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PODCAST

EPISODE 19:
ENERGY & INFRASTRUCTURE POWERING PRIVATE EQUITY

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

INTRODUCTION

Todd: Hello and welcome to another episode of BDOs Private Equity PErspectives Podcast. I'm Todd Kinney, National Relationship Director with BDO's Private Equity practice based here in New York City. Today I am thrilled to welcome two very special guests to discuss the private equity landscape for energy and infrastructure. First, I'd like to introduce Evan Turner, who is Founder and Managing Partner at Drillcore Energy Partners. Welcome, Evan.

Evan: Thank you.

Todd: Next, I'd like to introduce Michael Albrecht, who is a partner of Ridgewood Infrastructure. Welcome, Michael.

Michael: Thanks for having me, Todd.

INTRODUCTORY QUESTIONS

Todd: Yep. It's great to have both of you here. So, let's jump right in. Evan, as the Founder and Managing Partner at Drillcore, can you tell us about your role there and the origins of the company?

Evan: Sure. Thanks, Todd. So, Drillcore Energy Partners is a New York City-based investment firm focused on the energy industry with a particular focus on the upstream oil and gas space in the United States. We partner with family-owned and operated as well as privately owned and operated oil and gas companies where they're seeking off-balance sheet capital or a drilling partner for the development of their asset base. My role is involved with deal sourcing, structuring, execution, portfolio monitoring, as well as investor relations.

TOPICS DISCUSSED INCLUDE:

Todd: Awesome. Well, you definitely have a wealth of experience to bring to the conversation. Turning to Michael, you're a partner at Ridgewood Infrastructure. I'm sure our listeners would love to hear a little bit more about what Ridgewood does.

Michael: Sure, happy to do. Ridgewood Infrastructure is an infrastructure firm focused on the United States. We focus on opportunities from what we call the lower middle market. That's really a function of a couple of reasons. Our equity check size of as small as $50 million or upwards to of $150 million-plus—a segment that we find very fertile for investment origination and execution. We also see a real opportunity in terms of the investment profile of those opportunities. A large amount of capital is needed to help fund various infrastructure projects throughout the United States. In particular, we focus on water, wastewater, and other essential infrastructure such as pipelines, electric utilities, gas utilities, electric transmission, but very much have a broad mandate if it is within that infrastructure genre.

MIDDLE MARKET OVERVIEW

Todd: Awesome. Well, I appreciate the background and I think the combination of the two of you is going to lead to some great content for the listeners. So, there's an interesting finding from the recently launched BDO U.S. Private Capital Outlook Survey that I'll share with you and then get your feedback. Apparently, 32% of PE fund managers in the U.S. said that energy and natural resources is one of the top three sectors most likely to see increasing deal activity in 2020. So, I'm curious, and, Evan, I'll start with you, if this data surprises you at all.

Evan: It does not. It's one of the best performing sectors in the last year, publicly. However, it's been one of the worst-performing sectors of the past five years. And so a lot of private investors are seeking opportunities that they can buy either at a discounted rate on behalf of their investor base, as well as going after deals that maybe now that there's alignment with the bid-ask spread, with a slight increase in commodity prices over the past year, that they can actually make the right acquisitions for the right price for their portfolio and for their alignment with their firm. Specifically, on the upstream oil and gas side where we have a particular focus at Drillcore, we actually believe that there will be slightly an increase but right now that segment of the energy sector is a little bit "stale," and that there is not too much M&A activity from the private side. If there is, it's primarily equity capital commitments from venture capital focus funds or it's new issuance of debt and equity of publicly traded companies. I do believe that infrastructure, where Michael sits and other firms will actually see a lot of increased activity, more so than on the upstream side. And with a particular focus on water handling and saltwater disposal, as well as off-take via midstream pipeline and then eventually facilities at ports and other export-import terminals throughout the United States.

Todd: Nice. Michael, I have the same question for you. Do you find that data surprising?

Michael: No. I actually would have thought the number would have been greater than what the findings had. But I think as Evan pointed out relative to the upstream side, we're focused on the midstream angle as Evan pointed out. What we see is, as the commodity price environment has been relatively lower than I think a lot of folks would like, we're starting to see attractive valuation opportunities. Where many very high-quality midstream companies are just undergoing or they're perhaps seeing slightly over leverage occurring to their balance sheet, and they're looking for equity partners like Ridgewood Infrastructure to come in, help augment that balance sheet, invest in some of those more capital intensive projects. So, as we look at 2020, we expect the midstream sector to have a bit more velocity, a bit more deal flow as the commodity prices remain where they are. It will create a lot of opportunities I think.

