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Quantum's VanLoh: New 'Wave' of Private Equity Investment Unlikely

Private equity titan Wil VanLoh, founder of Quantum Capital Group, shares his perspective on the dearth of oil and gas exploration, family office and private equity funding limitations and where M&A is headed next.

By Deon Daugherty

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When Wil VanLoh tells you an upstream consolidation cycle has been remarkable, you can take it to the bank. He founded Quantum Capital Group in 1998 and has led one of the most successful private equity shops solely focused on energy. The experience has given VanLoh insight that is sought-after by executives and investors alike.

Deon Daugherty: What stage of the cycle are we in for E&P M&A, and then, where does private equity fit in?

Wil VanLoh: We've just gone through one of the largest consolidation periods that we've seen in the industry in a long time. There was several hundred billion dollars' worth of activity last year in deals announced, some of those obviously closed this year. They had to go through approval, shareholder approval and [challenges] with the FTC [U.S. Federal Trade Commission].

Now those companies, as those deals are closing, they're digesting and they're looking at things in terms of, all of a sudden, what was maybe core before may not be core now because of the new large assets that they brought in-house.

There's always a lot of rationalization that comes out of the back end of that. And then I think, there's tens of billions of dollars of private equity-backed companies that were not able to get liquidity in the early part of this decade and now they're at a point where they can, so they're looking to sell as well.

At least from our perspective, it's probably the most buyer opportunistic market we've seen in a long time, a lot of sellers.

If you go back and you look at that decade of the 2010 to 2019, there was something like $24 [billion], $25 billion a year raise for private equity funds to invest in the space. And over the last five years, that's been like $2 [billion] to $3 billion a year.

What you've seen is just this massive contraction in terms of institutions, large pension funds, endowments and foundations, and other kinds of financially oriented firms, sovereign wealth funds [that] have all meaningfully pulled back on the capital that they're putting to work in the traditional energy space. As a result, there's a big need for capital privately.

DD: Are companies living within cash flow now?

WVL: When the industry collapsed in late '14, early '15, over the next two or three years, this new kind of set of rules was kind of pushed upon the public companies where they had to live within cash flow.

Now, they're not just barely living within it. Most public companies are probably only spending about half their cash flow and they're sending the other half back to shareholders through buybacks and dividends.

And so, you've got a really interesting situation here where most public companies now have well-delineated acreage. They can just run whatever rigs they want to run on that acreage and they're going to be able to deliver very consistent, predictable results to the public shareholders.

That's a pretty good formula for the management companies to make sure they always hit their targets and get their bonuses and that their stock keeps going up every year.

DD: What does that mean for exploration?

WVL: The incentive for public companies to drill outside of cash flow or take a lot of risk in terms of trying to push the boundaries of plays is not really there. They've got plenty of inventory and at least decent acreage. It may not be core acreage but it has predictable results, and that's what the public shareholders are after.

The public has demanded that this capital discipline take hold amongst public companies and the public company boards and CEOs have responded to it. And there's kind of a compact now between the public investors and the public management teams. They're not going to take those kinds of risks they took in the early days of shale.

So, as these shales mature and the cores of the good plays get drilled up, the question really is: Where is that next wave of innovation going to happen? There's very little exploration going on, not only in the U.S., but I'd even say globally.

The majors have all pulled back massively from exploration and so have the public independents. I do think that we need well-funded private companies, not only to make the food chain work as the publics [companies] divest of the stuff that's not core to them—private companies are logical buyers for that—but we also need private companies to continue to innovate and do the things that private companies do better than the publics.

There's a lot of things that publics do better than privates, but I do think on innovation and pushing the envelope, privates seem to be a little better at that. And so we absolutely need capital to fund those endeavors.

DD: With a smaller pool of private cash out there, what does that do to access? Will these companies be able to emerge if there is 85% less than what we had 10 years ago available to them?

WVL: No.

DD: So how do they get started?

WVL: Well, I think you're seeing a lot of the one area that I call the bright spot, if you will, for capital in the private sector is family office money.

But to be fair, the family offices are looking at it and saying, "Hey, I can buy producing cash flowing assets at relatively high discount rates?" So instead of paying PV [present value] seven or eight for PDP, which we used to have to pay, you can pay PV-12 or 13 or 14 so I can get good yield and it's some good locations that go drill with that cash flow.

The family offices, at least that we've seen, are not so much interested in doing things that are innovating and pushing the envelope. They're just interested in making good cash flow investments and investments in producing assets that are cash flowing a lot. And they're not as interested in reinvesting in those assets and certainly not really interested in trying to find new plays or extend the productive fairways of existing plays. They're really more interested in just mining those cash flows and taking big dividends.

So, while there is a lot of interest from the family office community and the high net worth family office community in oil and gas, it's not the same kind of capital that was available five, 10 years ago that was the genesis of many of the early shale successes.

Now, to be fair, I do think the shales are obviously matured and we found the big ones. Are we going to find another Midland Basin or Delaware Basin for oil? Probably not. Are we going to find another Marcellus for gas? Probably not.

DD: Where is the growth opportunity set?

WVL: There's a lot of reservoir in the United States that has not had modern technology applied to it. Our general feeling is there's a lot of reservoir that may not even be shale or maybe just kind of conventional reservoir, but that was back in the days when we were developing conventional reservoirs. It was the inferior stuff that never could get developed using the technology and the commodity prices during that period of time.

In shales, we have developed these horizontal wells, we have developed these massive fracks, and we effectively created artificial permeability and porosity. That's what made those reservoirs give up hydrocarbons and economic quantities.

