Don't Ignore the Energy Sector

In an oil & gas market plagued by underperformance and significant volatility, uncertainty can breed opportunity for investors in the long term

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Many oil & gas producers, and those that have been investing with them, are struggling. Uncertain demand, excess supply, high levels of leverage, and lack of access to capital are a few of the reasons we have seen close to 200 bankruptcy filings from 2015 through the third quarter of 2019.

Larger public energy companies remain under pressure to rationalize operations in order to live within cash flow, while smaller companies, despite being over leveraged, are forecasted to continue outspending their cash flow in the near term. The financing markets remain tight as RBL leverage guidelines have not loosened since the OCC lowered them in 2016. The public debt and equity markets are inaccessible for most issuers, and a good portion of private market investors (both direct and fund investors) are saddled with legacy energy portfolios that have their investment committees unwilling to approve incremental commitments. Throw in some macro issues like uncertain economic growth, negative perceptions of fossil fuels, deepening trade tensions, and global political risks, and it is no surprise that Q3 2019 fundraising totals are the lowest in five years, as Preqin data shows, with just $7.9bn raised by 16 funds; $3.7bn of the total was accounted for by two funds, both of which have an infrastructure focus.

So, why would anyone take career risk by recommending commitments to a sector that has underperformed and experienced significant volatility and uncertainty? Some investors have continued to allocate to energy but have focused on midstream/infrastructure or downstream, which are considered less risky. Inefficiencies and bottlenecks continue in the gathering and distribution systems, providing ample investment opportunities. Renewables are also of increasing interest as climate change has been accepted by most as a legitimate threat, and managers that can invest in viable alternative energy opportunities while producing solid returns will attract capital. Then there are the contrarians who believe the adage that uncertainty breeds opportunity.

Contrarian investing is not for the faint of heart, but it can be very profitable. Buyout investors in 2008 and 2009 that were willing to take calculated risks while the world seemed to be falling apart ended up profiting handsomely. Similarly, we are seeing some forward-thinking LPs seeking ways to invest in upstream opportunities without significantly increasing the risk profile of their portfolios.

The most rational way to enter the market is with managers that have experience dealing with distressed situations and view complexity as an opportunity. Larger oil & gas companies are being forced to shed non-core assets, and smaller operators are cash strapped with a need to right-size their balance sheets. However, purchasing quality assets or companies out of bankruptcy, or spinning them out of larger companies, requires a unique skillset and a level of patience different from what was successful in the boom energy markets. Managers able to execute complex transactions and bring discipline to the capital allocation process, alongside management teams that embrace capital efficiency, can invest at reasonable multiples and position themselves to withstand downturns without missing out on the upside potential of a market recovery.

Advances in technology also provide an opportunity to identify interesting investments. The oil & gas sector has lagged behind in its adoption of sophisticated software applications, but that is changing. The technology angle can be played both with services businesses that surround producers and directly with producers. Service companies that apply technology to reduce the cost of extraction are attractive to producers of all sizes and can grow even in a challenging market. Producers that effectively utilize technology to identify reserves, locate drilling opportunities, and improve extraction will be the long-term survivors that can afford to be patient with their allocation of capital.

While uncertainty persists in the energy sector, oil & gas production is not going away in the near future and will continue to require capital. Given all of the headwinds discussed, it would be easy to take a pass on adding to one's energy exposure, but those with a tolerance for measured risk and a thematic approach to the sector will benefit in the long term.

Capstone Partners

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