Todd: Nice. Appreciate that perspective. We'll have to check our data numbers, maybe that's a higher number [laughter]. All right, another topic for both of you guys. Why do you think we're seeing more attractive returns in the middle market in particular? Michael, I might throw this one to you first and then we'll go to Evan.

Michael: Yeah. Happy to and I couldn't agree more, Todd. I think as we look at the various segments of the market in particular for private capital, the lower middle market creates a unique perspective and I think it's for a couple of reasons. I think the primary three related to, there's a greater number of companies there, so you have a broader depth. But also, secondly creates more fragmentation, which has more dislocation. And then many of the private capital funds that are in the marketplace, generally speaking, tend to be much larger, and they're seeking to put more dollars to work than they can employ in the middle market because just doesn't move the needle for them. So, as we look at that, we see a more fertile environment to go out and attack. But importantly, you need to have the right fit for purpose from both an equity investment size as I suggested, but then also from an investment strategy perspective. I think that's what's allowed Ridgewood Infrastructure to identify and close three investments over the last handful of months, on a bilateral basis. I think similarly with Evan and his firm, focusing on this space, creates a lot of opportunity and velocity.

Todd: Sure. Evan?

Evan: I couldn't agree more with you, Michael. The energy sector as a whole, specifically oil and gas, is one of the most fragmented sectors globally. And specifically, in the United States, there's over 10,000 privately owned and operated or sponsor-backed, oil and gas companies or partnerships. That allows creation at the lower to middle market landscape for investors like ours to pursue these types of transactions, where there's still value to be had. That is a structure that works for private investors like Drillcore and Michael's firm Ridgewood.

LANDSCAPE FOR CLEANTECH & RENEWABLES

Todd: Right, it's certainly a good time to be in the middle market. At BDO I can vouch for that. So, Michael, I'll ask you this next topic. We've really started to see some firms that have been rooted in traditional energy that are opening up really to a new mandate that includes alternative energy and renewables, really often coinciding with the new fundraise. So, is that something that perhaps your firm is focused on?

Michael: Yes. So, within the definition of how we look at infrastructure in the U.S., renewables has a place in our portfolio. And that's really rooted in—as you think about our investment strategy, a key piece of it is our focus on environmental and social governance. So, renewables very much fits that mandate. But as noted earlier given our middle market focus, it tends to be less so in the utility-scale renewables, more so as an example—commercial-industrial solar whereby you're doing smaller solar arrays, building them up into a larger portfolio—diversified portfolio of investment-grade opportunities, and then eventually passing those on to that long-term owner. And in one way we do that and create returns within renewables is by doing great partnerships. So, we look at as an example partnering with EPC firms or engineering procurement and construction firms whereby we can get in earlier and create that value for our investors.

COFFEE BREAK WITH BDO'S LAURENT WILLIOT

Todd: Okay, very insightful. Well, let's take our coffee break now and welcome our guest, Laurent Williot, who's a Managing Director in BDO Transaction Advisory Services practice in New York. Laurent has more than 20 years of experience in audit and acquisition advisory. Let's hear what he has to say.

Laurent Williot: Thanks, Todd. Thanks, Michael and Evan, for your insights. Today, as we start a New Year and even a new decade, I would like to discuss the opportunities that exist in energy and infrastructure.

First, let's agree on the definition. For most investors, the energy and infrastructure sector is made of a vast number of sub-sectors that includes oil & gas, power and utilities, telecom, transportation, and social assets. The energy and infrastructure sector presents some unique opportunities. First, the key strength of the sector is evidenced by the huge amount of cash that has been raised by infrastructure funds over the years. Since 2014, more than $500 billion dollars has been raised globally by the top 50 infra funds, according to the publication *Infrastructure Investor*. 2018 and 2019 were both record years, with about $100 billion raised each year. Mega funds, some exceeding $10 billion, have been raised recently by the likes of Blackstone, GIP, Brookfield, or EQT. This amount of dry powder has fueled M&A activity in the sector, in particular with regards to energy transactions. It is estimated that more than 2/3 of transactions by the top 10 infra funds are in the energy sector, whether it be oil & gas or electricity.

Second, the U.S. has huge needs for infrastructure. There are trillions in CapEx that are needed to replace a crumbling infrastructure, to meet the population growth and shift to cities, to build the digital infrastructure of tomorrow, meet renewable energy goals, etc. Digital infrastructure (including datacenters, fiber optic cables) has been subject to significant M&A activity in 2019, and this trend is expected to continue in 2020. Experts see opportunities for fiber in second-tier cities that have less competition than large population centers.

