tim.burroughs@incisivemedia.com

Going solo

The relative scarcity of independent oil and gas exploration and production firms in Southeast Asia doesn't reflect the region's wealth of natural resources opportunities. Private equity firms are catching on

WHEN KRISENERGY GOES PUBLIC IN Singapore in the next few weeks it will become only the second independent oil and gas explorer to list on the bourse. Hong Kong fares only slightly better, dominated by China's big three state-owned national oil companies (NOCs) with a few of independents on the fringes. NOCs also rule the roost in Malaysia and Indonesia.

KrisEnergy is a familiar private equity energy sector story: a team of geoscientists, engineers and operations specialists who previously worked for the oil majors in Southeast Asia created an exploration and production (E&P) start-up; using seed capital came from First Reserve, they leveraged their knowledge and relationships to secure oil and gas field licenses in Cambodia, Indonesia, Thailand and Vietnam.

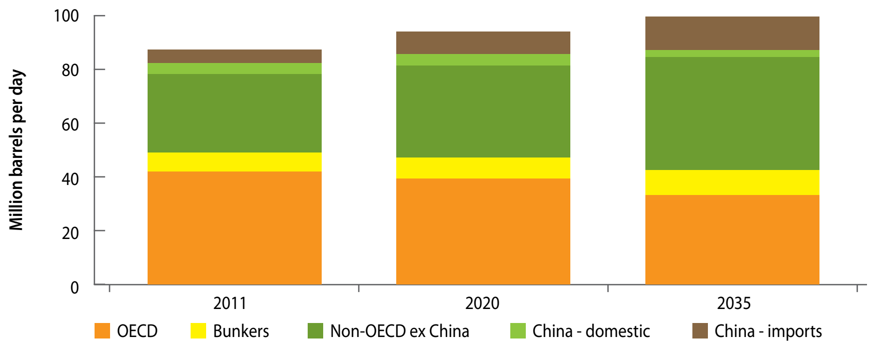
It is not familiar in Southeast Asia, though. Despite the region's established oil and gas credentials independents are few in number. They are also woefully underrepresented on the main boards of local stock exchanges, which isn't necessarily encouraging for private equity investors keen to maximize their exit options.

"In Asia there haven't been many listed junior E&P companies historically and that's partly because the stock exchange regulations typically made it more difficult for pre-production resources companies to be listed," says Leonard Tao, a director at Kerogen Capital, a PE firm that specializes in growth stage E&P investments. "As a result the investor base was less developed than in places such as Australia, Canada or London."

Efforts are now being made to redress the balance and KrisEnergy's impending IPO comes after the Singapore Exchange introduced specific admission rules for mineral, oil and gas exploration companies. These not only recognize the long lead time from resource identification to production – and the absence of profit during this period – but also the innate risks the industry presents, requiring minimum capital levels and frequent disclosures on project development and reserve values.

The Hong Kong bourse has taken similar steps, although developing the investor base in both locations will take time.

Oil demand projections



Source: International Energy Agency

The macro trend

In broad terms, this is a response to Southeast Asia's growing importance as an energy hub. The combination of urbanization, industrialization and sheer economic scale in China, India and Indonesia means that Asia is growth long and resources short. These countries will account for the bulk of new energy demand in the next 20 years, and they are inclined to look for supplies on their doorstep.

According to the International Energy Agency, countries outside the Organization for Economic Cooperation and Development – i.e. predominantly developing countries – will account for 57% of global oil demand by 2035, up from 44% in 2011. China's oil needs are expected to rise by two thirds over the same period, its share of global oil demand increasing from 10.3% to 15.1%. Eight in 10 barrels will be imported, compared to just over half in 2011.

On the supply side, Southeast Asia is interesting for two reasons: the decline in liquids and the rise of liquefied natural gas (LNG). Both offer opportunities for private equity, either backing independent E&P companies that are squeezing the last few barrels out of mature oilfields and reaching isolated gas deposits or supporting service providers looking to capitalize on the huge spending plans of Asia's NOCs.

"There is private and corporate money going into these operations and if it continues to be successful we will see more capital markets activity as well," says Jamie Paton, managing director for Asia at First Reserve. "Southeast Asia isn't as mature as the Gulf of Mexico or the North Sea but at this stage in its development it's good to see companies like Pearl Energy, Salamander Energy and KrisEnergy succeed."

A direct line can be drawn between Pearl 10 years ago and KrisEnergy today because they were started by the same people. The team proved their thesis with the former – Pearl built up a portfolio of production contracts and was sold to Mubadala in 2008 – and is now replicating it with the latter. The success of Pearl also gave rise to several other PE-backed players in the region, including Salamander, Mitra Energy and Black Platinum.

