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Trends Influencing Energy Transactions

Several trends bode well for continued robust activity in the oil and gas space for the foreseeable future.

Capital markets and M&A activity in the energy industry remains robust, with all categories showing significant improvement over comparable periods in 2013. According to Thomson Financial, global oil and gas M&A was US$136 billion in the first half of 2014 based on 850 transactions, as compared to US$109.7 billion of global oil and gas M&A based on 749 transactions in the first half of 2013 (increases of 24 percent and 13 percent, respectively). Also during the first half of 2014, the energy sector saw 14 IPOs raise US$6.9 billion in gross proceeds and 47 follow-on offerings raise US$23.3 billion. There were twice as many energy IPOs in the first half of 2014 (14) as compared to the first half of 2013 (7). We believe there are several trends that bode well for continued robust activity in the oil and gas space for the foreseeable future.

Consolidation of Public Companies in the Oil and Gas Space

E&P Companies

The development of US shale-based hydrocarbon reserves and the relative stability of commodity prices over the past several years have resulted in a significant increase in capital allocated to exploration and production (E&P) companies. Much of that capital has come from private sources (namely, private equity) but there is still a need for the public markets — both as a means of raising additional capital and as a mechanism for monetizing investments in E&P companies. As a result, there has been an increase in the number of new publicly traded E&P companies and a significant valuation uplift for many of those E&P companies that were public prior to the latest boom. The harsh reality of running a public E&P company, however, is that it is hard, very hard — particularly as rig availability gets more limited, midstream infrastructure constraints affect take-away capacity, differentials expand, commodity prices soften and the technical complexities of horizontal drilling make success more difficult. These challenges are more pronounced for smaller E&P companies which, while perhaps more nimble, must compete against larger and more well-capitalized companies for scarce resources. There are roughly 120 E&P companies that are publicly traded on either the NYSE or the NASDAQ and 87 of those companies have an equity market capitalization of less than US$5 billion. We believe the E&P sector could see meaningful consolidation over the next several years as consolidators begin to acquire smaller rivals and as larger companies seek ways to re-enter or expand in the most prolific plays.

MLPs

The pace of master limited partnership (MLP) acquisition activity has increased over the past several years as the size and number of MLPs have grown. Since the beginning of 2006, the number of MLPs has grown from 50 to 117, an increase of 234 percent, and the market capitalization of this asset class has ballooned from around US$100 billion to US$600 billion over the same period, an increase of 500 percent.

A number of MLPs have significantly increased the size and scope of their operations through public company M&A activity. But MLPs have not only been buyers. On occasion, MLPs have been the targets of other third party acquisition activity. The following table identifies some of the public company M&A activity involving MLPs over the past several years:

Buyer	Target	Value	Announcement	C Corp	MLP	C Corp	MLP
Breitburn Energy Partners	QR Energy	US$1.6 billion	August 2014		✓		✓
Koch Industries	Petrologistics	US$1.8 billion	May 2014	✓			✓
Energy Transfer Partners	Susser Holdings	US$1.8 billion	April 2014		✓	✓(1)	
Regency Energy Partners	PVR Partners	US$3.9 billion	October 2013		✓		✓
Kinder Morgan Energy Partners	Copano Energy Partners	US$3.2 billion	May 2013		✓		✓
Crestwood Midstream Partners	Inergy (2)	US$1.6 billion	May 2013		✓		✓(1)
Linn Energy	Berry Petroleum	US$2.5 billion	February 2013		✓	✓	
Energy Transfer Partners	Sunoco	US$5.3 billion	April 2012		✓	✓(1)	
Kinder Morgan	El Paso Corporation	US$21.1 billion	October 2011	✓		✓(1)	
Energy Transfer Equity	Southern Union	US$5.7 billion	June 2011		✓	✓	
Kirby Corporation	K-Sea Transportation	US$335 million	March 2011	✓			✓

(1) Target owned an MLP.
(2) Merger of equals.

The pace of public company MLP acquisition activity is expected to continue. Moreover, we expect an increase in the number of MLP targets of this activity. With some notable exceptions, the average MLP is relatively small when measured by market capitalization, as demonstrated in the following table:

Size of MLP	Number of MLPs
Less than US$500 million	12
US$500 million to US$1 billion.........	15
US$1 billion to US$2 billion.............	20
US$2 billion to US$3 billion.............	15
US$3 billion to US$5 billion.............	16
More than US$5 billion....................	27

Smaller MLPs that are unaffiliated with a large sponsor may find it more difficult to raise cash for future growth and, more generally, to compete against their larger and more well-capitalized peers. Given these and other factors, we believe the MLP market is ripe for further consolidation.

