PEI Alternative Insight
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June 19, 2018: Energy secondaries on the rise.

Energy secondaries have been a promising play over the last few years. Around $115 billion was raised by direct private equity funds focusing exclusively on energy since 2012, according to *PEI* data.

With many of the GPs active in the space having mixed track records due to macroeconomic volatility and commodity price fluctuations, opportunities for secondaries buyers abound. As one advisor puts it, anyone who has been around for many years is going to have some kind of chequered history. "It's a little hard to have dodged all the bullets," the advisor says.

Evan Corley, a partner and senior investment professional in Pantheon's global infrastructure and real assets team, says one driver of dealflow this year has been portfolio management. Institutional investors are either reducing allocations to energy because they have been disappointed with performance over the last four to five years, or they are so-called "green sellers" – groups such as US endowments and foundations which want to reduce their fossil fuel exposure.

"These are complicated assets with unique risks," Corley says, adding that sales from green sellers have been moderate.

With Brent crude on the rise, hitting $80 a barrel in May, buyers have been willing to pay more for stakes in energy funds. Average top bids or indications for fund interests in the strategy bounced back to single-digit discounts after at least two years of double-digit discounts in the 90 days to 28 February, according to data from intermediary Setter Capital.

The rebound in oil pricing is allowing buyer and seller expectations to better align, according to Corley. "For a period of time after commodity prices declined, there was a large bid-to-ask spread between buyers and sellers which corresponded with low asset values and low commodity prices," he says.

Spreads collapse

Sellers anticipated commodity prices would recover and expected bids to reflect that, leading to some sellers wanting at least par bids on their assets. While oil pricing hasn't fully recovered, the rebound has led to an increase in closed dealflow which was aided by bid/ask spreads collapsing, Corley adds.

Deal volume in the strategy remains low, accounting for just 2 percent of the $48 billion traded last year, down from 6 percent a year earlier, according to Campbell Lutyens' 2018 Secondary Market Overview Report.

One issue stymying deal volume is the tax complication some buyers face when looking at US oil and gas assets. The Foreign Investment in Real Property Tax Act means dispositions of some assets are subject to US tax even if the seller is a non-US person. Coupled with US tax reform in general, getting involved in oil and gas deals simply isn't worth it for non-US buyers unless they are buying downstream assets, says Fabrice Moyne, head of secondary investments at Paris-based Mantra Investment Partners.

Market participants are optimistic about GP-led secondaries transactions, in which managers use the market to restructure funds or address issues within their portfolios or LP base.

Corley says he has seen a meaningful increase in the number of GP-led opportunities over the last three years and that such transactions are becoming an important part of dealflow.

While these deals can be attractive for buyers as they're generally less competitive, they're inherently riskier than other deal types. Buying a diversified portfolio of energy fund interests comes with a natural hedge, particularly if the underlying fund assets play along the broader energy spectrum of upstream, midstream, downstream and services, compared with a GP-led deal which may involve three to six assets from a sole manager, says Philip Tsai, global head of secondaries advisory at UBS.

"The question for certain deals [becomes] how much of a crystal ball do you have for where oil prices need to go or not fall below for your investment to work out, and are you just making a commodity price bet?"