Third, renewable energy deals are also expected to show strong activity as states try to reach their RPS, or renewable portfolio standard goals, by their respective deadlines. As the share of renewable energy increases in the total amount of electricity generated, it will be more and more critical to have battery storage available to increase grid reliability and balance the intermittency inherent to solar and wind power. Energy storage might see a ramp-up in the next few years comparable to what was seen in the renewable energy sector over the last 10 years. Some experts expect the sector to grow by 700% over the next 5 years, as prices continue to drop and reach $100 per kilowatt hour (kWh) or lower.

Fourth, LNG (liquefied natural gas) exports will also be a driving trend in the sector as the U.S. becomes one of the largest producers of natural gas and reaches 30% of the total world capacity for LNG export.

Finally, technological and digital transformation will play a key role in helping companies cut costs, increase efficiencies, optimize supply chains and, ultimately, extract value from infrastructure assets.

And with that, back to you, Todd.

Todd: Thanks for sharing your insights, Laurent.

TECHNOLOGY & DIGITAL TRANSFORMATION

Todd: Now, let's return our conversation with Evan Turner and Michael Abrecht. Evan and Michael, at both your firms, there are applications of technology being used to evaluate investment opportunities for sure. Evan, I'll throw this to you first, then Michael. So, what does that look like for diligence, transaction and legal teams?

Evan: Thanks, Todd. You bring up a good point. We've seen a lot of enhancements in both the accuracy of technology and digital applications applied to the energy industry and we're seeing an increase in usage by firms similar to Drillcore. We use technology on a daily basis both at the fund level as well as at the portfolio or target company level. And this is related to acquisition targets by looking at digitization of maps, looking at results from the prospective targets or at the actual company level and applying this large data to make it a comprehensive understanding of where we can make decisions. We use this both by our investment team as well as in accounting and by our legal and transaction team.

Todd: Right. Michael, how about at Ridgewood?

Michael: Sure. And then, maybe to give a slightly different perspective than Evan's where he's applying those findings to get more accurate research perhaps for looking at oil content, we've seen it really impact us in how we communicate and work with our advisors, but then also how we cut and consume the results from those advisors. So, as an example, as we work with firms such as yours, Todd, in BDO and others, how we're interacting through the use of technology has allowed us to increase communication, provide feedback, receive feedback, answer any questions. And in addition, as we get results, when we've asked your team to sort of maybe pivot and look at sort of a different way of cutting it, you've been able to do that very quickly, accelerate that back to us. So, it's almost a real-time analysis. It informs our strategy. We've been working with these counterparties that we've certainly very much appreciated. And look, at the end of the day, we all know it really is that industry business operations knowledge that drives those fundamental views and assumptions but the technology that's being employed assists us in being more informed at a more expeditious pace.

WATER INFRASTRUCTURE

Todd: Right. Well, first, I guess, I'll thank you for the client testimonial there [laughter]. I wasn't expecting that but we're certainly seeing a lot of application of tech within BDO and I assume we weren't alone. So, moving on, Michael, I guess, as you're probably aware, the American Society of Civil Engineers gave U.S. water infrastructure a grade of D+. Not too good. Do you think this underinvestment in the U.S. has created opportunities?

Michael: It has, Todd, and maybe to scratch a little bit further beneath the surface on this underinvestment issue, it really is an important issue for the United States. To give you a sense of that and the magnitude of that, the EPA, the American Society of Civil Engineers, everybody has slightly different estimates of what's this going to cost, but just to give you some data points, there's a need of over $40 billion per year over the next 20 years to bring this problem up to an acceptable standard. Not the tier one standard but simply an acceptable standard so it's a trillion-dollar problem. And as you think about that investment in what is needed about half of that is due to maintenance on that infrastructure. The other half is due to growth as you see urban sprawl throughout the United States. Where that opportunity persists is not only that underinvestment but for a middle-market firm such as Ridgewood—highly fragmented opportunity. There's over 65,000 water and wastewater utilities in the United States for 300 million people. To put that in context, in the UK, 60 million people, there are 28. Not 28,000. There are 28 roughly, water and wastewater utilities. So as you think about the opportunity for consolidation, to invest in these communities, increase water quality—we view that as a win-win because one, we can find attractive opportunities to invest but then, two, we're providing high-quality service, water to those underlying communities.

GLOBAL PERSPECTIVE

Todd: Makes a lot of sense. I guess let's think globally and you started to hint at that. In your respective areas of focus maybe you could tell our listeners how you would compare U.S. versus overseas investments. Michael, I'll throw this one to you first and then let Evan chime in.

