

Privcap/Report

The Deepwater Opportunity

Is Now the Time to Invest?

The Panelists

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Deepwater Plays Remain Submerged for Private Equity

Several factors make the toughest oil and gas segment a daunting PE proposition, though that could change

The energy sector has been good to private equity, as specialized firms and some of the industry's largest players pumped capital into the North American energy boom of the last decade. Private capital has been part of the deal in oilfields, in natural gas well, pipelines, and energy services companies, and until the oil swoon of recent years, these have yielded rewards for general partners and investors.

But private equity hasn't been much of a presence in deepwater exploration and extraction, the most difficult and expensive frontier of the conventional oil and gas industry. Right now, the combination of low commodity prices, huge capital expenses for exploration and the rigs used for production, and the traditional investment time frames of most private equity funds present prohibitive hurdles. But some industry experts think private equity may be able to play a significant—and profitable—role in future deepwater investments.

Deborah Byers, managing partner for EY's oil & gas practice, sees a role for private equity emerging, based on a combination of ongoing energy demand, cyclical increases to oil and gas prices, and a looming wave of divestment and consolidation in the industry.

“One of the things that's been happening in the industry is that there have been cutbacks on service arms, areas like logistics, supply, and research and development areas, which are going to get cut along with some asset divestitures,” she says. “That will give private equity an opportunity to position itself for when deepwater does come back. And eventually, it will have to come back.”

But under current market conditions, many experts see a fundamental mismatch.

“It's tough for private equity for a couple of reasons,” says Steve Straty, Head of Energy Corporate Finance at Jefferies & Company, an investment bank. “It's expensive, and the lead times don't really fit with the general private equity model. That's often a three-to-five-year investment horizon, and many of these deepwater projects are really long-term undertakings.”

For that reason—and project costs that average between \$25 million and \$75 million per well, as much as five to 10 times the cost of a single well in the Permian Basin, and around \$650 million for an offshore rig—deepwater exploration and production has generally remained the province of the energy majors and a few specialized independent operators.

Private equity backing for offshore exploration and production has generally been in shallow and mid-depth projects in the Gulf, says Allen Brooks, managing director at PPHB, a Houston-based investment banking firm.

“Deepwater is one of the most expensive and challenging technical areas of the energy sector,” he says. “You're either all in or you're not, and a lot of people would rather not be in.”

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Specialists' Successes

There are some notable private-equity-backed deepwater ventures, even though the odds of success are daunting: Industry estimates suggest that only 15 percent of deepwater projects that get launched eventually produce enough oil and gas to be commercially viable. Successful entrants include Talos Energy, an independent offshore operator founded with backing from Apollo Global Management and Riverstone Holdings, and Ridgewood Energy, both of which operate deepwater projects in the Gulf of Mexico. Talos in November merged with Stone Energy Corp. to go public, combining its deepwater expertise with Stone's shallow and mid-draft capabilities.

Venari Resources, an independent deepwater oil exploration and production company also operating in the Gulf of Mexico, received \$2.4 billion in two rounds of funding from a group of private equity heavyweights that included Warburg Pincus, Kelso & Company, Temasek, The Jordan Company, BlackRock Private Equity Partners, and GIC, Singapore's sovereign wealth fund.

These are still exceptions to the rule. Brooks, says deepwater success doesn't happen quickly. Even the longest-running private equity funds are out of sync with the basic phases of deepwater projects.

"Look at deepwater offshore, it's often a 10-year time frame from the initial discovery and drilling to production, and that's past the lifespan of most funds," he says. "You have to have a true explorationist's mindset to be a private equity firm in this space, and not a lot of firms have that."

Because deepwater represents nearly half of all global offshore production, about 12 million barrels a day from a total of 25 million barrels a day, it remains a vital part of worldwide energy supplies. It's also one of the final areas where large reserves could still be proved.



Coming Consolidations?

While the deepwater segment remains at a low point in the energy price cycle, the industry will turn its focus back to it, most likely after some significant rationalization and contraction, says Byers. A recent report from the law firm Haynes and Boone noted that offshore oil drilling and service companies dominated energy sector bankruptcies through the end of October, with an \$8 billion filing by offshore services company Seadrill Ltd. clocking in as the largest bankruptcy of the year to date. Rig and drillship operator Ocean Rig UDW filed for bankruptcy protection in March with \$3.6 billion in debt, followed in November by Pacific Drilling, which filed with \$3.2 billion owed to creditors.

Byers says the amount of distressed debt accrued by distressed deepwater drillers and services firms has not yet been washed out of the system, which creates ripe conditions for strategic consolidation.

