Q&A | OCTOBER 2023

Spotlight with Evan Smith: Family Office Activity in the Energy Space

Evan Smith, Senior Vice President in Stephens' Energy Investment Banking team, recently spoke on the Capital Access: Private Equity panel at the Hart Energy Capital Conference 2023.

He shared insights along with Billy Quinn, Founder and Managing Partner of Pearl Energy Investments; Frost W. Cochran, Managing Director and Founding Partner of Post Oak Energy Capital; Brooks Despot, Director at EnCap Investments; and David Elder, Partner at Akin Gump Strauss Hauer & Feld LLP. Here are the highlights of Mr. Smith's insights.

Have you seen participants other than private equity sponsors enter the space to fill the void left by some of the larger institutions that have exited or reduced their activity in the energy space?

In 2017, Stephens launched our Family Office Coverage practice, which operates alongside our Financial Sponsors Group. This dedicated team covers family offices and keeps a database on which industries each family office is focused on, their investment parameters, and their typical funding levels. Stephens covers more than 350 families, with the typical family funding between $20 million to $200 million per transaction.

A significant number of family offices have entered or are seeking to enter the upstream space through direct investments, as larger institutional capital sources have exited. These deals can feature a variety of structures, such as buying a non-operated working interest directly from an operator, investing a minority corporate equity position in a sponsor-backed business, pursuing development exposure at the wellbore level for tax benefits, or facilitating management-led buyouts.

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I've spent a considerable amount of time this year working on transactions in the upstream space involving family offices. This year, Stephens has completed several capital raises involving family offices as well as a management-led buyout from a private equity sponsor that owned an oil and gas landfill business. We remain active on a number of new engagements and potential engagements involving family offices and expect that activity to continue well into next year.

In addition, the sector has seen several prominent family office deals announced, including the Rockies natural gas producer PureWest Energy completing an all-cash merger with a new entity sponsored by a consortium of family offices and financial institutions for total consideration of $1.84 billion.

What are some of the similarities and differences of those participants as compared to private equity? What type of deals are each of these groups targeting?

Family offices have become highly sophisticated investors, and often hire investing professionals from private equity or buy-side firms. This is just one reason why family office deals increasingly resemble PE deals. We see family offices having similar return expectations to private equity, yet family offices may be a bit more passive than PE firms, generally speaking.

Major investment priorities for family offices encompass achieving a three- to five-year payback period, having downside protection via hedging and a solid production base with steady cash flow, as well as a strong management team and operating track record. Unlike many PE firms, family offices can hold an asset indefinitely and can be quite flexible in the structure and form of their investment, which is beneficial to management teams.

It has become common for family offices to pursue transactions with sponsor-backed teams, as well as transactions in the minerals or non-operated space. These passive oil and gas investments generally have less capital intensity without heavy general and administrative (G&A) overhead costs.

We have seen some family offices enter the space by targeting secondary basins, where valuations may be reasonable and cash buyers may be less abundant. These areas generally have companies or assets that have recently tested the market (unsuccessfully), yet the assets still may have solid producing cash flow and potential upside opportunities that may be able to be acquired without allocating significant value to those opportunities. Many family offices view themselves as value investors and may view these types of PDP-heavy assets as an inflation hedge and something that could provide them with long-term yield.

Beyond family offices, are any non-traditional or alternative financing structures gaining traction in the space?

Asset-backed securitizations (ABS), volumetric production payments (VPPs), prepay products, and unitranche financing are all in use.

ABS financings were popular last year, with over $4 billion in transaction volume. Volume is lower this year, due to rising interest rates and commodity prices that were lower for much of the first half of 2023. However, the process and timeline for energy ABS transactions has continued to streamline in recent years, which I think could lead to ABS financings being used more for acquisition financings in the coming year.

VPPs and prepays remain active and have historically become more common in higher commodity price environments, where an operator can crystallize value for their production during commodity price highs. Stephens has evaluated several of these transactions for clients in the last 18 months, which are generally in the sub-$200 million range, and found significant interest from counterparties.

We also have been very active in the unitranche financing market during the last few years. This is largely due to the ongoing turmoil in the reserve-based lending (RBL) market, which has suffered since many big banks left the space for environmental, social, and governance (ESG) reasons as well as due to the headwinds oil and gas lenders faced during the COVID-19 pandemic. Therefore, we anticipate that the appetite for unitranche financings and other alternative financings could remain strong.

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