Well, those same technologies can be applied not only to higher quality rock, but the lower quality conventional rock, if you will. And we're seeing that on lock reservoirs that, back in the day, 10 [years] or 20 years ago, no one would've developed them because we didn't have the technology and we didn't have the commodity prices that the levels are at today to make them economic. I do think there is another wave of innovation that can happen in the United States that the privates can lead, and that's going to be taking the technologies we developed in the shales and applying those now back to some of the lesser quality conventional reservoirs.

DD: When we think about this new set of private companies that will emerge, when do you expect we'll start seeing them make announcements and we'll actually be able to quantify the wave?

WVL: I don't know if it'll be a wave. That's the problem. We need a wave, but there's so little capital involved that is available to the industry today.

I think it'll be very selective. There are only really a couple groups like us left out there that have access to meaningful capital. And we've all got our existing slate of teams that we will likely re-up with. Both of those teams I mentioned to you are re-ups that we've backed prior and sold out and are back in business with them. But then again, there will be some new people that come out and they will get backing. There just won't be near as many. I don't think they'll get backing as in years past. So, I don't think it's going to be a wave, unfortunately. But the really good teams, I'd say the competition for private capital is probably greater.

DD: As we go forward and these teams mature, develop the innovation needed to bring down cost and to drill into the fringier areas, is it the start of a new cycle? Will their success bring more capital back to the space so that other companies can get started?

WVL: I think that's a fair conclusion, that success does beget success. In a world where returns across most sectors globally are going to be very challenged over the next decade, I do think that the returns that oil and gas companies will be able to generate over the next decade are going to be some of the highest in the world.

I do think a lot of capital left the sector for two reasons. First and foremost, it started leaving the sector in 2014 for one simple reason, which was the industry was generating very poor returns, both public companies and private companies. And you can go look at the average return on capital employed of public companies during the 2010 decade and kind of pre-shale, it was kind of mid-teens. And very quickly, once the shale started, it went down into the low single digits.

It went from say 13% to 15% return on capital down to about 2% to 3% for most public companies.

The same thing happened for private companies. Private companies went from making probably mid-20s returns on their equity to single digit returns on their equity on average.

As a result of that prolonged underperformance at the same time when most sectors in the S&P were doing very well, capital fled both public companies and private companies because they could get better returns elsewhere.

And then in the latter [part of] the last five years, that was compounded by this whole ESG climate change scare, when a lot of investors just said, "Not only are the returns poor in this space, but there was also this whole ESG movement and this whole divest of hydrocarbons movement," which I now think people are realizing was not a very smart move.

If you care about climate change, if you care about ESG, there's no better place to invest in hydrocarbons than in the U.S. and Canada and behind the European-based companies because they're much better on the E, S and G. And divesting will do nothing to change global demand. The question really is not should we divest, the question is should we use our capital to influence and make the most ESG-progressive hydrocarbon country in the world, the United States, even better, and get hydrocarbons that have better ESG scores? The only place you can do that is U.S. and Canada and companies run out of Europe.

The combination, though, of bad returns and the ESG scare caused a lot of investors to leave the space. And now that the returns are coming back, investors are having to go, “Well, yeah, I still may have some concerns around climate change and ESG, but I understand the issue a lot better. And I understand that my not investing in hydrocarbons in the U.S. is actually going to make global greenhouse gas emissions worse because U.S. companies have the lowest greenhouse gas emissions of any hydrocarbon-producing country. And so, maybe I should look at oil and gas again.”

To your point, I think that if the industry continues to maintain its discipline, more capital will come back. The problem is, as more capital comes back, the cycle starts all over again.

The sentiment driving investors’ actions in investing or not investing in oil and gas over the last decade has been fear. And I think as returns get better, greed will start to drive investors’ actions. And as greed starts to drive investors’ actions, they’re going to get more aggressive and that, by its very nature, will push returns down because they will make investments under more aggressive terms, which therefore means they’ll get lower returns. And as the cycle starts all over again, at some point in the future, returns will get poor again and investors will get negative on the space again. And that’s how the space has been for 100 years and it’ll be for the next 50 years.

DD: Can private equity, family offices and other outlying forms of private capital fill the hole that’s been left by endowments and institutional investment now?

WVL: Not even close. This year will be a much bigger year for private equity fundraising. I mean, just us and EnCap alone will massively blow through what’s been raised over the last probably five years combined—that’s an anomaly.

The family offices may [invest] a few billion dollars in a year, but there’s no way they’re going to fill that gap of capital that left the space.

DD: Let’s talk about the underinvestment impact when we’re looking at supply/demand and the net impact of all of that on prices. Walk me through how you see the industry getting through and the global economy getting through this underinvestment cycle unscathed.

WVL: Well, the good news is when an industry shows discipline, like the industry is showing now, you don’t have oversupply right now, obviously OPEC+, so mainly Saudi and Russia have been trying to manage.

There has been an oversupply the last couple of years. And so, it’s required OPEC+ to be pretty disciplined in keeping barrels off the market, but they’ve done a pretty good job of keeping oil in that $70, $75, $80 [/bbl] range. And that's a really good price. Like public companies, the United States of America makes a lot of earnings and income at that range.

Gas prices, on the other hand, have been a little different. They popped up during the early days of the Russia-Ukraine conflict. They've come back down and they've been hovering in the kind of low $2[/MMBtu] range. And that's challenging for a lot of these companies. But I do think, in general, that capital discipline is good for the industry because it keeps the market in better balance. You don't have a glut and therefore companies can be profitable. It's not a bad thing to be profitable, despite that some people in Washington love to poke at the oil and gas companies for price gouging. They're not price gouging. They're just trying to run a profitable company for the employees and for the shareholders, and that's how companies stay in business.

I do think we're see a lot more discipline this time around from public companies, and I think that's going to be a good thing for the business. I think it's going to make for a much healthier business, much less feast and famine.