"That, is where I think there'll be areas where private equity can find a niche to play and potentially look at pretty good returns starting in 2018, 2020," she says. "I am optimistic about deepwater and offshore in general for two reasons. One is just that we need to open up new horizons because we have to, even if demand is flat, and continue to make investments to meet demand on a global basis. Secondly, cost curves have come down tremendously in deepwater operations. Much more so than may be obvious to the general public."

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Ripples on the Surface

Dan Pickering, chief investment officer of the energy-focused investment bank Tudor, Pickering, Holt & Co., says industry trends support lower costs, as overcapacity means the rigs that are being used have slashed rates simply to keep operating. But he also notes that many exploration and production projects are starting to aim for higher levels of standardization, one avenue to the less-obvious drop in costs Byers observes.

The wave of bankruptcies and companies verging on bankruptcy raises the possibility of a private-equity-led move to take a troubled company private, but high levels of debt among potential acquisition targets and the relatively short investment horizon for most private equity firms remain obstacles for any possible deal. Pickering sees little evidence of a near-term trend to consolidation or divestment that could attract private equity investors.

“Nobody seems willing to sell out at the bottom, so it’s more a situation where projects are just not happening, rather than getting sold,” he says.

He shares the general view that private equity forays into deepwater projects will be done by specialists, or with backing from the very largest firms. Should there be a pickup in private equity’s role in the deepwater sector, he sees the exploration phase as more promising for those backers than the long run-up to full production.



“Drilling three \$30 million wells is probably easier—and I’m not saying it’s easy—than pulling off a \$5 billion complete development project,” he says.

International deepwater exploration may hold some promise for particular private equity players, but Pickering says they’d have to be specialists, steeped in both technical expertise and the ability to operate in areas with high degrees of political risk and logistic complexity.

A more promising entry point for private equity firms seeking a piece of a resurgent deepwater sector would be finding specialty equipment makers that need deep-pocketed investors.

“There could be a real need for a valve or a completion tool, and the manufacturer could grow with the backing of a private equity sponsor,” he says.

Byers sees changes happening as the energy industry grapples with low oil and gas prices, and believes the general trend will eventually create conditions where private equity firms can balance the costs, risks, and potential rewards of deepwater investing. The low oil price climate has forced efficiency and cost-cutting on every segment of the industry, and cost curves have dropped sharply for deepwater operations.

“Some of this is transferring technologies, methodologies, that the companies have learned from [shallow-water and mid-depth] offshore operations, but some of it is just being leaner and meaner,” she says.

Private equity’s great strength is making companies more efficient, removing costs from both operations and supply chains. While the deepwater segment of the oil and gas industry poses greater challenges than many other sectors in which private equity has thrived, Byers sees conditions improving for closer alignment.

“All of that discipline is finally coming to fruition,” she says, “and is going to be moving into the deepwater.” ■

Deepwater Rising

Deborah Byers
Managing Partner,
Oil & Gas Practice, EY



An oil and gas veteran sees increased dealmaking in a market long shunned by private equity

Privcap: How have private equity investors regarded deepwater in recent years?

Deborah Byers, EY: The darling, as everybody knows, has been the unconventional. So with deepwater, the traditional wisdom is that you need \$80-plus oil to make deepwater work. You have these next-generation rigs, which are not cheap—half a billion dollars is an entry point. So it is a huge barrier, both for the capital intensity, the debt on the balance sheet, and, again, there was better investment that's been realized, certainly in the Permian, for example. That's been where everyone is rushed. So it has not been a focus.

Do you disagree with the conventional wisdom on deepwater break-even economics?

Byers: I absolutely disagree. This is why we're looking at deepwater as a potential area for investment—both because there will be a rationalization in space and, secondly, because costs have come down. I think several of the big operators are touting that they can operate competitively, potentially targeting that \$30 to \$40 sweet spot. That's the cost, so everyone is looking at cost takeout and transferring some of the efficiency gains they've seen onshore to offshore. And that starts to change the game. So if you're focused on being able to operate in deepwater—whether it's Brazil or the U.S. Gulf of Mexico—it starts to become very attractive.

Why do you expect consolidation in the space?

Byers: If you look at the natural cycles of M&A, when you have overcapacity and they start to fix their balance sheet because they need to be more cost-competitive, the natural next step is consolidation. That allows excess capacity to come out of the market. Frankly, you've seen some bankruptcies happening now with the large deepwater players with recent filings. That in itself will take capacity out of the market. But I think we've got probably another year before that occurs.

“They can operate competitively, potentially targeting that \$30 to \$40 sweet spot.”

—Deborah Byers, EY

Beyond the Gulf of Mexico, how is offshore Brazil looking as a deepwater play?

Byers: I'm going to say something surprising, which is that I think they're equivalent at this point. Other than the fiscal regime, as well as the potential geopolitical uncertainties surrounding Brazil—if you set that aside, in terms of the economics and attractiveness of those basins, I think they could be equivalent to the right operator. ■