Mark Thornton, now managing director of Indonesia Private Equity Consultants, led 3i Group's investment in Pearl back in 2004. 3i backed Salamander the following year, exiting when the company listed in London in 2006.

Based on the patterns seen in more developed markets, Thornton says it wasn't unrealistic to expect 30-40 independent E&P companies to have emerged in Southeast Asia by now. He offers three reasons why expectations haven't been met: the region's NOCs are more dominant than their counterparts in Europe and the US; uncertainty over local regulations; and the amount of time it takes to get deals done.

"I am working with a group from Europe that wants to build an oil and gas business in Indonesia. At first they wanted to do it themselves but now they realize they must find a local partner," Thornton adds. "A local partner can understand the politics and the implications of changing regulations, and also help deal

Proxy play: Oil and gas services

Malaysian sovereign fund Ekuinas spent much 2012 working on oil and gas services consolidation, purchasing and merging two companies to create Icon Offshore, the country's third-largest offshore support vessel operator. The efforts are part of a wider effort to cement Malaysia's position as Southeast Asia's preeminent oilfield services hub, but the capital expended is small change in the context of plans for the oil and gas industry as whole – MYR300 billion has been earmarked for exploration and production between 2011 and 2015 alone.

PE firms are devising investment strategies that capitalize on the regional expansion plans of every Southeast Asia's national oil company (NOC). Ancillary services are a popular option.

"Around the ecosystem of an offshore production unit there are multiple opportunities for investment: find the oil, get it out of the ground, move it –someone has to manufacture the extraction equipment, provide the services – and then move it, store it and eventually refine it. First Reserve looks at that whole chain, identifying robust companies we can build in that process," says Jamie Paton, the energy-focused GP's managing director for Asia.

First Reserve is an interesting example because the inroads it has made into the region's services space have come through global portfolio companies. DOF Subsea, a Norway-based subsea vessel and services provider, and CHC Helicopter, a helicopter transportation operator from Canada, have established a presence in Southeast Asia.

But what does it say about the local opportunity set? There are countless proxies for growth in exploration, production and development: tug boats, rig positioning, subsea equipment and drilling services, to name but a few. Industry participants are reasonably ambivalent as to how they get exposure – backing in a local player or bringing company in – but specialization pays off.

"Growing levels of upstream activity surrounding enhanced oil recovery and smaller marginal field developments is an important trend in Southeast Asia," says Ivor Orchard, executive chairman at Kerogen Capital. "This will particularly benefit specialist drilling contractors who have deviated and horizontal well drilling expertise, as an example, as well as other niche products and services providers to these types of field operations."

Headland Capital Partners and CHAMP Private Equity between them hold a majority stake in support vessel operator Miclyn Express Offshore, having been attracted to the company's differentiated offering. Miclyn works closely with Chevron in the Gulf of Thailand, carrying people and supplies to and from rigs, but the other arm of its business is far less generic, chartering vessels that meet particular client demands, for example in terms of engine and crane capacity or dynamic positioning.

"It's still an extremely fragmented industry," says Paul Kang, senior partner at Headland. "Miclyn is one of few players we felt ticked a lot of boxes – regional footprint, professionally managed, and then exceptional financial and operating metrics in terms of profitability, which stems from high utilization rates."

It is also hoped that specialization and a focus on long-term trends will help offset the impact of oil price movements on demand and supply for equipment and services.

Not everyone is convinced, though. Jason Cheng, managing partner at Kerogen, notes that many US GPs look at services as low-risk entry point to the Asia market, based on the successes they have enjoyed at home on the back of the shale gas revolution. "The opportunities are specific to each segment of focus, but historically services and midstream have not generated outsized returns," he says.

Headland's Kang admits the upside on services might be as great as exploration and production, but there is also far less execution risk. "The returns are still pretty significant – not IRRs of 100%, but possibly north of 30%," he says. "We are also looking at more proven businesses that probably have scale so the downside is more limited."

with localization issues such as local tendering requirements for contracts."

Pearl had an advantage in that the team was comfortable operating on the ground in Southeast Asia. It also knew the location of attractive assets, was able to acquire the contracts on favorable terms and get on with production.

Opinion is divided as to the availability of other management teams with similar expertise, despite the fact that oil majors have been present in the region for some time. Tim Baldwin, a partner at GEMS, claims to have met 300 companies in the past five years and few offered the ideal combination of technical experience, financial and strategic awareness and, perhaps most importantly, an ability to operate small enterprises in Asia.

