FINANCE

Managing investment

***Bob Maguire*, Managing Director, Carlyle International Energy Partners, will be speaking about how best to manage investment in a low price environment during day one of IP Week, on 21–23 February 2017.**

How much appetite do financial institutions have for investing in the oil and gas sector during a time of low prices?

There first has to be a directional view on oil price and activity levels in the coming five to 10 years – or at the very least, conviction as to the health of the sector and areas of opportunities. Ultimately, if an investor believes in an oil and gas price recovery, there are currently a number of near-term opportunities through the value chain. Longer term strategies may also manifest themselves in the coming quarters.

An institution's investing experience will also play a big part. In the last cycle there have been situations where buyers overpaid, over-levered or mismanaged the business and, therefore, found themselves nursing losses or lost their investments entirely. Institutions that have been 'burnt' may be less willing to commit in this new environment, driven partially by their investors' concerns, but also due to lower conviction.

Finally, the geographic spread of opportunities versus sources of capital is also likely to play a part and potentially temper activity levels. Traditionally North American-focused institutions (the largest independent investors) may find it more difficult stepping out and chasing opportunities in international markets. Conversely, outside of North America there is the need for new capital as well as an array of additional opportunities.

What do you see as the key investment opportunities – be it technologies, sectors, regions – in the next five years?

In the upstream I would group them into three main categories: (i) majors or large international oil companies (IOCs) disposing of non-core assets or portfolios for portfolio/strategic rationalisations; (ii) consolidation strategies in regions such as Africa, Latin America and parts of South East Asia; and (iii) distressed sales of both assets and corporates – in some cases pursued directly by lenders or debt to equity owners. Asset opportunities exist in exploration, appraisal, development and production stages, so it's a question of the investor's appetite for risk and desire for exposure along the value chain. It's true that exploration, appraisal and development has become relatively 'cheaper' given the downturn in the services space, so you can do more for less or even double down in exploration activities for example.

On the technology side, the low oil price environment is forcing operators to seek more efficient solutions, so there's a place for new technology or concepts. The difficulty is industry take-up – upstream companies are not known for being early adopters of new technologies with lengthy and stringent qualification requirements.

How do you see the financial markets evolving going forward?

Equity capital markets remain volatile and uncertain, partly due to the lack of near-term visibility on commodity prices. Company business models are being tested with varying degrees of success, but not without cracks appearing. It is probably also the case that the market has yet to fully factor in longer term trends, as well as a degree of apprehension to see how the various subsectors shake out following this period of low oil price. From a fund raising perspective, only the highest quality issuers are likely to contemplate equity raises. However, pricing is likely to be punitive to compensate investors' returns expectations.

Debt capital markets throughout the subsectors remain subdued again on the back of oil price uncertainty, but perhaps more meaningfully as a result of RBL (reserve base lending) redeterminations, write-downs taken by banks and bond/structured debt holders taking haircuts, restructurings or outright bankruptcies as a result of the downturn. Lending appetite, therefore, remains patchy – with high quality credits finding demand, whilst lower quality credits are having to resort to direct/structured lending routes (eg mezzanine-type structures) or expensive loan deals. There is a possibility that debt markets will start to open as the oil price stabilises and as cost cutting and cashflow management begins to have a more material impact on corporate profitability.

Should investors be looking to diversify their portfolios in the future; and how can they best mitigate risk in a low-price environment?

This will heavily depend on the investors' strategies, current portfolio mix and risk appetite. A diversified portfolio can provide protection from downturns. However, if you are talking about an oil and gas portfolio you will always be exposed to commodity price risk (either directly through exposure to production or indirectly through the value chain). In terms of mitigating low-price environment risk, a well-conceived hedging strategy could probably go a long way. However, if an investor believes that we are in the trough, then be mindful of missing out on any price recovery. ●