Michael: Sure. I mean, just riffing off of my prior comment, I think as you think about the United States, we do in particular within water as an example, see many, many more opportunities. Then part of that is it's very much that fragmentation, the underinvestment, any attractive fundamentals within the United States, a very stable, transparent environment to be investing. But then through the asset management or value creation stage of ownership, you're working with sophisticated regulators, environmental agencies, that want to see continued investment put back into these companies. And those fundamentals that I talked about, another aspect of it is the environmental, social governance focus and applying that. So, you tend to see roughly across the country approximately 20% of the water that's treated is actually lost through the transmission to the homes through leaking pipes and aging infrastructure. So, if we can rectify that, not only is that great for the environment but it also actually lowers the bills for consumers and that's something, an aspect, that we focus on. How can we give back and be more efficient with these assets and within the water space? As an example, the U.S. really has that opportunity relative to many other international countries.

Todd: Yeah. Well we'll get in to ESG in the next question. But Evan, what are your thoughts?

Evan: Yeah. As Michael pointed out, the U.S. does have a lot of opportunities, and that's where we at Drillcore focus and a lot of other upstream energy-focused funds are focused on. We see an enhancement in acquisition and drilling, and the capital that is chasing that is gearing up to increase with new fund raises as well as additional investments from both public markets and the private sector in oil and gas. We're seeing a number of acquisition opportunities here in the United States, so we're focused here versus overseas. There are more dedicated funds that are privately held for oil and gas investment for the upstream side versus international funds. So, in the United States, there's a lot of competitors in this space and that allows us to potentially find cosponsors, or an ability to find a minority that we're not doing the majority control investment opportunity with another partner here in the United States. So, we're excited to see where this new decade leads us in the energy space, and we're happy to be a part of it and contributing to employment opportunities, as well as on behalf of investor bases.

ESG

Todd: Alright. Great. Well, I think we all agree whether it's infrastructure or energy, just massive market opportunities. So, good luck to both of your firms. Let's jump in to actually our final question, and it's about ESG investing trends. Because for our listeners sake, ESG stands for environmental, social, and governance. There's certainly growing evidence that suggests that ESG factors, when integrated into investment analysis and portfolio construction, really may offer investors potential long-term performance advantages. So, Evan—I'll ask you and then we'll have Michael chime in—do you see ESG investments having a bright and lucrative future?

Evan: Sure, Todd. I'll chime in. I definitely agree. I do believe ESG policies and investment opportunities are scaling up and it is an almost necessary requirement to have an ESG policy if you're in the oil industry. And we are seeing a lot of opportunities that allows an oil and gas focused firm to rise above the competition by showing not only are your results better on a per well basis or portfolio basis, but also showing that you're not having any oil spills or any leaks in pipeline. These are important factors that help us make a good name for ourselves in the oil and gas industry.

Todd: Yeah. Michael, you've already touched on ESG in a previous response, but what are your thoughts?

Michael: Sure. I agree with Evan. I think it absolutely adds value. How we think about it is, one, it's part of our investment philosophy. It's one of the aspects we focus on a great deal. In fact, during our due diligence of investments, we engage specific ESG advisers to work with us and analyze the company's current progress, what could we be doing to enhance that going forward. And one, full stop, that's an important aspect to us but to your very specific question, does that sort of trickle down from a returns perspective to investors, and we absolutely think it does. We've seen it benefit our firm from both. We partner with many corporates, strategics, with municipalities, and those entities find it highly valuable that Ridgewood does have a focus on ESG, because that's their partner. They have a mission and values around that focus. For us, having a similar mission and value statement, it allows us to create better investments from an origination perspective. Then as we eventually go to monetize those investments, the potential buyers put a premium on companies that are focused on these aspects. So, I think there's a—I think they call it a triple bottom line, where the company is—it's a win for them, it's a win for the community and the associated customers, and then for that long-term buyer, everyone's winning and benefiting from that sort of focus, holistically.

Todd: Nothing wrong with a win-win-win, right?

Michael: Yep.

Todd: Well, listen, guys. We've come to the end of the podcast, this edition. But really appreciate you both being here. We value the relationship with your firms and wish you nothing but success in the years to come.

Michael: Thank you, Todd.

Evan: Thank you, Todd. We appreciate it.

Todd: Thanks for joining us. To our listeners, thanks so much for tuning in. If you haven't already, we'd love for you to subscribe, rate, and leave a review of the show on iTunes. Until next time, this is BDO's Private Equity PErspectives.

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