Yieldco Opportunities

In 2013, a new type of vehicle went public with a story very similar to an MLP but without possessing assets that would qualify for pass-through tax treatment. This type of entity, the yieldco, typically owns, operates and acquires contracted renewable and conventional generation and other infrastructure assets, which are not “MLP-able” assets. Like MLPs, yieldcos and similar companies are positioning themselves as vehicles for investors seeking stable and growing dividend income from a diversified portfolio of low-risk, high-quality assets. Yieldcos are typically able to minimize their US federal tax exposure (and thereby maximize the amount of cash distributed to investors) through the use of net operating losses and accelerated tax depreciation.

In the last two years, the following six yieldcos have gone public:

Name	Type of Assets	IPO Date	Yield at IPO
TerraForm Power	Solar	July 17, 2014	3.6%
NextEra Energy Partners	Solar & Wind	June 26, 2014	3.0%
Abengoa Yield	Conventional Generation, Electric Transmission, Solar & Wind	June 12, 2014	3.6%
Pattern Energy	Wind	September 26, 2013	5.5%
TransAlta Renewables	Hydro & Wind	July 31, 2013	7.5%
NRG Yield	Solar & Wind	July 16, 2013	5.5%

We believe that the yieldco format could offer a number of companies a public exit that might have been unavailable several years ago.

Expansion of the Use of Yield Oriented Structures by Companies Outside the United States

Investors in the United States continue the search for yield. Over the past several years, over 60 companies with operations in the US have gone public either as MLPs or yieldcos. Over this same period, seven companies with operations exclusively or predominantly outside the US have gone public in the US using the same structures. We currently see significant interest in these yield-oriented structures from companies outside the US, particularly in Europe and Asia.

International shipping companies were the first non-US companies to identify the potential of this market. These companies viewed their ships or “floating assets” as ideal candidates for the MLP structure because these assets typically traverse the globe under long-term contracts with creditworthy counterparties and do not have any US ports of call (and thereby do not incur US taxes). More recently, VTTI Energy Partners LP went public as the first MLP with fixed assets (refined products terminals) substantially outside the US (in Europe, the Middle East and Asia). Similarly, Abengoa Yield plc recently completed its initial public offering as a yieldco with an asset base consisting of renewable energy, conventional power and electric transmission lines on three different continents (North America, South America and Europe).

The expansion of the US yield-oriented market to companies with assets predominantly outside the US could be a significant growth area over the next five years.

Continued MLP Asset Class Diversification

For the last 20 years, the primary focus for MLPs has been on the classic asset categories: midstream companies in all of their forms, upstream companies with very stable asset portfolios and shipping companies with long-term contracts. In recent years, however, we have seen an expansion of the types of companies using an MLP structure as set forth in the following table:

Name	IPO Date	Type of Asset	IPO Yield	August 22, 2014 Yield
Westlake Chemical Partners	July 29, 2014	Ethylene production	4.6%	3.6%
PBF Logistics Partners......	May 14, 2014	Crude oil rail and truck terminals	5.2%	4.7%
Cypress Energy Partners ..	January 21, 2014	Saltwater disposal and other water and environmental services	7.8%	6.4%
OCI Partners	October 3, 2013	Methanol and ammonia production facility	11.8%	10.1%
OCI Resources..................	September 18, 2013	Trona ore mining and soda ash production	10.5%	8.5%
Emerge Energy Services...	May 8, 2013	Sand production and fuel processing and distribution	16.4%	3.8%
Susser Petroleum..............	September 19, 2012	Wholesale distributor of motor fuels	8.5%	3.5%
Hi-Crush Partners	August 15, 2012	Sand production and related processing	11.1%	3.7%

As the depth and breadth of the MLP market continues to expand, we believe that more, and less traditional, types of companies will pursue this path, including:

- **Mining**: For the mining industry, the vast majority of its products and activity should generate qualifying income for purposes of the MLP qualifying income test. At the risk of oversimplifying the analysis, the following must be considered:
  - Does the ore or mineral qualify for a depletion deduction under the Internal Revenue Code? These types of ores and minerals include: gold, silver, copper, iron ore, molybdenum, nickel, sulphur and zinc – just to name a few.
  - Does the activity constitute mining, which includes extraction, sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment?

  Historically, only the coal companies have taken advantage of the MLP structure. With more activists pushing this construct and more mining companies looking for ways to diversify their capital resources and enhance shareholder value, we believe that a broader set of mining companies will start to take advantage of the MLP structure.

