Oil and Gas Industry Investing No Longer Just for the Experts

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Investing in oil and gas-related businesses has historically been the domain of specialty funds staffed with teams of industry experts. Many generalist private equity funds have, however, awakened in recent years to the fact that this not need be the case. Such investors typically have existing strategies and initiatives designed to create advantages and add value in an ever-more competitive acquisition environment. Those specializing in the industrial services or manufacturing industries, for instance, are discovering that their skill sets are every bit as applicable to companies serving the oilfield as to those focused on general industry. Once invested, many also discover that the industry is not as mysterious or volatile as previously assumed.

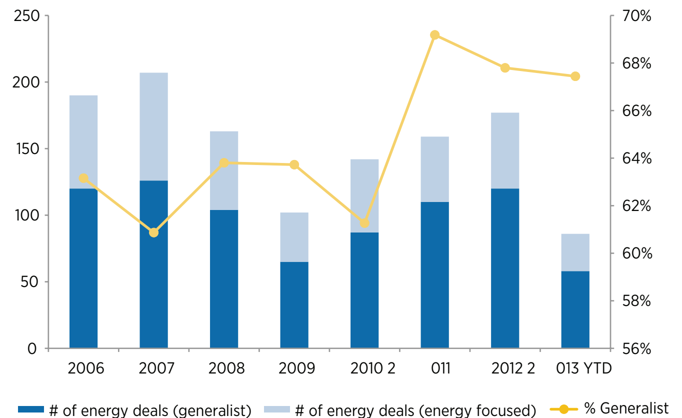
The thesis is fairly straightforward. Generalist firms recognize the need for some level of exposure to the oilfield as part of a diversified portfolio strategy. They can no longer afford to neglect a major and growing part of the U.S. economy that currently generates nearly 8.0% of U.S. GDP. The oil and gas industry was among the first to recover after the 2008 recession and has remained one of the consistent bright spots in the U.S. economy. The good news is there is an enormous and ever-expanding universe of private middle market companies in oilfield services, products and equipment. The energy industry is entrepreneurial by nature, encouraging new business formation and embracing of the kind of risk-taking necessary to achieve success.

Determining how to partner with such businesses depends on how much direct or derivative commodity price risk an investor is willing to accept. An admittedly simplistic rule is that the farther the company's product or service is removed from the drill rig, the less it is explicitly exposed to fluctuations in commodity prices.

Oil and gas exploration and production ("E&P"), unlike other industry segments, remains primarily the province of specialist investors. It requires substantial expertise and upfront capital costs to locate reserves, acquire mineral rights and execute a drilling program. Drilling costs often exceed $10 million per well, necessitating a substantial commitment to establish a diversified portfolio of any size. This frequently exceeds the available allocation from a typical middle market private equity fund, and the investment is directly exposed to commodity price risk.

Companies manufacturing or fabricating capital equipment used in new well completion are nearly as cyclical those in the E&P segment, thus often trading at relatively modest multiples. A rig fabricator, for instance, sees its market segment grow only when the increase in rig count is accelerating and even a steady state requires consistent new builds. During such periods, however, companies can generate outsize earnings that provide for rapid debt repayment or dividend recapitalizations. Some replacement business is also available as older rigs are retired in favor of more technically advanced equipment used to drill shale and other unconventional formations. Services likewise tied to new completions such as well planning, site preparation, drilling, fracking and fluids management are in more consistent demand as long as market prices keep the specific formation economically feasible. Providers of wear parts rely on recurring replacement business that is also more stable than newbuild activity. Most investments in these types of businesses therefore require a reasonably informed view on the part of the investor regarding forward commodity prices and their potential effect on the product or service being provided.

Less exposed are providers of services for producing wells such as monitoring and site maintenance. Middle market manufacturers



production equipment are also discovering that major providers have abandoned much of the U.S. onshore market in favor of international and offshore opportunities, providing a profitable opening for smaller businesses to what is still a robust part of the industry.

In the midstream sector, pipeline construction and related services tying newly completed wells to the U.S. transmission infrastructure (which is in early stages of construction in many areas experiencing their first major development of oil and gas reserves) yield to the less-cyclical business of supporting existing pipeline systems. Testing, inspection, repair and maintenance services, and replacement of pipe and wear components are common examples.

Once at the refinery, the relationship of company revenue to crude prices diminishes further. Refineries certainly experience cycles of their own and may delay certain activities for a period of time. However, the U.S. refinery system consistently operates at nearly 90% of capacity even when fuel prices are unfavorable. Planned service may therefore be postponed but never completely foregone. Companies providing products, equipment and services to the downstream segment are thus ideal investment candidates for patient investors, as the business is a matter of not "if," but "when."

An area of opportunity that overlays all industry segments is that of safety and environmental products and services. Regulatory scrutiny is becoming increasingly stringent and is unlikely to relent. Failure to consistently maintain infrastructure can lead to catastrophic results that endanger lives, damage property and attract lawsuits and regulatory fines. While such events are rare, the steep downside risk is not worth any short-term savings to be gained from half-efforts.

While no business serving the oil and gas industry is immune to the cycle, solid management, customer and geographic diversification, and judicious use of leverage provide the same risk management benefits as in any other market. Industry tailwinds remain as global energy consumption is expected to continue increasing. The domestic industry is rapidly expanding into geographies where oil and gas have not historically been produced. Technologies and expertise developed primarily in the U.S. provide opportunities for international expansion. These all are general market attributes that private equity finds strongly appealing. The proof is in the data. [X%] of the energy-related transactions closed by GulfStar Group since 2005 with private equity groups were with generalist investors, versus [Y%] in the fifteen preceding years. The opportunities are there, and this is not a trend that GulfStar expects to reverse any time soon.