SECONDARIES

Stronger pipeline

After a tough couple of years, energy secondaries prices have shown signs of bouncing back in 2017. Rod James looks at the drivers behind the recovery and where the investment opportunities lie

Over the past 18 months, the direction of the energy secondaries market has been subject to as many dodgy predictions as crude oil prices themselves. Every time a recovery looks to be on the cards the same stubborn problems persist, weighing down the performance of the asset class.

The collapse in oil prices during 2015 caused energy asset values to plummet, burning the fingers of many investors in the primary and secondary markets. Eventually an environment of relatively low but stable oil prices formed, but so did a persistent mismatch between the expectations of buyers and sellers in the energy secondaries market. Buyers wanted big discounts and sellers, though often keen to divest, weren't willing to take that big a haircut.

Since the fourth quarter of 2016, and at risk of making another bad prediction, the market really does seem to have turned a corner.

According to secondaries advisory firm Setter Capital, the average top price of the asset rose from 87.59 percent of net asset value to 89.41 percent between 31 May 2016 and the same period a year later. This is still well below the 95.17 level recorded on 31 May 2015, but a welcome recovery nevertheless. While this increase is certainly helped by the low baseline of 2016, the recovery appears to be built on good fundamentals.

"Although there are still a number of energy funds and GPs that have not fully recovered from the 2016 energy downturn, on a blended basis, pricing for this sector is up 2.11 percent between May 2016 to May 2017," says Maria Chateauvert, senior analyst at Setter Capital. "The uptick in pricing is mainly attributed to a rebound in commodities pricing and a stronger buyer demand, partly caused by a lacklustre 2016."

Stronger buyer demand is partially driven by a changing attitude on the part of sellers. According to one source on the buyside, some less sophisticated buyers have realised that energy stakes are especially difficult to price and require a strong understanding of the actual assets that underpin the stake. They also realise that the lower oil-price environment is here to stay. As a result they are dramatically shrinking their positions or withdrawing from the asset class completely, and now are willing to do so at a discount.

"I assume there are some institutional investors who will get out and not come back," the source says.

LAGGING VALUATIONS

The effects of the commodities slump are still clear, particularly in the upstream. There are a lot of assets with too much leverage or high exploration costs, particularly in the North American unconventional energy space such as shale gas which depends on oil prices of $60, $70 or $80 per barrel to be remotely viable.

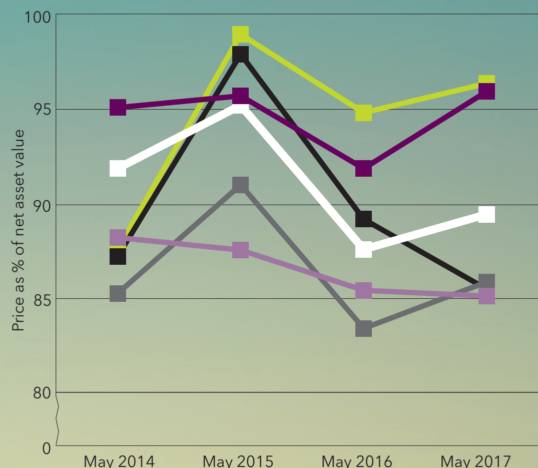
But amid this, the rising oil price and withdrawal of sellers is leading to the emergence of some high-quality fund stakes whose valuations have not been updated to reflect the positive new environment.

According to Fabrice Moyne, a partner at Mantra Investment Partners, some companies in the oil and gas downstream have seen an appreciable improvement in profits and EBITDA since the fourth quarter of 2016. The greater pricing power of these firms is also helping drag some upstream firms out of the doldrums as demand increases at one end of the chain spur production at the other end.

"Most of them had ugly 2016 numbers so the decent ones, which don't have too much debt, should have good numbers to show in 2017," says Moyne. "If oil prices

HOW ENERGY SECONDARIES COMPARE

Energy secondaries are recovering after falling sharply following the 2015 oil price slump. The chart illustrates the average top price that a secondaries stake sold for as a percentage of net asset value across a range of fund types



Source: Setter Capital

- LBO
- Fund of Funds (PE)
- Secondary (PE)
- Energy
- Real Estate
- Infrastructure

don't drop again in 2018, it should look quite bright. For good services companies that have been marked down quite a bit, this is a very good time to buy, even at a small discount."

A source with an interest in the energy secondaries market feels that valuations are already catching up with improved market conditions, and that the window to strike might be closing.

"Last year we would be buying what we liked at 80 or 90 cents on the dollar," he says. "But with the improvement in commodity pricing, and because these reference dates are at least six months or potentially nine months old, by April those assets had been written up in value so our effective discount had been wiped out."

> **Energy, partly as a result of commodity price volatility, had created an environment with dislocated values**
>
> Kevin Warn-Schindel

A MARKET FOR SPECIALISTS

The market for energy secondaries seems to be dominated by groups at both ends of the spectrum: the largest funds, with their aggressive cross-sector approaches and huge resources to put into due diligence, and the small energy specialists seeking bargains in the mid-market. What both have in common is the expertise required to see value in assets that are so difficult to price.

The past year has also seen the emergence of infrastructure funds with a strong energy mandate such as Ardian's $1.5 billion ASF VII Infrastructure, which reached first close at $700 million in March 2017. Then there are real assets funds such as HarbourVest's Real Assets III, which closed in April on $366 million, and aims to combine the different types of upside that various classes of real asset can produce.

"You have a dynamic in real assets where core infrastructure, because of low interest rates among other factors, is fully valued today," says Kevin Warn-Schindel, managing director at HarbourVest. "And energy, partly as a result of commodity price volatility, had created an environment with dislocated values and in some cases a degree of distress.

"If you can buy into exposure to these assets at a discount to net asset value then you're able to capture some of your return not necessarily from future value uplift, but as part of the purchase price discount. That is a component of our thesis for the strategy and investors awarded us with allowing us to manage their capital."

As long as energy prices remain on a steady path, the energy secondaries market is likely to continue on the road to recovery. But the number of travellers is likely to be lower and their focus more specialised. ■