Still, assuming the stars align and a determined PE investor is able to assemble a dream team, where should the capital go?

"Liquids production in Asia is declining and it is likely to continue to do so. Hence, a major focus for the industry in Southeast Asia will be in enhanced oil recovery and the development of smaller marginal fields," says Ivor Orchard, executive chairman at Kerogen. "Gas, on the other hand, is attractive and becoming more so. There is significant growth in consumption as well as latent demand. In the past 10-15 years I've seen gas prices in Indonesia go from low single digits per MMBTU (million British thermal units) to $6 and now in some cases $8-10."

Contract prices for LNG delivered to Asia have topped $15 per MMBTU this year, but even if these levels can't be sustained the region is protected by its relatively low output costs. According to a recent estimate, LNG projects in Australia – which has seen a lot of investment in this area – have an average production cost of $9-10 per MBTU; in Indonesia it is $5-7 per MMBTU.

Fleet of foot

The quirk of Southeast Asia is that the major fields are already well covered, so the chances of discovering substantial new reserves of conventional oil and gas – as has been done in parts of Africa – are minimal. There has been a shift in focus to deepwater exploration but results have been mixed. Several oil majors are expected to return deepwater production sharing contracts to the Indonesian government after three years of exploration failed to deliver any meaningful reserves.

Independent operators must make a virtue of their nimbleness, identifying emerging opportunities in areas such as shale gas and coal-bed methane in Southeast Asia. They are also interested in stranded deposits that are largely untouched by the majors because the E&P infrastructure is so far away and the size of the reserves doesn't justify a build-out.

Then there is oil and gas field aggregation, which is just as attractive today as when Pearl implemented the model a decade ago. They had watched developments in the Gulf of Mexico and the North Sea where oil majors would work fields close to depletion until it was no longer worth their time or money to lift the final reserves. Independents with a lower cost base would then move in and finish off the job.

The strategy becomes even more lucrative if improved recovery techniques mean the "difficult 20%" a developer turned its back on 10 years ago can now be extracted at a more reasonable price.

GEMS' Baldwin cites the example of reserves found close to pinnacle reefs in the Philippines. If drilling starts in the wrong place the oil becomes very difficult to extract. Companies have walked away from the resulting mess, but with patience and hindsight, recovery is possible.

"Once the first restructuring gets done in a robust way you will see a wave of these assets come up," Baldwin adds.

Orphaned assets

Southeast Asia is littered with small, marginal and mature fields that have been abandoned by the majors. Petronas estimates that Malaysia alone has 106 marginal fields containing 580 million barrels of oil and it is now trying to optimize production from these assets.

In order to get E&P players interested, it has introduced a risk service contract intended to balance the risks and returns so that E&P players are willing to invest in these assets. Petronas remains the project owner with the contractors acting as service providers who commit capital and start receiving payment once production begins. Four contracts have so far been awarded.

"Malaysia has been looking to bring in juniors and independents to develop fields of around 20 million barrels which are too small or uneconomic for large oil and gas companies to develop," says Jason Cheng, managing partner at Kerogen. "It is an interesting opportunity but it comes down to the quality of the assets and whether you have the right management team."

There are different approaches towards leveraging these opportunities, depending on risk appetite. Kerogen targets existing discoveries that can be taken up the development curve and avoids more capital intensive projects because these entail much higher risk. Mitra, however, goes in the other direction, specializing in high-impact exploration across Southeast Asia with NOCs reiled upon to support the drilling phase.

> **"Malaysia wants to bring in juniors and independents to develop fields of around 20 million barrels which are too small for large oil and gas companies to develop"**
>
> – Jason Cheng

First Reserve follows long-term energy sector trends on a global basis and then identifies companies that can operate in particular geographies, often backing start-ups where there is a pre-existing relationship with the team – as was the case with KrisEnergy.

While a familiarity with the region and the industry's place within it are essential for investee companies to prevail, technology is undeniably also a key factor in creating opportunities, regardless of strategy.

Improvements in seismic imaging have allowed companies to identify reservoirs of oil that have never been seen before and thereby pushing an even deeper water exploration industry and all the specialist services it requires from submersibles to ocean-bed moorings. Technology is also at the heart of North America's shale gas revolution as fracking techniques and equipment developed by independent firms – some of them PE-backed – facilitate the commercialization of previously inaccessible resources.

"Technology plays an important role in our industry and we are always looking for companies that can harness these developments," says First Reserve's Paton.