to downsize.

However, despite these perceived drawbacks, most of the transformative factors that respondents brought up are positive.

The most-mentioned game changer is unconventional oil and gas, particularly shale gas. With interest in unconventional resources springing up around the world, the replication of North America’s success would be another “revolution.” As one US-based vice president states: “Whether it is Europe, Latin America or Asia, every country is looking to explore their shale gas resources. As shale gas exploration begins worldwide, we see a major change happening in the oil and gas industry in the next five years, and a major opportunity for PE.”

Numerous survey respondents also mention the opportunities of technological innovation in the oil and gas industry that could change the focus of some PE investments. In particular, renewable energy technology could change the business for oil and gas companies and, at the same time, will affect how PE invests in oil and gas. More than a few respondents note that a technological breakthrough in renewable energy can lead to a significant decline in oil and gas equity.

Another long-term game changer to PE in oil and gas is the increasing internationalization of the state-owned/controlled oil and gas companies, or the so-called NOCs. Their asset acquisition activity, often under advantaged terms, represents a competitive challenge not just to the international oil companies (IOCs), but to PE as well. As have the IOCs, PE firms may have to modify their strategy to stay in the game and keep returns high. Similarly, rising resource nationalization will equally affect PE activity in the oil and gas industry, just as it affected corporate activity.

As PE firms diversify their investment portfolios, oil and gas opportunities are rapidly emerging globally. PE firms in all regions are compelled to adjust their business strategies to respond to the evolving landscape and to decide on which segments of the oil and gas risk spectrum to focus on. There are upcoming developments on the horizon, the most preeminent of which is in the growth in unconventional oil and gas. These game changers mostly serve to broaden the scope of future investment parameters available to PE oil and gas players.
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