- **Chemicals**: While many chemical producers are unable to take advantage of the MLP structure because their activities do not qualify for MLP pass-through tax treatment, a number of basic chemical producers may be able to use the MLP structure. For instance, Westlake Chemical Partners recently went public as an MLP for the purpose of operating, acquiring and developing ethylene production facilities and related assets. Westlake's only asset at the time of IPO was a 10 percent limited partner interest and the general partner interest in a subsidiary company that owned three ethylene production facilities. Prior to the IPO, Westlake obtained a favorable private letter ruling from the IRS to the effect that the production, transportation, storage and marketing of ethylene and its co-products will constitute qualifying income. In order to remove some of the cash flow volatility from its business, at the time of the IPO, the Westlake MLP entered into a 12-year ethylene sales agreement with its sponsor, under which the sponsor agreed to purchase 95 percent of the planned ethylene production each year on a cost-plus basis that is expected to generate a fixed margin per pound. The Westlake MLP also entered into a feedstock supply agreement with its sponsor for the supply of all feedstocks required to produce ethylene under the ethylene sales agreement. Other chemical producers with qualifying products similar to ethylene would likely want to follow a similar strategy in order to create an MLP with distribution stability and growth potential.

  Paper: A recent report by the hedge fund Perry Capital has the paper and packaging industry seriously considering the MLP structure. In order to obtain the best IPO pricing for this type of MLP, the sponsor would likely need to enter into some form of tolling arrangement with the MLP to minimize volume and price volatility (similar to the Westlake MLP).

- **Royalties:** In June 2014, Viper Energy Partners went public for the purpose of owning, acquiring and exploiting oil and natural gas properties in North America. Normally, this would be just another E&P MLP. But Viper's only assets consist of mineral interests (that is, royalties) in oil and natural gas properties in the Permian Basin in West Texas, substantially all of which are leased to working interest owners who bear the costs of operation and development. This structure could provide E&P companies, land owners and others with an opportunity to monetize a valuable asset (royalties and overrides) while using the proceeds to continue the development of their core properties or for other purposes.

- **Other:** Energy services companies are also eligible for MLP treatment, although the nature of their activities and resulting cash flow variability may make execution more difficult. Companies like Emerge Energy Services and Cypress Energy Partners have managed to tap into the MLP market using a disciplined and diversified business strategy to manage cash available for distribution. As other energy services companies evaluate their businesses and seek additional capital or monetization opportunities, we believe that more and more will gravitate to the MLP sector. Some obvious candidates include drilling services, fluid handling services, hydraulic fracturing services and general oilfield services. We would note that upcoming announcements by the Internal Revenue Service regarding the limits of MLP qualifying assets may affect some of these industries.

Midstream Infrastructure Expansion

The massive expansion of US hydrocarbon production in recent years — resulting in large part from dramatic improvements in drilling technology and the consequent unlocking of shale-based reserves — has created a significant need for additional midstream energy infrastructure in most basins. Private equity firms and others are funding management teams all over the country to develop additional midstream infrastructure and, for the oil and gas producers, it can't come soon enough. Production without take-away capacity is not valuable — differentials start to widen, wells get shut in and value is lost. But building midstream infrastructure is a time and capital intensive endeavor, so there will be a lag as sites are identified, permits are obtained, funding is secured and projects are constructed. More and more midstream companies are in need of capital to take advantage of significant infrastructure investment opportunities, which should lead to more public and private M&A activity in the midstream space along with additional midstream energy IPOs.

Crude-by-Rail Opportunities Abound

US and Canadian crude oil production has increased significantly in recent years. The Energy Information Administration estimates that total US crude oil production will grow 47.1 percent from 2012 to 2020. Similarly, the Canadian Association of Petroleum Producers estimates that total Canadian production of crude oil will grow 49.6 percent over the same time period. With take-away capacity in some of the biggest producing basins constrained by the lack of sufficient midstream resources, the transportation of crude oil and other petroleum products by rail has, not surprisingly, increased. For example, according to the Energy Information Administration and the Association of American Railroads, average U.S. rail carloads of crude oil and petroleum production were around 6,000 carloads per week in 2006, as compared to around 16,000 rail carloads per week for July 2014, an increase of over 160%. We believe that shipments of crude oil and other petroleum products by rail should continue to accelerate, notwithstanding new and proposed federal safety regulations governing the industry.

Private Equity's Power

Private equity funds have focused significant time and money on the energy industry. According to some estimates, private equity funds and their portfolio companies have accounted for roughly a third of all buyside activity in the energy industry over the past several years. This voracious appetite is fed by outsized return opportunities on many energy investments and massive cash piles in need of investment by private equity funds.

