

## Private Equity, Energy, and Resources: How the Leopard Has Changed Its Spots

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In recent months, private equity groups increasingly have signaled their intent to be material players in the ongoing consolidation in the global economies of energy and natural resources. The appeal of cash flow and increasing multiples in the sector have, for the present, eliminated doubts and fears that private equity has held on the vagaries of commodities prices. This is seemingly the case across myriad commodities including base and precious metals, alternative energy, and oil. Somewhat surprisingly, private equity also appears to be taking its first cautious steps across emerging and developing technology plays in biofuels and biomass and into such areas as coal to liquids. This increased appetite for investment and development across the sector is arguably a departure for private equity and may signify a paradigm shift in risk tolerance and investment strategy.

Traditionally, private equity groups have been acquisitive from the standpoint of securing opportunities for value creation. This is often demonstrated most visibly in situations in which a private equity firm is presented with an opportunity to invest in superior management opportunities and, in particular, situations where capital availability had been constrained. Private equity, however, has been somewhat reluctant to direct its investment toward commodity plays, especially mining and energy, given the perception that commodity-price volatility and industry operating costs made for a difficult investment scenario. Private equity has seen the commodity play as being fundamentally at odds with its accepted investment approach—to undertake investment, restructure business opportunities, enhance operations, and exit or refinance the opportunity across a short to medium time frame.

The exit strategy for private equity within the constraints imposed by commodity-price cycles always has been difficult to balance. This is a direct consequence of the fact that an investment in a mining company or an oil play is often a longer-term play across the commodity-price cycle, which is an investment during the extended period of mine or oilfield exploration, development, and extraction. This requires patience and a long-term view on the investment and risk/return profile, which deviates from current private equity investment strategies.

### Unprecedented Consolidation

What has caused this changed behavior and increased sector commitment? The answer, in one word, is *consolidation*. Across the energy sector, which includes mining, oil and gas, alternative energy, alternative fuels, and utilities, for the past several years there has been an unprecedented wave of consolidation activity in a flight to quality. Many of the world's larger energy companies have diversified their commodity and geographic footprint in an effort to derive market strength and economies of scale.


Growth through the current commodities-price cycle has been directed through acquisition, as opposed to exploration and development; in many cases, this growth has been supported against a backdrop of sustained higher cash flows and commodity prices. Global energy companies have leveraged this cash position into accelerated growth.

There is strong evidence to affirm that the cash flow strength has begun to attract private equity. The expectation, however, is that private equity will cautiously continue to approach the energy sector, aligning itself strategically with recognized industry players with strong and sustainable competitive positions.

Private equity is further attracted to the energy space given the strong trend in merger-and-acquisition activity, which has demonstrated a drive toward increasing multiples in Europe, Asia, and, in particular, the Americas. According to analysis conducted by KPMG, there is a high degree of confidence in the future of merger-and-acquisition activity, with strategic buyers remaining more bullish than private



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equity firms. The analysis suggested that 67% of strategic buyers believe that merger-and-acquisition activity will increase, with only 4% expecting a decrease in activity in 2008. Private equity is only moderately less bullish in its expectations—58% believe that mergers and acquisitions will increase, while only 1% believe that near-medium-term activity will decrease.

Key drivers in merger-and-acquisition activity and private equity's role include the relative and absolute decline in the value of the US dollar. The devaluation of the US dollar has many ramifications, specifically a correlation of its decline with an increase in dispositions of US assets and acquisitions by foreign buyers.

A compelling case for energy investment by private equity is driven by the availability of money. According to Thomson Financial, US private equity raised a record amount of money in 2006—some 322 funds raised more than USD 215 billion. This total has translated into growth in buyout and mezzanine fundraising activity in the vicinity of 251% over the period 2003–2006. In 2006, USD 127 billion in new money flowed into the hedge fund industry, nearly tripling the USD 47 billion in 2005. Hedge funds have been aggressive and creative in their entry points and are now significant players in mergers and acquisitions, especially in the middle market.

Investors in the energy space have generated significantly deeper pools of investment capital to deploy in the space. At the same time, they have significantly enhanced their intellectual capital. The emergence, development, and commitment of an experienced investor class with a background in energy,

including Natural Gas Partners, Quantum Energy Partners, and GE Capital, has elevated the interest in energy and natural resources investments and provided a significant investment impetus to the development of greenfield and brownfield projects. The core energy expertise of these investors is expected to drive a continuing round of development as well as merger-and-acquisition activity.

The changing paradigm is demonstrated clearly by the successful ethanol development originated and executed by Americas Strategic Alliances through ASAlliances Biofuels. The ASAlliances venture was announced in December 2004 and represented the assembly of a world-class group of investors, operators, and strategic partners. ASAlliances arguably represents a road map for the future of private equity in the energy and resources space. This transaction matched up Cargill, an agricultural and industrial products major; Fagen, a leading design, engineering, and construction firm; and United Bio Energy, a leading ethanol operating and service company. In June 2007, Verasun Energy agreed to buy three ethanol plants from ASAlliances Biofuels for \$725 million for a sum total of 330 million gallons per year in ethanol production capacity.

