THE EVOLVING ENERGY MARKET

- Brian DeFee, **Capstone Partners**

Tom Carr: What is the current state of play in the energy fundraising environment?

Brian DeFee: Demand for energy funds since 2014 has been a real roller coaster ride. In late 2014 through early 2015, many investors wanted nothing to do with energy managers, especially those focused on upstream assets. The LPs' investment committees (ICs) asked them to dig deep into their underlying portfolio companies to determine exactly how much and what type of exposure they had to the wellhead. More specifically, ICs wanted to know the extent of losses in the unrealized private portfolio and how much dry powder exposure was outstanding. Since valuation marks for private managers are delayed in terms of reporting, many LPs spent most of 2015 and part of 2016 trying to answer their ICs' questions. Generally speaking, the more aggressive endowments, foundations and family offices had considerable exposure (i.e. losses) while more conservative LPs (e.g. public pension funds and insurance companies) were a bit more protected.

According to Preqin, 32 North American energy-focused equity funds closed in 2015, raising $28bn in investor capital. In 2016 the figures were better, with 36 funds raising $45bn, but a significant portion of the aggregate capital was raised in Q4 2016. Throughout the early part of 2016 there was little interest in energy as the LPs were still licking their wounds. Numerous LPs were forced to the sidelines until their portfolios recovered and some of the dry powder was deployed. However, other LPs recovered more quickly and saw the downturn as an opportunity to add exposure. In 2017, we have seen 28 energy funds close, raising $24bn in capital.

Interest in energy strategies has been growing throughout the year; however, we are still not matching 2016 fundraising levels. It is a case of the haves and have nots – between those that 'have' deployed and returned capital to investors and those that 'have not'. From a fundraising perspective, GPs that have demonstrated positive results are raising new funds or even successor funds with relative ease, while other GPs are struggling. LPs are considerably more discerning than in years past, including the stalwart energy investors, which has contributed to lengthier fundraises.

Another interesting development we have witnessed as of late is a number of portfolio companies spinning out to raise institutional capital in owner-operator strategies. More specifically, management teams are going directly to the institutional investor community and bypassing energy GPs. These groups have earned considerable attention as they are often micro-focused on specific energy plays or basins, and they eliminate a layer of fees between the GP and management team. However, some argue that these groups do not provide geographic diversity for their LPs and that the team lacks experience as portfolio managers.

On a final note, over the past quarter or two we have begun to see some investor fatigue with so many GPs in the market raising capital. Again we are seeing LPs go to the sidelines, but this time due to the notion that there is too much dry powder chasing too few deals (which is a similar sentiment in private equity, I should add). The North American private energy sector is currently sitting on $60bn of dry powder and $100bn of unrealized value. Sceptical LPs are questioning GPs' assertions that this capital will be deployed efficiently in the near term and will hit their return targets.

TC: Are new energy managers entering the space or has the bulk of the capital raised come from established managers?

BD: Since the downturn we have seen a considerable number of new entrants tap the institutional community for first-time funds. Many of these spin-out teams come from large, well-established GPs. In almost every case, the story line is that the best returns are at the lower end of the market and it is difficult to move the needle with a multibillion-dollar fund. This theme is similar to what we have encountered in the buyout sector. The LP community has welcomed these new firms as they look to identify the next generation of successful managers. The argument is a compelling one in that the smaller end of any market is less efficient and ripe for outperformance. Plus, with established GPs raising larger and larger funds, a natural buyer universe exists for the smaller energy managers, offering a viable exit strategy as long as a compelling amount of development upside remains for a strategic or financial buyer. However, it is not lost on LPs that the new paradigm in the fracking shale revolution requires a considerable amount of capital to support teams that have an increased number of wells and increased drilling length to complete lateral wells. Also, many believe, or will argue, that the US is the new global price-setter for oil and that global demand will continue to grow steadily over the coming years, so significant capital will be required to satiate global demand.

TC: Do you have any advice for energy managers in market today?

BD: That is a tough question as every manager is different with its own unique set of circumstances. I wish there was a crystal ball to let managers know how/if a future fundraise will be successful. However, I think it is essential that GPs prove to investors that they can deploy capital (not just commit capital to teams) quickly and at compelling entry prices; this usually requires a differentiated sourcing process. We often hear LPs lament about the dry powder on the sidelines and the number of managers that are unable to deploy capital. The bottom line is GPs should not give into the temptation of

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overpaying for assets just to get capital deployed, and they need to make sure they are getting the dollars in the ground versus just having it allocated to projects.

For investors, capital preservation is equally as important as capital deployment. LPs will give managers a considerable amount of credit for staying conservative in their underwriting and ultimately navigating the downturn with success. GPs need not be shy about disclosing this fact and should ensure that LPs understand just how deep the downturn hit specific basins where their assets are/were located. LPs will appreciate an understanding of the exact steps that the GP and the management team took to preserve capital (e.g. modest use of leverage, considerable focus on optimizing LOEs etc.).

Lastly, GPs should raise the appropriate amount of capital for the size of their team and underlying investments. Prior to the downturn LPs witnessed GPs growing larger, often considerably larger, with each consecutive fund. However, the GPs that have remained committed to their niche of the market and have not tried to raise significantly larger funds have typically been in and out of market more quickly.

TC: Outside of energy, what interest have you seen from investors in natural resources investments such as metals & mining or agriculture?

BD: To be candid, we have seen less interest in other natural resources sectors outside of energy over the past couple of years. Global energy strategies still dominate the natural resources fundraising landscape, with agriculture and metals in a distant second and third place, respectively. According to Preqin, 148 energy funds are currently in market globally (as at January 2018), targeting almost $84bn. For agriculture/farmland strategies the figures are 45 funds raising $11bn and for metals & mining the numbers are 14 funds raising $7.6bn. Clearly LP interest lies in the oil patch.

The LP view on metals & mining is that private capital strategies have been extremely volatile over the past several years and have not met their return expectations. Furthermore, many GPs have not beaten their public market benchmarks, which has also frustrated investors. Rightly or wrongly, LPs are questioning private capital mining strategies with the argument being that the best management teams can simply access the public markets in Toronto.

The issue is, the TSE has been effectively closed to management teams for quite some time with new equity issuances being at all-time lows. Investors' concerns are also compounded once we layer on questions around environmental, social and governance (ESG) factors as well as commodity price risk and potential FX risks. Given all of these factors, the sector will likely continue to be capital constrained, which one might argue is an opportunity for contrarian investors to make some money.

Agriculture/farmland, timber and water strategies do not necessarily suffer from the same performance perception issues or ESG-related concerns as metals; however, these lower-risk/lower-return strategies have not been terribly interesting for illiquid, private market portfolios as the public benchmarks continue to put up solid returns. Their lack of correlation to the public markets seems to gain little attention with the LP community. However, it is worth noting that an LP's knowledge of these strategies is often significantly less than for energy strategies.

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