ENERGY

Profiting from the fall

Energy prices may still be languishing but opportunities in the E&P sector are still there for the patient investor

With oil prices remaining significantly down from 2014 highs, gas prices languishing and forecasts for both remaining bleak and scattered, it is no secret that a number of exploration and production (E&P) companies are facing adversity. Similarly, many funds and investment managers, even those with limited energy experience, are looking for opportunities to deploy a reportedly unprecedented amount of capital with the hopes of earning outsized returns from a price rebound.

Investors who explored the space in the wake of the price plunge generally did not find the opportunities they expected, and those who deployed capital are finding that their investments are not yielding particularly quick returns. Immediate liquidity concerns were largely mitigated by patient banks, swift cost-cutting and continued proceeds from deep in-the-money hedges.

Additionally, prior to a second severe price retreat in June, several companies recapitalised their balance sheets utilising follow-on equity issuances or second (and third) lien debt. Price volatility and hope led to a wide bid-ask spread, resulting in few asset level transactions or significant investments as buyers and sellers could not see eye-to-eye on future prices or the depth of the pain.

Now that expectations of a price rebound have broadly dissipated, the spread is beginning to narrow and the potential of a liquidity crunch is becoming more of a reality as formerly wide-open capital markets remain tight, hedges roll off and shrinking borrowing bases loom. Many E&P companies now find themselves in one of three places: headed for restructuring, regardless of future prices (highly-leveraged companies with generally less desirable assets acquired at high prices); facing some liquidity-induced stress, but able to survive by pulling on short-term liquidity levers through dispositions, capital raises or finding a partner to help carry the load (highly-leveraged players with generally quality assets); or generally well-capitalised, but potentially looking for growth capital to take advantage of attractive opportunities (lower-leverage or newly-backed players with solid assets).

While the full run of traditional investment approaches are available, many may find common equity disappointing and risky, and debt challenging in highly-leveraged companies with existing facilities. Also, sponsoring management teams may be less attractive due to competition with established players and given companies are unlikely to be selling their better assets. Investors with a desire to increase their exposure in E&P may prefer vehicles closer to the hydrocarbons including preferred equity in existing players facing some liquidity-induced stress, but likely to survive with some private capital to meet commitments; production payment plays; and joint ventures.

PREFERRED EQUITY

The downward pressure on oil prices has spurred an increase in preferred equity financings over straight common and recently announced raises reflect that money will still follow teams with established relationships and a track record of success. Further, master limited partnerships continue to search for opportunities to maintain distributions, including by partnering with E&P companies seeking to monetise developed or midstream assets, and have been looking at preferred equity as a key funding source.

However, potential investors should be aware that preferred (in addition to common) investors are exposed to the same company-wide (versus asset-specific) cash flow and corporate management practices that may have placed the company in tenuous straits in the first place. So it will be key to scrutinise historical performance to assess whether previous success was driven by quality investments, good timing or both.

PRODUCTION PAYMENTS

Production payment plays involve cash payments to working interest owners in exchange for a stated volume of future production, percentage of production proceeds or percentage of the difference between production proceeds and royalties, lease operating costs and taxes. These transactions had fallen out of fashion during the boom due to accounting complexities and readily available capital compared with the yield on production payments, but as the need for liquidity grows, these opportunities may re-emerge.

Such structures come with the advantage of providing investors with a potentially stable cash stream and, if properly designed, bankruptcy protection in many states. That said, many investors may find it difficult to deploy a significant amount of capital

Drilling down: *investors need to consider preferred equity, production payments and joint ventures*

and will face price and reserve risks, and possibly diversification risk if their partner focuses on developments outside the area of mutual interest.

JOINT VENTURES

As evidenced by Linn Energy's recent alliances with GSO Partners and Quantum Energy Partners, energy joint ventures such as drilling companies and acquisition companies have become of particular interest lately. In these arrangements, an investor partners with an E&P company to create either an asset-level or entity-level joint venture in which the investor typically provides almost all of the capital for a jointly-developed drilling or acquisition programme in return for a working interest in the assets (ie, direct ownership of the underlying reserves). Once the investor earns an agreed-upon internal rate of return on its capital investment, the investor's working interest can revert to a significantly lower percentage for the remaining life of the asset or investment.

These structures are particularly attractive to companies as it permits them the ability to retain their best assets and meet operational obligations, while avoiding equity dilution or adding new debt to the balance sheet. Investors have been particularly drawn to these joint ventures as it provides them the ability to partner with trusted players to target desirable assets while allowing a higher level of control over the timing and use of their investment and, depending on structuring, a level of bankruptcy protection.

Further, the returns and arrangements can be highly structured to help investors meet targeted returns while incentivising the partner to focus on the venture and capture upside.

SETTING YOURSELF UP FOR SUCCESS

As with any investment, potential investors will need to consider a variety of factors, including their comfort with distressed and industry-specific investments, level of desired involvement, time horizon and the technical capabilities to handle diligence and operational matters.

Shale-related investments have largely been a real estate game based on timing and as investors get closer to the assets, it will be critical for them to understand the economics of the play into which they are buying (economics which change rapidly in response to the underlying commodity price), including the cost structure, classification and specific characteristics of the underlying reserves.

Although these close-to-the-asset structures may provide increased control, investors will need to be more engaged in the investment on an ongoing basis. As such, investors not acclimated to E&P or without large technical staffs may require the use of outside experts or outsourced back-office management.

Ultimately, investors should see many investment opportunities of all stripes in E&P as prices continue to languish, but the real key to grasping the outsized returns will likely be patience, the willingness to get a little closer to the hydrocarbons and, as always, proper diligence. ■

Authors:
Shubi Arora, *partner, Akin Gump Strauss Hauer & Feld LLP;* ***Josh Sherman,*** *partner, Opportune LLP;* ***Sean Clements,*** *managing director, Opportune LLP;* ***Jhett Nelson,*** *counsel, Akin Gump Strauss Hauer & Feld LLP*