Every private equity investment carries with it the need for an eventual exit, either through the M&A market or the IPO market. In recent years, private equity funds have taken the previously less traveled route of exit through IPO (either partial or complete) instead of an outright sale for some of their investments. The renewed focus on the IPO market has been driven by the meaningful value arbitrage between the private M&A market and the public capital markets. The following table sets forth some of the IPO exits by private equity in recent years:

Company	IPO Date
Independence Contract Drilling	August 2014
Viper Energy Partners	June 2014
PBF Logistics	May 2014
Parsley Energy	May 2014
Rice Energy	January 2014
RSP Permian	January 2014
EP Energy	January 2014
Arc Logistics Partners	November 2013
Antero Resources Corporation	October 2013
Athlon Energy	August 2013
USA Compression Partners	January 2013

Notwithstanding the increase in IPO exits, private equity remains a big participant in M&A exits, which has been the more traditional method for value realization. According to one estimate, around 40 percent of all sell-side energy M&A activity in recent years has been driven by private equity.

As private equity energy investments mature, the funds will continue to look for exit opportunities, which should support continued robust M&A and IPO activity in this sector.

Energy-Focused Activism

Shareholder activism has expanded dramatically over the past several years, with over 360 reported shareholder activism campaigns in 2013 and over 275 reported shareholder activism campaigns so far in 2014. Shareholder activists have broadened their appeal among the general public and, more importantly, among institutional investors by focusing on governance reforms and enhancing shareholder value. The energy industry has not been immune to this trend and, in fact, the number of activists targeting the energy industry appears to be increasing. The following table sets forth a list of some of the activist campaigns in the energy industry over the past several years:

Company	Announced	Activist	Demands
Apache Corporation	July 2014	• JANA Partners	• Divest non-core international assets
Endeavour International Corporation	May 2014	• Lone Star Value • Talisman Group	• Board representation
Penn Virginia Corporation	March 2014	• Soros	• Sale of company

Company	Announced	Activist	Demands
Cliff's Natural Resources	January 2014	• Casablanca Capital	• Board representation • Management ouster • Break-up
WPX Energy, Inc.	October 2013	• Taconic	• Board representation
QEP Resources, Inc.	October 2013	• JANA Partners	• Separate midstream business (Oct 2013)
Whiting Petroleum Corporation	September 2013	• Galbraith Global	• Divest Whiting USA Trust I
Oil States International Inc.	April 2013	• JANA Partners • Greenlight	• Separate oilfield services segment from accommodations segment and convert accommodations to a REIT (April 2013)
Talisman Energy Inc.	February 2013	• West Face	• No publically disclosed demands
Transocean Ltd.	January 2013	• Carl Icahn	• Special dividend of >US$4.00/share (Jan 2013) • Board representation (3 nominees; Mar 2013)
Nabors Industries Ltd.	January 2013	• Pamplona	• Discussions with management on performance and declining market share (Jan 2013)
SandRidge Energy Inc.	November 2012	• TPG-Axon • Mount Kellett	• Review strategic alternatives (Nov 2012) • Replace CEO (Nov 2013) • Board representation (Nov 2012) • Consent solicitation to remove board (Dec 2012)
Murphy Oil Corporation	October 2012	• Third Point	• Spin-off retail business, Sale of Canadian assets, and Exit UK refining business (Oct 2012)
Chesapeake Energy Corporation	May 2012	• Carl Icahn • Southeastern	• Change compensation practices (May 2012) • Board representation (4 nominees, May 2012)
CVR Energy, Inc.	January 2012	• Carl Icahn	• Evaluate business and strategic alternatives (Jan 2012) • Board representation (9 nominees, Feb 2012) • Offer to acquire company (Feb 2012)
Marathon Petroleum Corporation	January 2012	• JANA Partners	• Discussions with management regarding business strategy, structure, capitalization, repurchase policy, and governance (Jan 2012)
El Paso Pipeline Partners LP	May 2011	• JANA Partners	• Separate business (May 2011)

Many of the shareholder activist campaigns in the energy industry are focused on asset rationalization, as opposed to sales of the entire company or wholesale changes in management (although activists will certainly resort to that tactic if ignored or progress — in their eyes — appears to come too slowly). Many activists in the energy space are advocating spin offs, sales of non-core assets and, increasingly, the use of MLPs — all as a way of increasing shareholder value through different types of monetization strategies. For example, seven recent MLPs were the result of activist campaigns. Shareholder activism in the energy space is likely to continue for the foreseeable future, and M&A and MLP activity could increase as a result.

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This article is one of a series that examines trends in the oil and gas industry.