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Money flows to midstream assets

Private equity firms spruce pipelines, storage facilities with eye toward big profits

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Midstream oil and gas assets -- consisting mainly of pipelines and processing and storage facilities -- continue to be hot properties as private equity firms ramp up their interest in this energy sector.

Pipelines and related assets used to be owned and operated primarily by two groups: The major oil companies and some newer, more entrepreneurial players known as MLPs, or master limited partnerships.

Two of the oldest, and largest of the MLPs are Houston-based Kinder Morgan Energy Partners LP and Enterprise Products Partners LP.

But last month, on the same day that Enterprise Products Partners announced a $74.5 million acquisition of two midstream subsidiaries of El Paso Corp., a start-up private equity firm in Houston, K-L Energy Partners LLC, teamed with Dallas-based leveraged buyout firm Hicks, Muse, Tate and Furst Inc. to buy Dallas midstream energy company Regency Gas Systems LLC.

"A lot of private equity-backed companies are buying midstream assets," says Bill Swanstrom, an attorney with the Houston law firm Locke Liddell & Sapp LLP, who has been involved in a number of such deals over the last year. "The majors are selling them off because they are too costly and don't fit into the majors' strategy of focusing on upstream exploration and production."

Swanstrom points to Houston-based Targa Resources Inc., a company formed in 2003 by New York-based private equity firm Warburg Pincus, which has invested more than $1 billion in energy companies since the late 1980s.

Warburg, which previously funneled money primarily into the exploration and production sector, stated that its purpose with Targa is to build a midstream energy company. It took a big step in that direction last April by acquiring a huge chunk of midstream assets in Texas and Louisiana from oil major ConocoPhillips Co.

In December, Targa picked up Enron North America's 40 percent stake in Louisiana pipeline company Bridgeline LLC and said it intends to buy the remaining 60 percent of Bridgeline owned by ChevronTexaco.

Targa, Swanstrom figures, will probably eventually go public or be sold to an MLP.

The strategy of the private buyers currently in this market is to buy up assets in deals that are too small for companies like Kinder Morgan or Enterprise until they can accumulate a critical mass, and then "flip them to an MLP," Swanstrom says.

Indeed, this is precisely the business strategy of K-L Energy Partners, which was formed in April 2004 by energy veterans Robert Kincaid and Gary Luce.

Another part of K-L's strategy is to change the cost structure and commercial operations of these assets to lower their risk and reduce their capital requirements so they will be more attractive to the MLPs.

"MLPs have to grow by acquisition and to increase their dividends," Luce says. "So they try to create operating scale around low-cost models. They don't want a lot of volatility, but their management may not have the skill set" to revamp an asset's operations to reduce its volatility, he says.

Wealth of deals

The entry of private equity into the midstream energy market is a result of fundamental changes in the energy picture as well as shifting fortunes in other sectors.
"The dynamics have changed in the North American energy market," says Luce. "High energy prices, lower gas supply, new LNG projects, logistical changes -- all of these factors are changing the supply patterns. Private equity's role is to go in with risk capital to help the industry change to face the new challenges in the marketplace."
Private equity "got interested in looking for something new after the dot-com meltdown," Luce says.
At about that same time, the energy merchant sector imploded and midstream assets -- as well as experienced energy managers -- were up for grabs.
K-L's partner on the Regency deal, Hicks Muse, has long been a generalist leveraged buy-out firm that was not in the energy sector.
But last year the company "made a strategic decision to target energy," says Kincaid.
"They saw the wealth being created in the energy sector and asked us to help them vet a deal with Regency," he says.
Kincaid and Luce ended up investing in Regency and being seated on the company's board.
Meanwhile, the partners are continuing their fund-raising efforts.
Kincaid, who was formerly with Haddington Ventures, an energy-focused venture capital firm, says the firm's fund will ultimately invest in six to eight midstream and downstream assets.
Luce was with natural gas pipeline company EOTT, and the two met while working on a re-capitalization plan for EOTT last year. EOTT ultimately was sold to pipeline company Plains All American Pipeline LP.
The two saw "macro changes" coming in the North American oil and gas infrastructure:

- New processing and storage facilities needed to handle gas being imported through new LNG facilities;
- further processing and logistical infrastructure needed to support downstream markets; and
- new technologies relating to hydrocarbon monitoring and energy delivery.

Still, private equity investment in oil and gas remains a fairly small world, Kincaid and Luce say.
There are only about a dozen energy-focused private equity funds which specialize in either E&P or services or midstream.
"We are one of only two or three in the midstream," says Kincaid.
And with Luce's background in downstream and refining, the two figure they have "as good or better expertise as anyone."
Kincaid and Luce say their fund will also look closely at firms with products and services targeting midstream assets, such as environmental services and monitoring equipment and technology.

Such peripheral businesses may also benefit from a spillover effect.
"The question is whether there are enough assets to meet the demand," says attorney Swanstrom. "There are more buyers than sellers now. People we know on the buy side are looking hard for deals, and this is driving prices up. It's getting harder to get a good deal now."
So, who still has midstream assets to sell?
Swanstrom points out that BP, ExxonMobil Corp. and ChevronTexaco Corp. are looking to sell some of their midstream assets, while Shell Oil Products US, ConocoPhillips and Entergy-Koch LP have already sold off most of theirs.
In Houston, El Paso Corp. and Dynegy Inc. "may still have to sell off additional assets to meet debts," he says.

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