### A New Paradigm

Is this the new investment strategy for private equity? Are these strategic alliances that will ameliorate risk while still providing the upside with equity return? The reality is that the game has not fundamentally changed, nor has the outcome. The private equity play is still to execute a relatively quick entry and exit while generating a material return for the risk undertaken. What appears to have changed is that the players have more money, they are more sophisticated investors, and they are willing to “play ball” with strategic entities as partners of choice and convenience.

But a level of caution must be maintained. While private equity companies have traditionally sought and may continue to seek leverage plays, debt capitalization ratios are increasing. Purchase prices witnessed in current and recent transactions as well as associated leverage levels are at their highest points over the preceding decade. The clear ramifications for increasing leverage situations are the potential for greater default potential. However, the expected rate of default for US speculative grade debt remains well below historic average levels. A good deal of this relative strength remains supported by current higher commodity, fuel, and energy prices. The warning signs are clear: With increased leverage levels, Standard & Poor's predicts an increase in default rates in the coming months.

What can be described as irrational market exuberance should temper in 2008 toward manageable and sustainable growth patterns. The need for private equity to fuel growth in energy- and minerals-company consolidation remains significant. The opportunity for value creation among the energy plays for the patient and consistent investor remains significant, as there continues to be strong sustainable support for commodity prices. However, it equally requires a fundamental shift in the investment approach, time horizon of investment, and investment return expectations.

The successful model for private equity in energy investment is for a strategic tie-in and the potential for exit through divestiture of noncore assets. The growth path should not come at the expense of materially higher leverage positions for the energy companies.

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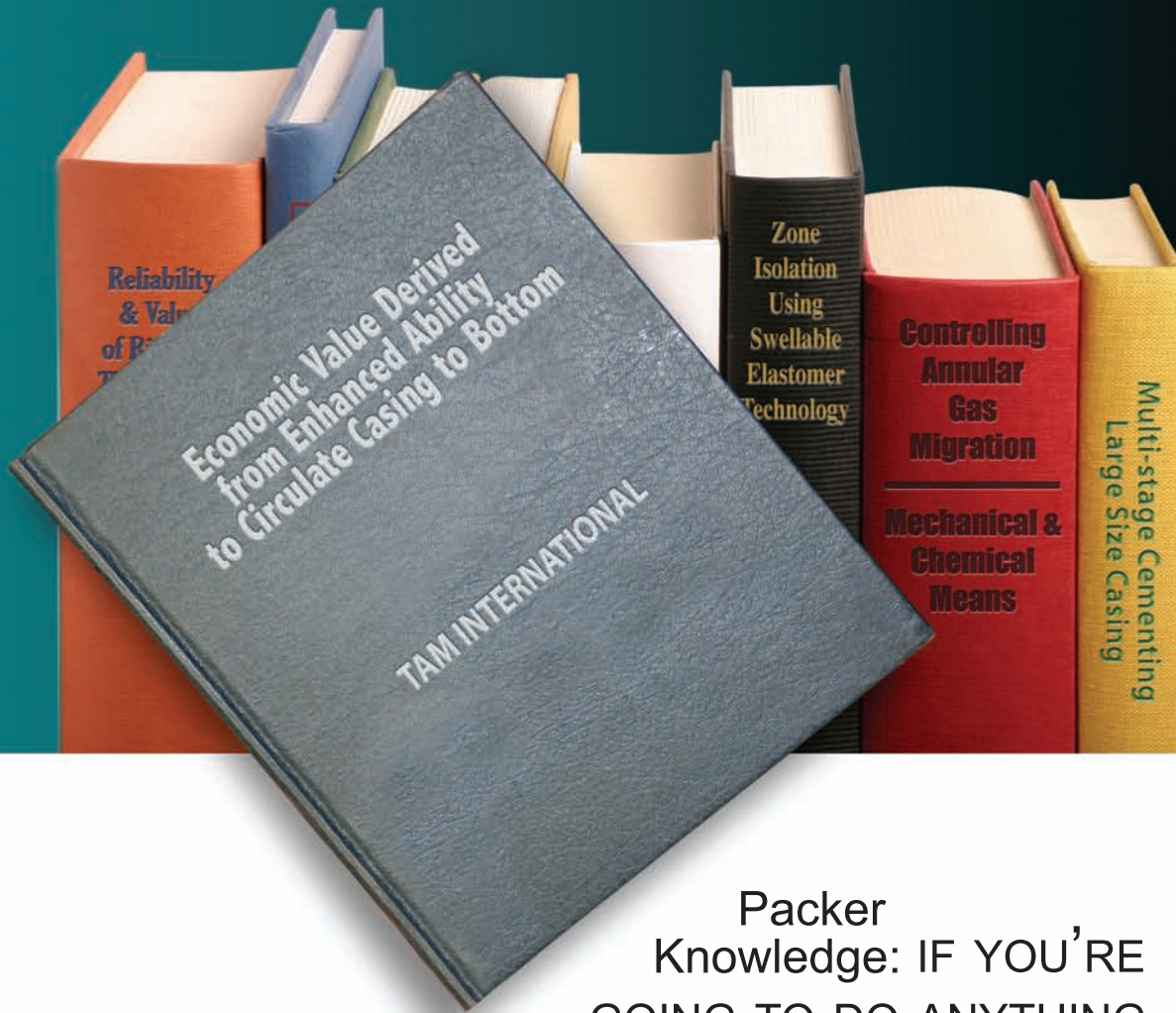
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